COURT FILE NUMBER	1601-11552
COURT	COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL CENTRE	CALGARY
APPLICANT	NATIONAL BANK OF CANADA IN ITS CAPACITY AS ADMINISTRATIVE AGENT UNDER THAT CERTAIN AMENDED AND RESTATED CREDIT AGREEMENT DATED JANUARY 15, 2016, AS AMENDED
RESPONDENT	TWIN BUTTE ENERGY LTD. IN THE MATTER OF THE RECEIVERSHIP OF TWIN BUTTE ENERGY LTD.
PARTY FILING THIS DOCUMENT	ARGO PARTNERS AND HUSKY OIL OPERATIONS LIMITED
DOCUMENT	**WRITTEN BRIEF OF ARGO PARTNERS AND HUSKY OIL OPERATIONS LIMITED (Reply to *Ad Hoc* Committee Application re: Subordination)** ***June 30, 2017*** **Honourable Mr. Justice Jeffrey**

BOOK 1 OF 2
(BRIEF AND AUTHORITIES TABS 1-7)

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I. OVERVIEW

1. Pursuant to an Order pronounced on September 1, 2016 (the "**Appointment Order**"), FTI Consulting Canada Inc. (the "**Receiver**") was appointed as receiver of the property of Twin Butte Energy Ltd. ("**Twin Butte**").[1] The Receiver realized sufficient funds from operations and the sale of Twin Butte's property to pay Twin Butte's secured lenders in full and surplus proceeds are available for distribution to Twin Butte's unsecured creditors.[2]

2. An *ad hoc* committee (the "***Ad Hoc* Committee**" or the "**Committee**") of holders (the "**Subordinate Debenture-holders**") of subordinated unsecured debentures (the "**Subordinate Debentures**") issued by Twin Butte pursuant to a Convertible Debenture Indenture dated as of December 13, 2013 (the "**Trust Indenture**") between Twin Butte and Valiant Trust Company (now Computershare Trust Company of Canada) (the "**Trustee**") has brought an Application (the "**Priorities Application**") seeking an Order:

   (a) declaring that: (i) the onus is on Senior Creditors (as defined in the Trust Indenture) to establish that they are entitled to a priority distribution in accordance with Article 5 of the Trust Indenture; and (ii) no Senior Creditor has discharged that onus;

   (b) authorizing and directing the Receiver to make all distributions to all unsecured creditors on a *pari passu* basis notwithstanding Article 5 of the Trust Indenture; and

   (c) bankrupting Twin Butte.

3. This Written Brief is filed on behalf of Husky Oil Operations Limited ("**Husky**") and Argo Partners ("**Argo**"). Argo and Husky are Senior Creditors as defined in the Trust Indenture and oppose the Priorities Application. Husky is an unsecured trade creditor of Twin Butte

[1] Eighth Report of FTI dated June 6, 2017 (the "**Eighth Report**"), para. 1.
[2] Eighth Report, paras. 2 and 13.

owed $880,092. Argo has acquired by assignment in excess of $1 million of unsecured trade claims against Twin Butte.

4. Argo and Husky oppose the Priorities Application. Contrary to the assertion made by the *Ad Hoc* Committee, there is no attempt to "gain priority" over the Subordinate Debentures.[3] The *Ad Hoc* Committee is attempting, having acquired the Subordinate Debentures with full knowledge of their relative priority and taking full advantage of the benefits afforded to them under the Trust Indenture, to abrogate from Article 5 of the Trust Indenture and claim *pari passu* treatment with the Senior Indebtedness.

5. The Receiver also opposes the Priorities Application and supports making distributions in accordance with the Trust Indenture.

6. The *Ad Hoc* Committee has filed no evidence in support of the Priorities Application.

7. The Receiver has delivered two Reports in connection with the Priorities Application. The Receiver has also filed a Written Brief dated June 20, 2017 (the "**FTI Brief**").

8. Argo and Husky adopt and repeat the FTI Brief.

II. FACTS

9. This Application is based on the interpretation of the Trust Indenture and the application of established legal principles with respect to, *inter alia*, privity of contract and the ability of creditors to voluntarily subordinate their claims to the claims of other creditors in an insolvency proceeding.

10. Pursuant to the Trust Indenture, Twin Butte issued $85 million of Subordinated Debentures that are according to the terms of the Trust Indenture fully subordinated to the Senior Indebtedness owing to Senior Creditors.[4] Senior Indebtedness is defined broadly to mean "all obligations, liabilities and indebtedness of the Corporation which would, in accordance with GAAP, be classified upon a consolidated balance sheet of the Corporation as liabilities

[3] Written Brief of the *Ad Hoc* Committee dated June 7, 2017 ("**Committee Brief**"), para. 7.
[4] Eighth Report, para. 5 and Appendix A.

of the Corporation and, whether or not so classified" and to specifically include: (a) accounts payable to trade creditors; and (b) all costs and expenses incurred by any Senior Creditor in enforcing payment of or collecting Senior Indebtedness.[5]

11. The key provisions of the Trust Indenture *vis-a-vis* the right and relative priority of the Subordinate Debenture-holders and the Senior Creditors provide, *inter alia*:

    (a) the Senior Creditors are entitled to the benefit of the Trust Indenture—Article 1.18;

    (b) obligations in respect of the Subordinate Debentures are subordinated to the payment in full of the Senior Indebtedness—Article 5.1;

    (c) on a distribution in an insolvency proceeding, the Senior Indebtedness is to be paid in full before any payments are made in respect of the Subordinate Debentures—Article 5.2(a);

    (d) any distributions from the Receiver to which the Trustee of the Subordinate Debenture-holders may be entitled are required to be paid to the Senior Creditors to the extent necessary to pay the Senior Indebtedness in full—Article 5.2(b); and

    (e) the effect of any default under any of the Senior Indebtedness is, *inter alia*: (a) no further payment(s) are made in respect of the Subordinate Debentures until the default is cured; and (b) any payment(s) that are made to the Trustee or a Subordinate Debenture-holder are in trust for the benefit of the Senior Creditors and are to be paid over to the Senior Creditors to pay the Senior Indebtedness—Article 5.5.

12. Twin Butte prepared and issued a Short Form Prospectus dated December 6, 2013 (the "**Prospectus**") in connection with the issuance of the Subordinated Debentures.[6] The subordination of the Subordinated Debentures and the Subordinate Debenture-holders

[5] Trust Indenture, Art 1.1 "Senior Indebtedness" (p. 8).
[6] Eighth Report, Appendix B.

rights in the event of the insolvency of Twin Butte are described on pages 11, 22, 23 and 37 of the Prospectus.

13. In or about September of 2016, National Bank of Canada, in its capacity as administrative agent on behalf of a syndicate of secured Senior Creditors ("**National Bank**") brought an Application seeking to have a receiver appointed over Twin's Butte's property. That Application was based on events of default that triggered Article 5.5 of the Trust Indenture.[7]

14. The Receiver sold substantially all Twin Butte's property in or about March of 2017 and has implemented a claims procedure pursuant to an order announced by this Court on April 27, 2017.[8] As at June 2, 2017, the Receiver was holding over $82 million for distribution to Twin Butte's unsecured creditors.[9]

15. Under the terms of the Trust Indenture, the Receiver should distribute the money it is holding first to the Senior Creditors to satisfy the Senior Indebtedness in full prior to making any distribution to the Trustee in respect of amounts owing in respect of the Subordinated Debentures.[10]

16. The *Ad Hoc* Committee seeks to have the Court direct that the Receiver distribute to the Senior Creditors and Trustee on a *pari passu* basis. This will result in the Senior Creditors receiving less and the Trustee receiving more than would be the case if the Receiver were to distribute in accordance with the Trust Indenture. The *Ad Hoc* Committee's position is that the Receiver is not obliged to make distribution in accordance with the Trust Indenture and the Senior Creditors cannot enforce the terms of the Trust Indenture because they are third-party beneficiaries who are not party to the agreement.

[7] Affidavit of Murray D'Angelo sworn August 31, 2016 ("**D'Angelo Affidavit**"), paras. 38-44
[8] Eighth Report, para. 15
[9] Eighth Report, para. 14.
[10] Trust Indenture, Art 5.2.

III. ANALYSIS

A. Role of the Receiver

17. The *Ad Hoc* Committee opposes the Receiver's involvement in the Priorities Application. Argo and Husky submit that the Receiver is correct that it ought to take a position on the Priorities Application.[11]

18. In providing the Court with its position with respect to how it should make distributions to Twin Butte's unsecured creditors, the Receiver is not advocating for one group of creditors against another group of creditors.[12] The Receiver is obliged to consider the rights and obligations of all stakeholders, including the rights of Twin Butte and the Senior Creditors, and the obligations of the Trustee under the Trust Indenture and make a recommendation to this Court as to what is the fair result having regard to, *inter alia*, the provisions of the Trust Indenture.

19. The Trust Indenture provides for how proceeds realized by the Receiver should be distributed and in taking the position that the Trustee ought to be bound the agreement made with Twin Butte as to the priority of the Senior Indebtedness the Receiver is not acting improperly or in contravention of its fiduciary duties. The Receiver's position that any distribution(s) ought to be made in accordance with Article 5—that the Subordinate Debenture-holders ought to be held to their bargain *vis-a-vis* the relative priority of the Senior Indebtedness—is well supported by the case law.[13]

20. There is no reasonable basis upon which the Subordinate Debenture-holders could, given the terms of the Trust Indenture and the Prospectus, have had any expectation that they would receive a *pari passu* distribution from the Receiver. As noted in *Homburg Invest*

[11] FTI Brief, paras. 8-13.
[12] Committee Brief, para. 18.
[13] *Air Canada (Re)*, 2004 CanLII 34416 (ON SC) **[Tab 1]**, *Stelco Inc. (Re)*, 2006 CanLII 27117 (ON SC) aff'd, 2007 ONCA 483 (CanLII) **[Tab 2]** and *Deloitte & Touche Inc.* v. *Shoppers Trust Co.*, 2005 CanLII 7878 (ON CA) **[Tab 3]**.

Inc. (Arrangement relatif à), giving effect to a contractual subordination in an insolvency proceeding does not result in unfairness to the subordinated creditor.[14]

B. Distribution by the Receiver

21. Husky and Argo support the position taken by the Receiver in the FTI Brief with respect to how any distributions should be effected. The Receiver should effect distributions to pay the Senior Indebtedness first and in full, including costs and interest, before making any distribution to the Trustee or the Subordinate Debenture-holders.[15]

22. As set forth below, the Senior Creditors have the right to enforce the Trust Indenture and, even if they do not, trust provisions in the Trust Indenture bind the Trustee to respect the priority afforded to the Senior Indebtedness. However, even if this were not the case, the fact that the Senior Creditors might not, for technical legal reasons, be able to enforce the Trust Indenture as against the Subordinate Debenture-holders does not mean, as the *Ad Hoc* Committee argues,[16] that the Receiver ought to be directed to ignore Article 5 of the Trust Indenture and provide the Subordinate Debenture-holders with a windfall. As an Officer of this Court the Receiver should respect the Trust Indenture as an agreement entered into by Twin Butte and the Trustee with the full expectation on the part of both parties that it would bind them as to the priority of the Subordinate Debentures in this exact situation.

C. Interpretation of the Trust Indenture

23. There is no serious dispute with respect to the legal principles governing the interpretation of the Trust Indenture as set forth in paragraphs 23 and 24 of the Committee Brief. There is also no dispute that the law with respect to subordination agreement is properly state in *Bank of Montreal* v. *Dynex Petroleum Ltd.* In that case, the Alberta Court of Queen's Bench found that provided that if a subordination agreement is "clear and unequivocal," it

[14] *Homburg Invest Inc. (Arrangement relatif à)*, 2014 QCCS 3135 (CanLII), para 43 aff'd, *Taberna Preferred Funding VI Ltd. c. Stichting Homburg Bonds*, 2015 QCCA 62 (CanLII) **[Tab 4]**.

[15] FTI Brief, para. 7.

[16] Committee Brief, para. 22.

will be given effect in accordance with its terms and "commercial reality requires that [subordination agreements] be given effect".[17]

24. However, the statement in paragraph 25 of the Committee Brief to the effect that a "plain and ordinary reading" of the words of the Trust Indenture leads to the conclusion that the Senior Creditors are not entitled to enforce Article 5 is not correct. As set out further below, the Trust Indenture provides for the absolute subordination of the Subordinate Debentures to the Senior Indebtedness and for the rights of the Senior Creditors to enforce Article 5.

25. The *Ad Hoc* Committee builds much of its argument in support of a *pari passu* distribution by isolating specific words and then assigning meaning to those words without regard to the context. For example, the focus on the use of the word "effect" in Article 5.7 without reference to that title of the Article—***Confirmation*** of Subordination (emphasis added)—or the final sentence in the Article—*However, nothing [in this Article] shall impair the rights of any Senior Creditor who has not entered into [a formal subordination agreement].* The Committee also argues for an interpretation that ignores provisions of the Trust Indenture that do not support its position. For example, the argument at paragraphs 54 and 67 of the Committee Brief to the effect that the Trust Indenture does not contain "trust provisions" ignores the fact that Article 5.5 of the Trust Indenture provides for any amounts paid by Twin Butte to the Trustee after circumstances arise that constitute a "default" permitting a Senior Creditor to demand payment of Senior Debt to be held in trust and paid over to the Senior Creditors.[18]

26. Argo and Husky adopt and repeat paragraphs 33 to 45 of the FTI Brief with respect to the interpretation of the Trust Indenture.

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[17] *Bank of Montreal* v. *Dynex Petroleum Ltd.*, 1997 CanLII 14795 (AB QB), para. 68 **[Tab 5]**. Note the decision was appealed and issue of the subordination was not addressed: See *Bank of Montreal* v. *Enchant Resources Ltd.*, 1999 ABCA 363 aff'd, 1 [2002] SCR 146 (CanLII) **[Tab 5]**.
[18] Trust Indenture, Article 5.5 (p. 50).

D. Senior Creditors can Enforce Article 5 of the Trust Indenture

27. The *Ad Hoc* Committee asserts that the only Canadian insolvency decision that has considered the issue of privity in the context of a subordination agreement among unsecured creditors is *Stelco.*[19] While the only reported case where the issue of privity was specifically considered in the context of a subordination agreement among unsecured creditors appears to be *Stelco*, there are a number of cases where the courts have given effect of subordination agreements in the insolvency context.[20] The *Ad Hoc* Committee is unable to point to a single case where voluntary subordination provisions such as those contained in the Trust Indenture were found to be not enforceable in accordance with their terms.

28. The *Ad Hoc* Committee takes the position that the Senior Creditors cannot have the benefit of Article 5 and for that reason the Receiver should ignore the provisions of Article 5 when making distributions to the Senior Creditors and the Trustee. In taking this position, the Committee relies on the doctrine of privity of contract and the assertion that the Senior Creditors cannot enforce the rights provided to them by the Trust Indenture because they are not parties to the Trust Indenture.[21]

29. The doctrine of privity of contract is not absolute and there are a number of exceptions to the doctrine that permit third-party beneficiaries to enforce agreements to which they are not party.

i. Enforcement of Trust Provisions[22]

30. The *Ad Hoc* Committee does not dispute that the doctrine of privity of contract does not prevent a person from enforcing trust provisions included in a contract for that person's

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[19] Committee Brief, para 51.

[20] *Air Canada (Re)*, 2004 CanLII 34416 (ON SC) **[Tab 1]**, *Stelco Inc. (Re)*, 2006 CanLII 27117 (ON SC) aff'd, 2007 ONCA 483 (CanLII) **[Tab 2]**, *Deloitte & Touche Inc.* v. *Shoppers Trust Co.*, 2005 CanLII 7878 (ON CA) **[Tab 3]** and *Rico Enterprises Ltd. (Re)*, 1994 CanLII 996 (BC SC) **[Tab 6]**.

[21] Committee Brief, paras. 41-67.

[22] The trust provisions are, as set forth below, also relevant to the issue of contracting out of a *pari passu* distribution.

benefit. The *Ad Hoc* Committee refers, quite correctly, to there being "a well-established rule that a third party beneficiary can enforce a trust agreement".[23]

31. In *Stelco*, the Ontario Court of Appeal affirmed that the legal principle that a person not party to a contract could enforce trust provisions in its favour apply to a trust created by a subordination agreement in favour of senior creditors not party to it.[24] The *Ad Hoc* Committee accepts that the Court of Appeal decision in *Stelco* is correct in terms of the applicable legal principles and that the Senior Creditors are able to enforce as against the Trustee any trust provisions included in the Trust Indenture for their benefit. The position (incorrectly) taken by the *Ad Hoc* Committee is; however, that the trust exception does not apply in this case because the Trust Indenture does not include trust provisions upon which the Senior Creditors can rely.[25]

32. The Committee's position that the Trust Indenture contains no trust provisions is not correct. Admittedly, the trust provisions contained in the Trust Indenture are different from those considered in *Stelco*, but the Trust Indenture does include clear provisions appointing the Trustee as trustee for the benefit of the Senior Creditors.[26]

33. The trust indenture considered in *Stelco* included trust language in the insolvency distribution provisions of that indenture—the equivalent to Article 5.2 in the Trust Indenture. Those provisions provided that in the event that payments were received in respect of the subordinate debt in reorganization proceedings before the senior debt was paid, any such amounts would be held in trust for, and turned over to, holders of the senior debt.[27]

34. Article 5.2 of the Trust Indenture does not include provisions that parallel those considered in *Stelco*, but there are trust and turnover provisions in the Trust Indenture and they are much broader than those considered in *Stelco*. Article 5.5 of the Trust Indenture—

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[23] See Committee Brief, paras. 52 and 67.
[24] *Stelco Inc. (Re)*, 2007 ONCA 483 (CanLII), para. 24 **[Tab 2]**.
[25] Committee Brief, paras. 53 and 54
[26] Trust Indenture, Article 5.5. The Ad Hoc Committee (incorrectly) refers to Article 5.2 of the Trust Indenture.
[27] Committee Brief, Schedule B. See also *Stelco Inc. (Re)*, 2007 ONCA 483 (CanLII), para. 18 **[Tab 2]**

No Payment if Senior Indebtedness in Default—provides that on enforcement of **any** of the Senior Indebtedness, **all** of the Senior Indebtedness must be paid in full in priority to the Subordinate Debentures. The Article goes on to address defaults (a term that is not defined by the Trust Indenture) with respect to **any** Senior Indebtedness that that permits a Senior Creditor to accelerate the maturity or demand payment of Senior Indebtedness. In such circumstances:

(a) no payments may be made by Twin Butte to the Trustee with respect to the Subordinate Debentures;

(b) the Trustee and the Debenture-holders are not entitled to receive payments on account of the Subordinate Debentures; and

(c) any payments received by the Trustee or the Debenture-holders are held in trust for the Senior Creditors.[28]

35. The factual matrix that led to the appointment of the Receiver included the triggering of Article 5.5 of the Trust Indenture in or about June of 2016 as a result certain events of default under Twin Butte's secured lending facilities.[29]

36. The provisions of Article 5.5 were clearly intended to apply in insolvency proceedings in respect of Twin Butte. The Article specifically references the ability of the Trustee to preserve its rights in an insolvency proceeding notwithstanding the restrictions imposed by the Article.[30]

37. The legal principle that a third-party can enforce trust and turnover provisions included in an agreement for its benefit is not confined to specific trust provisions. The parties to a contract can constitute one of the parties as trustee for a third-party and thereby confer on the third-party a right to enforce the trust irrespective of specific nature of the trust.[31] The fact that the trust provisions contained in the Trust Indenture are triggered on a default in

[28] Trust Indenture, Art 5.5 (p. 50).
[29] See D'Angelo Affidavit, para. 41.
[30] Trust Indenture, Art 5.5 (p 50).
[31] *Stelco Inc. (Re)*, 2007 ONCA 483 (CanLII), para. 24 **[Tab 2]**.

respect of any Senior Indebtedness whereas the trust provisions consider in *Stelco* were triggered in a reorganization of the debtor is irrelevant to the analysis—the point is that the beneficiary of a trust arising under an agreement is entitled to enforce that trust against the trustee/party notwithstanding that the beneficiary is not a party to the agreement.

38. Even if the Receiver were to effect a *pari passu* distribution to the Trustee in respect of the Subordinate Debentures, the Trustee would be obliged to hold amounts paid to it in trust for the Senior Creditors and until such time as the Senior Indebtedness was paid in full.[32]

ii. Collateral Contract

39. In the context of an agreement between parties that includes provisions that are for the benefit of a third party, a collateral contract can be created pursuant to which the third-party beneficiary is provided the direct benefit of those provisions if the third-party beneficiary provides independent consideration in return for a benefit provided to it under the main contract thereby giving rise to a contract that is directly enforceable by the third-party beneficiary against the parties to the main agreement.[33]

40. Often these collateral contracts are implicit, but in this case Article 5.16 of the Trust Indenture memorializes a collateral contract that permits the Senior Creditors to directly enforce Article 5 of the Trust Indenture. Pursuant to Article 5.16 of the Trust Indenture the Subordinate Debenture-holders acknowledge and agree that:

(a) the subordination of the Subordinate Debentures pursuant to Article 5 is an inducement and consideration provided to the Senior Creditors in return for the Secured Creditors providing or continuing credit to Twin Butte; and

[32] This would apply to any payments made to the Trustee or the Subordinate Debenture-holders. Article 5.5 is clear that any payment(s) received after a default under any of the Senior Indebtedness is to be held in trust and paid over until the Senior Indebtedness is paid in full.
[33] GHL Fridman, *The Law of Contract in Canada* (6th ed.), (Carswell) at pp. 516-7 **[Tab 7]**.

(b) the Senior Creditor's accept the benefit of the subordination pursuant to Article 5 by giving or continuing credit or, in the case a person acquiring Senior Indebtedness, the act of acquiring the Secured Indebtedness.[34]

41. The *Ad Hoc* Committee acknowledges that the purpose of the subordination of the Subordinate Debentures to the Senior Indebtedness is to enhance the ability of Twin Butte to obtain credit from the Senior Creditors.[35] The Subordinate Debenture-holders were aware of the subordinated position of the Subordinated Debentures and that Senior Creditors would be extending credit based on their priority position *vis-a-vis* the Subordinate Debentures in any insolvency of Twin Butte. The benefits provided by the Trust Indenture (and the price paid in the open market for the Subordinated Debentures) no doubt reflected the risk associated with their subordinated position *vis-a-vis* the Senior Indebtedness.

42. The Subordinate Debenture-holders ultimately benefited from the Senior Creditors extending or continuing credit to Twin Butte insofar as that credit enabled Twin Butte to carry on business and make payment to the Trustee in respect of the Subordinate Debentures.[36] The Prospectus clearly advises that the ability of Twin Butte to borrow money is a factor in the ability of Twin Butte to continue to carry on business and the "likelihood that purchasers of the [Subordinated] Debentures will receive payments owing to them under the terms of the [Subordinated] Debentures will depend on [Twin Butte's] financial health and creditworthiness at the time of such payments".[37]

iii. Principled Exception

43. In *London Drugs Ltd.* v. *Kuehne & Nagel International Ltd.*[38] and *Fraser River Pile & Dredge Ltd.* v. *Can-Dive Services Ltd.*[39] the Supreme Court developed a principled

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[34] Trust Indenture, Article 5.16 (p. 52).
[35] Committee Brief, paras. 8 and 10. See also Trust Indenture, Article 5.16 (p. 52). Note that Article 5.16(b) is clear that proof of actual reliance by Senior Creditors will not be required.
[36] GHL Fridman, *The Law of Contract in Canada* (6th ed.), (Carswell) at p. 517 **[Tab 7]**.
[37] Prospectus, pp 37 and 38.
[38] *London Drugs Ltd.* v. *Kuehne & Nagel International Ltd.*, 1992 CanLII 41 (SCC) **[Tab 8]**.
[39] *Fraser River Pile & Dredge Ltd.* v. *Can-Dive Services Ltd.*, 1999 CanLII 654 (SCC) **[Tab 9]**.

exception to the doctrine of privity to permit a third-party to rely on provisions included in a contract for its benefit where other exceptions to the doctrine are not applicable. This principled exception is based on giving effect to the intention of the parties that the third-party be provided with a benefit under the agreement. The principled exception applies where:

(a) the parties to the agreement intend to provide a third-party with a benefit; and

(b) the matters in issue fall within the scope of agreement between the parties to the agreement.[40]

There is no dispute that the Trustee and Twin Butte intended that the Senior Creditors would have the benefit of Article 5 of the Trust Indenture. Husky and Argo note, for example:

(c) Article 1.18 of the Trust Indenture provides specifically that the Senior Creditors are entitled to the benefit of the Trust Indenture;[41]

(d) Article 5.1 provides *that each holder of any such Debenture by his acceptance thereof, whether directly or on his behalf, agrees to and shall be bound by the provisions of this Article 5;*[42] and

(e) Article 5.10 provides that the rights of the Senior Creditors to enforce the subordination is not impaired by the acts of Twin Butte[43].

44. There is also no dispute that the matters raised by the *Ad Hoc* Committee on the Priorities Application relate directly to Article 5 of the Trust Indenture—the *Ad Hoc* Committee is attempting to deprive the Senior Creditors of the very provisions that were included in the Trust Indenture for the benefit of the Senior Creditors.

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[40] In *Fraser River Pile & Dredge Ltd.* v. *Can-Dive Services Ltd.*, 1999 CanLII 654 (SCC), paras. 27 and 28 **[Tab 9]**.
[41] Trust Indenture, Article 1.18 (p. 12).
[42] Trust Indenture, Article 5.1 (p. 47)
[43] Trust Indenture, Article 5.10 (p. 51)

45. In *Stelco*, the Ontario Superior Court applied the principled exception to permit a third-party beneficiary to enforce a subordination agreement. On appeal, the Ontario Court of Appeal did not overturn the Superior Court's finding that the senior creditors were third-party beneficiaries based on the application of *Fraser River*. The Court of Appeal found it unnecessary to address the issue because the agreement in issue in that case included provisions that required that in an insolvency proceeding all proceeds received by the subordinate creditor(s) be paid over to the senior creditor(s)[44] such that it was not necessary to determine whether the subordinate creditors were otherwise third-party beneficiaries.

46. Contrary to the assertion made by the *Ad Hoc* Committee, there is no absolute prohibition on the ability of a third-party beneficiary to found an action or application against a party to the agreement to enforce provisions included in that agreement for its benefit.[45] The principled approach to privity permits the Court to determine, based on both common sense and commercial reality, whether the doctrine of privity should be relaxed in the given circumstances.[46]

47. The cases relied on by the Committee do not support the proposition that the principled exception can never be applied where a third-party beneficiary brings an action or application to enforce a contact. In *Liu* v. *Calgary Chinatown Development Foundation*, the Court of Appeal accepted that a third-party beneficiary could prevent a party from acting contrary to the agreement, but found that the provisions were not enforceable for other reasons.[47] *Parwinn Developments Ltd.* v. *375069 Alberta Ltd.*, involved an action by a real estate agent to recover a commission provided for in an agreement between the defendant and another real estate agent. The principled exception developed in *Fraser River* was clearly not applicable.[48]

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[44] *Stelco Inc. (Re)*, 2007 ONCA 483 (CanLII), paras. 6, 16, and 18 **[Tab 2]**.
[45] Committee Brief, para. 65
[46] *Fraser River Pile & Dredge Ltd.* v. *Can-Dive Services Ltd.*, 1999 CanLII 654 (SCC), para. 24. **[Tab 9]**
[47] *Liu* v. *Calgary Chinatown Development Foundation*, 2017 ABQB 149 (CanLII), para. 32 **[Tab 10]**. See also *541788 Alberta Ltd.* v. *Bourgeois & Company Ltd.*, 2017 ABQB 363 at paras. 59-61 (CanLII) **[Tab 11]** .
[48] *Parwinn Developments Ltd.* v. *375069 Alberta Ltd.*, 2000 ABQB 31 (CanLII), para. 32**[Tab 12]**

48. In *Brown* v. *Belleville (City)*,[49] on the other hand, a non-party to an agreement initiated proceedings to enforce the terms of an agreement. The Ontario Court of Appeal considered the principled approach developed by the Supreme Court and found that it afforded an exception to the doctrine of privity that permitted the non-party to enforce the terms of the agreement.

49. The "sword vs shield" issue raised by the *Ad Hoc* Committee is a red herring in this case. There is no attempt by the Senior Creditors to found an action or application seeking relief against the Trustee (or Twin Butte) based on a breach of the Trust Indenture. The Senior Creditors are relying on the Trust Indenture as a "shield" to oppose an Application by the *Ad Hoc* Committee seeking an Order requiring that the Receiver effect a distribution that is not in accordance with Article 5 of the Trust Indenture.

50. If the Senior Creditors are prevented from relying on the rights provided to them under the Trust Indenture in the face of a frontal attack by the *Ad Hoc* Committee, the Subordinate Debenture-holders will be permitted to abrogate covenants to which they were expressly subject when they acquired Subordinate Debentures and does not reflect commercial reality or common sense.[50] The Trust Indenture was negotiated as between sophisticated commercial parties and ought to bind the Subordinate Debenture-holders in accordance with its terms. To permit the *Ad Hoc* Committee to stand behind the doctrine of privity of contract in these circumstances would be fundamentally unfair to the Senior Creditors.

E. *Pari Passu* Principle not Violated by Voluntary Subordination

51. Article 5 of the Trust Indenture provides for the subordination of the Subordinate Debentures to Senior Creditors. The practical effect of this is that there will not be *pari passu* treatment among Twin Butte's unsecured creditors.

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[49] *Brown* v. *Belleville (City)*, 2013 ONCA 148 (CanLII) **[Tab 13]**. See also *Stelco Inc. (Re)*, 2006 CanLII 27117 (ON SC) at paras. 72 – 76 **[Tab 2]**, where the fundamental consideration is described as being whether in the particular case the relaxation can be described as "incremental", and *541788 Alberta Ltd.* v *Bourgeois & Company Ltd.*, 2017 ABQB 363 (CanLII) **[Tab 11]**.

[50] *London Drugs Ltd.* v. *Kuehne & Nagel International Ltd.*, 1992 CanLII 41 (SCC), p. 415 **[Tab 8]**.

52. The *Ad Hoc* Committee argues that the *pari passu* principle in section 141 of the *Bankruptcy and Insolvency Act*[51] is absolute and cannot be varied by Article 5 of the Trust Indenture and that they are entitled to a *pari passu* distribution. Aside from the fact that Twin Butte is not bankrupt and section 141 does not apply to distributions by the Receiver, the law with respect to the *pari passu* principle has evolved to the point that it is now clear that unsecured creditors can voluntarily agree to subordinate their claims in a liquidation notwithstanding section 141.

53. The *pari passu* principle is intended to protect creditors of an insolvent debtor from being **involuntarily** forced to accept less than their fair share of the proceeds realized from the debtor's property. It **does not** prevent a creditor from voluntarily agreeing to subordinate its claim. An agreement among Twin Butte and the Senior Creditors to subordinate the Subordinate Debentures would contravene the *pari passu* principle, but an agreement by the Trustee to voluntarily subordinate to the Senior Creditors does not.[52]

54. In *Air Canada (Re)*, 2004 CanLII 34416 (ON SC) the Court considered an application by a group of creditors seeking to have the benefit of a subordination by holders of notes in favour of **some** unsecured creditors shared by **all** unsecured creditors.[53] The Court found that the subordination provisions were enforceable in accordance with their terms:

> ***Even within a bankruptcy context there is no impediment to a creditor agreeing to subordinate his claim to that of another creditor.***[54]

55. In *Deloitte & Touche Inc.* v. *Shoppers Trust Co.*, the Ontario Court of Appeal directed a distribution that reflected the fact that certain notes were contractually subordinate to other creditors:

> ***The law also was – and the terms of the respondent's contract expressly provide – that the claims of subordinate noteholders are subsidiary to all other claims in the insolvency. The respondent subordinated noteholder is***

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[51] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 (the "**BIA**") **[Tab 14]**

[52] R. Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell) para. 8-08 **[Tab 15]**

[53] The term "Senior Indebtedness" in the relevant agreements was not defined as broadly as in the Trust Indenture and arguably did not include all unsecured creditors.

[54] *Air Canada (Re)*, 2004 CanLII 34416 (ON SC), para. 10 **[Tab 1]**.

not entitled to recover any of his principal or interest until those other claims have been paid in full.[55]

56. It is also worth noting that provisions such as the trust and turnover provisions included in Article 5.5 of the Trust Indenture are effective notwithstanding that *pari passu* principle. Even if the Receiver were to make a distribution *pari passu*, the Article 5.5 would require that the Trustee pay over to the Senior Creditors amounts received in respect of the Subordinate Debentures until the Senior Indebtedness is satisfied in full.[56]

F. Equity Claims Argument has no Merit

57. The *Ad Hoc* Committee asserts that Article 5 is not enforceable by the Senior Creditors because it purports to subordinate the Subordinate Debentures to Senior Indebtedness that what would be equity claims in a bankruptcy of Twin Butte.[57] There is no dispute that in a bankruptcy of Twin Butte the trustee would not be able to make a distribution to a creditor in respect of a claim for unpaid dividends or shareholder distributions.[58]

58. The provisions of the BIA with respect to equity claims are intended to protect unsecured creditors and reflect the underlying policy that equity is subordinate to debt. These provisions do not, however, prevent a creditor from voluntarily agreeing to subordinate its unsecured debt claim to the payment of an equity claim, provided that the agreement does not to force others to involuntarily subordinate to the equity claims. There is no policy basis to prohibit an unsecured creditor from agreeing that amounts otherwise payable to its debt claim ought to be paid to a creditor in respect of an equity claim.

59. Section 139 of the BIA provides for the subordination of "deemed" equity—in general terms, a creditor who advances funds based on a participation in profits.[59]

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[55] *Deloitte & Touche Inc.* v. *Shoppers Trust Co.*, 2005 CanLII 7878 (ON CA), para. 27 **[Tab 3]**
[56] *Lehman Brothers International (Europe) & Ors (Re)*, [2014] EWHC 704 (Ch) (14 March 2014), para. 81 **[Tab 16]**. The trust provisions are also relevant to the issue of privity.
[57] Committee Brief, paras. 88-89.
[58] BIA, s. 140.1 **[Tab 14]**.
[59] BIA, s. 139 **[Tab 14]**.

60. In *Rico Enterprises Ltd. (Re),*[60] the Supreme Court of British Columbia found that there was no prohibition on a creditor contractually subordinating its claim to a section 139 claim and made an order giving effected to the contractually-agreed priorities.

61. Even if the *Ad Hoc* Committee is correct that Trust Indenture provisions that provide for the Subordinate Debentures to be subordinate to equity claims are not enforceable, that issue is addressed by Article 1.14 of the Trust Indenture. That provision expressly provides that invalidity or unenforceability of any provisions or part of a provision does not impact the validity and enforceability of the other provisions of the Trust Indenture.[61]

G. *Ad Hoc* Committee's "Damages" Argument is Without Merit

62. The *Ad Hoc* Committee argues that the Trustee has: (a) a debt claim based on the amount owing on the Subordinate Debentures; and (b) a "damage" claim based on the failure of Twin Butte to offer to acquire the Subordinate Debentures subsequent to the Receiver selling the property of Twin Butte over which it was appointed.[62]

63. Argo and Husky repeat and adopt the positions taken by the Receiver in connection with the argument made by the *Ad Hoc* Committee with respect to the "damage" claim filed by the Trustee.[63]

64. The *Ad Hoc* Committee position is that:

   (a) the sale of property by the Receiver was a "change of control" within the meaning of the Trust Indenture that obliged Twin Butte to make an offer to purchase the Subordinate Debentures, which it did not thereby giving rise to a default; and

   (b) on default under the Trust Indenture a damage claim arises in favour of the Trustee that is not "in respect of" the Subordinate Debentures, but is "in respect of" the default by Twin Butte.

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[60] *Rico Enterprises Ltd. (Re)*, 1994 CanLII 996 (BC SC) pp. 22-24 **[Tab 6]**.
[61] Trust Indenture, Article 1.14 (p. 12).
[62] Committee Brief, paras. 78-86.
[63] FTI Brief, paras. 56-72.

65. The Committee's position is without merit. Even assuming that the *Ad Hoc* Committee is correct that there has been an Event of Default, the Subordinate Debenture-holders remedy on default is **acceleration of the amount owing under the Subordinate Debentures.**[64] Aside from the fact that the Trustee was prohibited from pursuing its remedies by Article 5.5 of the Trust Indenture,[65] any "damages" to which the Trustee is entitled is limited to payment of the amounts owing under the Subordinate Debentures.

66. The Trust Indenture is effective to fully subordinate even a "damage" claim to the Senior Indebtedness. The Trust Indenture is clear that:

(a) the Senior Indebtedness is required to be paid in full in an insolvency before any payment is made on account of **any liability or obligation in respect of the indebtedness evidenced by the Subordinate Debentures;**[66]

(b) any distribution to which the Trustee is entitled must be paid over to the Senior Creditors;[67]

(c) the Trustee is not entitled to receive **any payment or benefit in respect of the Subordinate Debentures** until the Senior indebtedness is paid in full;[68] and

(d) any payment received by the Trustee in respect of the Subordinate Debentures is be held by the Trustee in trust for the Senior Creditors and has to be paid over to the Senior Creditors to pay the Senior Indebtedness.[69]

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[64] Trust Indenture, Article 8.2 (p. 65). It should be noted that there was an event of default under the Trust Indenture in or about June of 2013: See D'Angelo Affidavit, para. 42.
[65] The June 2013 default triggered Article 5.5: See D'Angelo Affidavit, para. 42.
[66] Trust Indenture, Article 5.2(a) (p. 48).
[67] Trust Indenture, Article 5.2(b) (p. 48).
[68] Trust Indenture, Article 5.5 (p. 50).
[69] Trust Indenture, Article 5.5 (p. 50). The best that the Ad Hoc Committee could hope for in terms of results is a distribution of funds to the Trustee that would have to then be paid out by the Trustee to the Senior Creditors. The *Ad Hoc* Committee cannot be suggesting that the Trustee would act in contravention of the Trust Indenture and in breach of trust and pay funds out to the Subordinate Debentures that it holds in trust for the Senior Creditors. This Court should not authorize or condone anything that would be akin to permitting the Trustee (or the Subordinate Debenture-holders) to act in breach of trust.

H. No Individual Subordination Agreements Required

67. The *Ad Hoc* Committee asserts that the effect of Article 5.7—which is referred to as the Priority Mechanism in the Committee Brief—is that:

    (a) the subordination of the Subordinate Debentures to the Senior Indebtedness provides by Article 5 of the Trust Indenture is only "potential"; and

    (b) each Senior Creditor is required to have obtained a formal subordination agreement with the Trustee pursuant to Article 5.7 as a pre-condition to that Senior Creditor being able to rely on Article 5.

68. This argument is made by the *Ad Hoc* Committee in support of its "main" position[70] and the argument forms the basis for its "alternative secondary position"[71] to the effect that only Senior Creditors who have received formal subordinations pursuant to Article 5.7—of which there are none—have the benefit of Article 5.

69. Husky and Argo adopt and repeat the argument in paras 49 to 55 of the FTI Brief in connection with the Committee's argument with respect to Article 5.7 of the Trust Indenture. The *Ad Hoc* Committee's argument that each Senior Creditor was required to request that Twin Butte obtain from the Trustee a formal subordination to "perfect" the subordination provided for by, *inter alia*, Article 5.1, 5.2 or 5.5 of the Trust Indenture is not supported by the language used in Article 5.7.

70. Article 5.7 provides a mechanism by which Twin Butte **can** obtain from the Trustee a formal subordination agreement **confirming** the subordination of the Subordinate Debentures to Senior Indebtedness owing to a Senior Creditor. The position taken by the *Ad Hoc* Committee with respect to the application of Article 5.7 is contrary to the express language of the Trust Indenture. Article 5.7 is specific in stating that it does not "impair the rights of any Senior Creditor who has not entered into such an agreement".[72] In addition, the Prospectus is clear that formal subordination agreements in favour of the

[70] Committee Brief, paras. 68-77.
[71] Committee Brief, paras. 90-104.
[72] Trust Indenture, Article 5.7 (p. 51).

Senior Creditors are not a pre-condition to the subordination of the Subordinated Debentures to the Senior Indebtedness.[73]

71. It is also worth noting that Article 5.10 provides that no act or failure to act on the part of Twin Butte impacts or impairs the ability of a holder of Senior Indebtedness from enforcing Article 5. This clause cannot be reconciled with any requirement that an individual subordination be obtained to give effect to, *inter alia,* Article 5.1, 5.2 and 5.5.

72. To the extent that formal subordinations pursuant to Article 5.7 are required, there are no restrictions on when a formal subordination can be requested from the Trustee. Under Article 5.7, Twin Butte can, at any time, request that the Trustee provide a subordination to a Senior Creditor and the Trustee is obliged to provide a subordination when requested to do so by Twin Butte.[74]

73. The Appointment Order prohibits the Trustee from failing to honour its obligations under the Trust Indenture.[75] The stay imposed by the Appointment Order does not restrict the ability of Senior Creditors to request that the Receiver exercise Twin Butte's right under Article 5.7 to request subordinations from the Trustee.[76] The intention of the stay is to preserve Twin Butte's property for the benefit of creditors and not to protect the Trustee or to prevent the Senior Creditors from taking any steps necessary to "perfect" their rights under Article 5 *vis-a-vis* the Trustee.[77]

I. Amount Recoverable Senior Creditors

74. The costs and expenses incurred by the Senior Creditors in responding to the Priorities Application ought to be paid by the Receiver to the Senior Creditors prior to any distribution being made to the Trustee. The Trust Indenture:

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[73] Prospectus, p. 23 (Subordination).
[74] Trust Indenture, Article 5.7.
[75] Appointment Order, para. 10.
[76] The stay prevents the exercise of rights against Twin Butte or the property over which the Receiver has been appointed: Appointment Order, paras. 8 and 9.
[77] The Appointment Order permits proceedings and registrations to preserve rights: Appointment Order, paras. 8 and 9.

(a) includes in the definition of Senior Indebtedness all costs and expenses incurred by the Senior Creditors in enforcing payment of or collecting the Senior Indebtedness;[78] and

(b) provides for the payment in full of Senior Indebtedness in absolute priority to the Subordinate Debentures.[79]

75. The inclusion of enforcement and collection costs and expenses in the Senior Indebtedness makes good commercial sense. It provides a disincentive to the Subordinate Debenture-holders taking steps—such as the Priorities Application—to block or impede payment of the Senior Indebtedness and reflects the absolute priority of the Senior Indebtedness over the Subordinated Debentures.

J. No Ability to Challenge Senior Creditor Claims

76. The *Ad Hoc* Committee's threat that if they are not successful on the Priorities Application, they may still dispute the claims of Senior Creditors is an improper attempt to intimidate the Senior Creditors. While the Claims Procedure Order provides the *Ad Hoc* Committee with the right to review claims, and a limited right to independently dispute claims, against Twin Butte, the Trust Indenture limits the *Ad Hoc* Committee's rights *vis-a-vis* Senior Creditors. Article 5.15 of the Trust Indenture prohibits the Subordinate Debenture-holders from "contesting or bringing into question" the validity or enforceability of the Senior Indebtedness.[80]

K. Distribution Mechanics

77. The mechanism adopted by the Receiver for distribution of the proceeds from the sale of Twin Buttes property to the Senior Creditors and the Subordinate Debenture-holders should ensure that the Senior Indebtedness is paid in full before the Subordinate Debenture-

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[78] Trust Indenture, Article 1.1 "Senior Indebtedness" (p. 8).
[79] Trust Indenture, Article 5.1 (p. 47) and 5.2 (p. 48).
[80] Trust Indenture, Article 5.15.

holders receive payment in respect of the Subordinate Debentures as provided by Article 5.2 of the Trust Indenture.

78. The mechanism proposed by the *Ad Hoc* Committee appears to contemplate that:

(a) the Receiver calculate the dividend payable to the Senior Creditors and the Trustee;

(b) the Receiver pay over to the Senior Creditors the distribution allocated to them plus such portion of the distribution allocated to the Trustee as may be necessary to pay in full the Senior Indebtedness, including interest and costs, owing to each of the Senior Creditors; and

(c) any amount of the distribution allocated to the Trustee after the Senior Indebtedness has been paid will be paid by the Receiver to the Trustee for distribution to the Subordinate Debenture-holders in accordance with the terms of the Trust Indenture.

79. This is acceptable to Husky and Argo and is in accordance with Article 5.2 of the Trust Indenture.[81]

L. Bankruptcy of Twin Butte

80. The Subordinate Debenture-holders are prohibited from initiating bankruptcy proceeding against Twin Butte until such time as the Senior Indebtedness is paid in full.[82]

81. There is also no evidence to support the *Ad Hoc* Committee's request that Twin Butte be placed into bankruptcy. In their Application, the Committee references bankrupting Twin Butte for the purpose of "subsequently applying to pursue claims of Twin Butte against third parties" pursuant to section 38 of the BIA, but there is no reference in the Committee's materials as to what potential claims might exist as against third parties. It is more likely that the Committee wishes to trigger a bankruptcy to trigger the application of s. 141 of the BIA.

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[81] The mechanism in Article 5.5 could also be used, but that imposes on the Trustee the burden of making distribution to the Senior Creditors.

[82] Trust Indenture, Article 5.5 (p. 50).

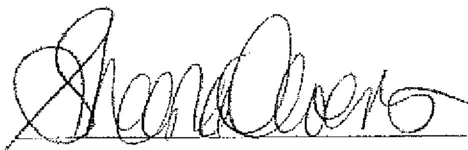
82. In the Ninth Report dated 21 June 2017 (the "**Ninth Report**"), the Receiver indicates that a review it conducted of materials transactions undertaken in the three months prior to the Appointment Order revealed nothing unusual.[83]

IV. Conclusion and Relief

83. Argo and Husky respectfully request that this Court direct that the Receiver make distributions to pay the Senior Indebtedness in full, including all costs and expenses incurred in connection with the Priorities Application and interest, prior to any distribution being made to the Trustee in respect of obligations owing under the Subordinate Debentures.

84. In the alternative, should this Court determine that formal subordinations are required pursuant to Article 5.7 of the Trust Indenture, Husky and Argo respectfully request that the Receiver be directed to exercise Twin Butte's right under Article 5.7 to require that the Trustee enter into formal subordination agreements with each of the Senior Creditors in respect of the Senior Indebtedness owing to that Senior Creditor.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 23rd day of June, 2017.



for E. Patrick Shea
Gowling WLG (Canada) LLP

for Thomas Cumming
Gowling WLG (Canada) LLP

[83] Ninth Report, para. 19

TABLE OF AUTHORITIES

1. *Air Canada (Re)*, 2004 CanLII 34416 (ON SC)
2. *Stelco Inc. (Re)*, 2006 CanLII 27117 (ON SC) aff'd, 2007 ONCA 483 (CanLII)
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7. GHL Fridman, *The Law of Contract in Canada* (6th ed), (Carswell)
8. *London Drugs Ltd.* v. *Kuehne & Nagel International Ltd.*, 1992 CanLII 41 (SCC)
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10. *Liu* v. *Calgary Chinatown Development Foundation*, 2017 ABQB 149 (CanLII)
11. *541788 Alberta Ltd.* v *Bourgeois & Company Ltd.*, 2017 ABQB 363 (CanLII)
12. *Parwinn Developments Ltd.* v. *375069 Alberta Ltd.*, 2000 ABQB 31 (CanLII)
13. *Brown* v. *Belleville (City)*, 2013 ONCA 148 (CanLII)
14. *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, ss. 139, 140.1, and 141
15. R. Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell)
16. *Lehman Brothers International (Europe) & Ors (Re)*, [2014] EWHC 704 (Ch)

TAB 1

COURT FILE NO.: 03-CL-4932
DATE: 20040405

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 SECTION 191 OF THE *CANADA BUSINESS CORPORATIONS ACT*, R.S.C. 1985, c. C-44, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF AIR CANADA AND THOSE SUBSIDIARIES LISTED ON SCHEDULE "A"

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

Sean F. Dunphy and *Ashley John Taylor*, for the Applicants, Air Canada

Monique Jilesen, for the Monitor, Ernst & Young Inc.

Kevin P. McElcheran, for CIBC

Joseph M. Steiner, for GTAA

Mark E. Meland, for The Summitomo Trust & Banking Co. Ltd., and Tokyo Leasing Co., Ltd.

Gregory Azeff, for GECAS Inc.

Harvey Chaiton, for Dr. Ratthey and Rainer Manthey (DM Bondholders)

S.R. Rickett, for Bayerische Landesbank

David R. Wingfield and *Kim Mullin*, for Tudor Investment Corp. and other Senior Financial Creditors

A. Kauffman, for Ad Hoc Committee of various Financial Creditors

HEARD: March 17, 2004

2004 CanLII 34416 (ON SC)

FARLEY J.

Re: Perpetual Subordinated Debt

[1] Canadian Imperial Bank of Commerce, Greater Toronto Airports Authority, Airbus, Cara Operations Limited and IBM Canada Limited (collectively "Trade Creditors") moved:

(A) for a declaration that the holders of Subordinated Perpetual Debt

(a) 5$^{3/4}$% Subordinated Bonds 1986ff (Swiss fr 200,000,000);

(b) 6$^{1/4}$% Subordinated Bonds 1986ff (Swiss fr 300,000,000);

(c) 6$^{3/8}$% Interest-Adjustable Subordinated Bonds 1987ff (DM 200,000,000);

(d) Subordinated Loan Agreement (Yen 20,000,000,000); and

(e) Subordinated Loan Agreement (Yen 40,000,000,000)

(collectively "SP Debt") are not entitled to vote or receive any dividend or other distribution from Air Canada unless and until the claims of all unsecured creditors, including those whose claims are in respect of borrowed money, have been paid in full;

(B) a declaration that any entitlement of holders of [SP Debt] must be distributed not to such holders but to all unsecured creditors *pro rata* in relation to their proven claim; and

(C) such further and other relief as this Honourable Court deems just.

[2] Air Canada ("AC") moved for an order authorizing it and its subsidiary Applicants under these CCAA proceedings "to incorporate the terms of the settlement reached between certain holders of [AC's] Senior Debt and certain holders of [AC's SP Debt] in the Applicants' plan of compromise or arrangement, to be filed (the "Plan")". This settlement was described by AC as follows at item 5 of the grounds:

5. Negotiations subsequently took place and an agreement has been executed between certain holders of Senior Debt and certain holders of [SP Debt] pursuant to which:

(a) Holders of [SP Debt] shall not be included in a separate class, but rather shall be included in a general class of unsecured creditors;

(b) Notwithstanding the treatment of holders of [SP Debt] as herein proposed, each creditor holding [SP Debt] shall be entitled to vote the face value of its claim in the same manner as all other unsecured creditors;

(c) The holders of [SP Debt] shall be entitled to a distribution under the Plan which provides to them, in the aggregate, on a *pro rata* basis, twenty-six percent (26%) of the aggregate distribution which would otherwise be made to them if they were not subordinated to Senior Debt;

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(d) Seventy-four percent (74%) of the aggregate distribution which would otherwise be made to the holders of [SP Debt] if they were not subordinated to Senior Debt, shall be distributed, on a *pro rata* basis, to the holders of Senior Debt, in addition to all other distributions to which they are entitled as unsecured creditors under the Plan;

(e) For certainty, a party entitled to a distribution in accordance with the foregoing shall be entitled to receive a corresponding portion of all direct or indirect benefits which may accrue to or be enjoyed by unsecured creditors pursuant to any rights offering, over-subscription mechanism or otherwise; and

(f) The mechanism described above shall allow for the distributions set forth above to occur without the necessity of the holders of Senior Debt or Air Canada enforcing the subordination covenants directly against the holders of [SP Debt].

[3] Certain investors ("DM Bondholders") who hold or represent the beneficial holders of approximately 26 million DM of the Deutsche Mark Bonds ("DM Bonds") asserted that since there was no winding-up, liquidation or dissolution of AC, then the subordination of the DM Bonds was not triggered. They relied on the fact that s. 8(2) of the terms of the DM Bonds reads as follows:

> S. 8(2) Upon any winding-up, liquidation or dissolution of the Borrower, whether in bankruptcy, insolvency, receivership or other proceedings including special Act of Parliament or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise.

There is no reference to "reorganization" in addition to "winding-up, liquidation or dissolution" as is the case of the SF Bonds or the Yen Loan Agreements:

<u>SF Bonds s. 7</u>

> Upon any distribution of assets of the Company (other than such as is referred to in Section 8(2) and in respect of which the Principal Paying Agent has not exercised its rights contained in Section 8(22) or upon any dissolution, winding up, liquidation or reorganization of the Company, whether in bankruptcy, insolvency, reorganization, receivership or other proceedings or upon any assignment for the benefit of creditors of any other sequestering of the assets and liabilities of the Company or otherwise,

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Yen Loan Agreements para. 6.4.2

> Upon any distribution of assets of the Borrower (other than such as is referred to in Clause 10(h) where the surviving company assumes all the obligations of the Borrower) upon any dissolution, winding up, liquidation or reorganization of the Borrower, whether in bankruptcy, insolvency, reorganization or receivership proceedings or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise in or upon any similar or analogous proceedings or event: -

No explanation was given for the difference in language so we are left in the dark as to whether it was intentional on a negotiated basis or simply inadvertent drafting.

[4] Each of the SP Debt instruments contains subordination provisions. While all the provisions are not identical, they are substantially similar. The following are definitions from the November 14, 1989 Yen Loan Agreement:

> "Indebtedness" – the principal, premium, if any, and unpaid interest (including interest accrued after the commencement of any reorganization or bankruptcy proceedings) or any indebtedness of the Borrower for borrowed money, whether by way of loan or evidenced by a bond, debenture, note or other evidence of indebtedness and whether secured or unsecured, including indebtedness for borrowed money of others guaranteed by the Borrower;
>
> "Senior Indebtedness" – means all Indebtedness, present or future, which is not expressly subordinated to or ranking *pari passu* with the Loan whether by operation of law or otherwise, in the event of a winding-up, liquidation or dissolution, whether voluntary or involuntary, whether by operation of Law or by reason of insolvency legislation;

[5] The end result is that upon the happening of the relevant triggering event, the holders of the SP Debt have contractually agreed that they will be subordinated to Senior Indebtedness. The Trade Creditors assert that there will be untold difficulty in determining what is "borrowed money" as this is an undefined term. With respect, I disagree as not every term has to be defined in an agreement in order to determine its meaning and it would not appear to me to be all that difficult to draw the line if, as and when that becomes necessary.

[6] The Trade Creditors also submit that as among the unsecured debt, as the unsecured SP Debt is subordinated to Senior Indebtedness (also unsecured), then the doctrine of subordination requires that the SP Debt be subordinated to all unsecured debt – (that is, not only the Senior Indebtedness but also all unsecured debt). They rely upon what they say is "a fundamental principle of Canadian insolvency law that, excepting only specifically enumerated preferred

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creditors, all unsecured creditors are entitled to *pro rata* distribution" and that this principle is reflected in s. 141 of the *Bankruptcy and Insolvency Act* ("BIA"):

> S.141 Subject to this Act, all claims proved in a bankruptcy shall be paid rateably.

However, this is a CCAA insolvency proceeding not a BIA one. The jurisprudence in CCAA proceedings is that any plans of arrangement are treated as contracts amongst the parties (including the minority voting against) and that the court in a sanction hearing will review the creditor approved plan to see if it is fair, reasonable and equitable, wherein equitable does not necessarily mean equal. See *Alternative Fuel Systems Inc. v. Remington Development Corp.* 2004 ABCA 31; *Re Sammi Atlas Inc.* (1998), 3 CBR (4th) 171 (Ont Gen Div).

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[7] The Trade Creditors rely upon *Re Maxwell Communications Corporation PLC (No. 2)*, [1993] 1 WLR 1402 (Ch Div) where at pp. 1411-2 in approving the proposed distribution, Vinelott J. concluded that a bilateral subordination between a debtor and a creditor can be effective:

> The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after the commencement of a bankruptcy or winding up. I do not think that it does. It seems to me plain that after the commencement of a bankruptcy or a winding up a creditor must be entitled to waive his debt just as he is entitled to decline to submit a proof.
>
> If the creditor can waive his right altogether I can see no reason why he should not waive his right to prove, save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full; ...
>
> So also, if the creditor can waive his right to prove or agree the postponement of his debt after the commencement of the bankruptcy or winding up, I can see no reason why he should not agree with the debtor that his debt will not be payable or will be postponed or subordinated in the event of a bankruptcy or winding up.
>
> (emphasis by Trade Creditors)

However, I would caution that this quote must be taken in context; similarly for the second Vinelott J. quote. Then in reliance upon Vinelott J.'s views at p. 1416, the Trade Creditors submitted in their factum:

20. Accordingly, the Court gave effect to the bilateral subordination provisions as a waiver of the credit to its entitlement to receive any distribution **until all unsecured** creditor claims have been paid in full.

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> 21. In giving effect to the subordination, the Court distinguished on the facts previous decisions of the English courts that had addressed arrangements that disturbed rateable distribution among unsecured creditors. The Court, however endorsed the fundamental principle that a debtor cannot validly contract with one unsecured creditor for any advantage denied to other unsecured creditors.

Vinelott J. stated at p. 1416:

> [If] the clearance arrangements had had the effect contended for by Air France they would clearly have put a member of the clearance arrangements in a position which would have been better than the position of other unsecured creditors. The arrangements would therefore unquestionably have infringed a fundamental principle of bankruptcy law, which is reflected in but not derived from section 302 or its predecessor, that a creditor cannot validly contract with his debtor that he will enjoy some advantage in a bankruptcy or winding-up which is denied to other creditors.
>
> In my judgment I am not compelled by the decisions of the House of Lords in the *Halesowen* and *British Eagle* cases, or by the decisions of the Court of Appeal in those cases or in *Rolls Razor Ltd. v. Cox*, [1967] 1 Q.B. 552, to conclude that a contract between a company and a creditor, providing for the debt due to the creditor to be subordinated in the insolvent winding up of the company to other unsecured debt, is rendered void by the insolvency legislation.
>
> (emphasis by Trade Creditors)

[8] The Trade Creditors went on at paras. 23-24 of their factum:

> 23. However, also consistent with the decision of the English Court in *Maxwell* and cases enforcing the policy of rateable distribution among unsecured creditors which were accepted in *Maxwell*, such agreement cannot be enforced to provide an unsecured creditor (or any subset of unsecured creditors) an advantage in an insolvency proceeding which is denied to other unsecured creditors. Put simply, the [SP Debt] holders are free to waive claims if they choose, but neither they nor the debtor can direct that the resulting benefit shall be distributed preferentially to some unsecured creditors and not others.
>
> 24. Treating the holders of [SP Debt] as being subordinated to all unsecured creditors is consistent with key principles of Canadian insolvency law and with the terms of the subordination itself. Such holders should not be entitled to receive any dividend until creditors with

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> "borrowed money" claims are paid in full. As claims arising from "borrowed money", in the case, are unsecured claims, they are entitled to receive *pro rata* distributions under Air Canada's plan of arrangement with all other unsecured creditors and will be paid in full only when all other unsecured claims are paid in full.

[9] With respect, I disagree. The Trade Creditors did not bargain or pay for any benefit or advantage in respect of the SP Debt nor are they parties to any agreements in respect thereto and it is important to observe that they have not been designated as third party beneficiaries (nor have they asserted that they were). The cases cited by the Trade Creditors would not appear to me to have much if any relevance to the situation in this case. *Ex parte MacKay* (1873) 8 Ch App 643 dealt with a situation where a creditor had bargained with the debtor for additional rights upon the bankruptcy of that debtor. *British Eagle International Airlines Ltd. v. Compagnie Nationale Air France*, [1975] 1 WLR 780 (HL) involved the applicability of the laws of bankruptcy to the existence of mutual debts existing as of the date of bankruptcy. *Re Gingras Automobile Ltée*, [1962] SCR 676 deals with the legal question of paramountcy. *Hamilton and others v. Law Debenture Trustee Ltd. and others*, [2001] 2 BCLC 159 (Ch Div); *Maxwell supra*; *Re British & Commonwealth Holdings PLC (No. 3)*, [1992] 1 WLR 672 (Ch Div) each dealt with instruments that had rights on their face that were subordinated to the rights of <u>all other creditors</u>.

[10] Even within a bankruptcy context there is no impediment to a creditor agreeing to subordinate his claim to that of another creditor. See *Re Rico Enterprises Ltd.* (1994), 24 CBR (3d) 309 (BCSC) where Tysoe J. observed at pp. 322-3:

> ...If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.
>
> It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the same class as the subordinating creditor should not receive the benefit of a subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the

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distribution and give it to the party in whose favour the subordination was

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> granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

See also *Re Bank of Montreal v. Dynex Petroleum Ltd.* (1997), 145 DLR (4th) 499 (Alta QB) at p. 529 (reversed on appeal on other grounds); Roy Goode, *Legal Problems of Credit and Security*, 3rd ed. (Sweet & Maxwell: London, 2003) at p. 55. It would seem to me that a guide-lining principle should be that as discussed in A.R. Keay, *MacPherson's Law of Company Liquidation* (London; Sweet & Maxwell, 2001) at p. 717:

> However, they [the courts] would permit a liquidator to distribute according to an agreement made along the lines of the latter situation providing that to do so would not adversely affect any creditor not a party to the agreement, *i.e.*, creditors not involved in the subordination agreement would not receive less under that agreement than would have been received if distributions had been made on a *pari passu* basis.

See also J.L. Lopes, "Contractual Subordinations and Bankruptcy" (1980), 97 No. 3 *Banking Law Journal*, 204 at p. 206.

> At the conclusion of the bankruptcy proceedings, a dividend is allocated to all unsecured creditors, including the subordinated creditor, on a pro rata basis. The dividend allocated to the subordinated creditor is paid over to the senior creditor, to the extent of its claim, with the subordinated creditor retaining the remainder of the dividend if the senior creditor is paid in full.* This process neither affects the amount of claims against the debtor nor the dividend paid to unsecured creditors. (*See, e.g., *In re* Associated Gas & Elec. Co., 53 F. Supp. 107, 114 (S.D.N.Y. 1943).)

[11] It seems to me that what should be looked at with respect to the settlement is the substance and not the form, although it does seem to me that it would be better for form to follow substance. In essence, what the settlement provides for (the settlement to provide some certainty of the result and therefore avoid the uncertainty of the claim by that the SP Debt subordination provision may not be effective vis-à-vis the Senior Indebtedness and the issue of whether the SP Debt would be entitled to a separate class with the possibility of a veto being exercised by this class against a plan of reorganization, otherwise acceptable to the other creditors) is that the SP Debt would receive its rateable share of "proceeds" under the proposed plan but as a result of the agreement between the adherents to the settlement, then the SP Debt adherents would transfer 74% of their proceeds to the benefit of the Senior Indebtedness and retain 26%. It would also appear that the same result could obtain with a partial assignment of SP Debt claims or a declaration of trust in favour of the Senior Indebtedness, with the *quid pro quo* being that there be no subordination as to the remaining 26% beneficially owned by the holders of the SP Debt.

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[12] There was no problem with this type of subordination arrangement in *Horne v. Chester & Fein Property Developments Pty Ltd. and Ors* (1986), 11 ACLR 485 (Vic SC) at pp. 489-90 where Southwell J. stated:

> In the speech of Viscount Dilhorne, there is a discussion of a number of authorities, of which "the weight of opinion expressed ... appears to me to be in favour of the conclusion that it is not possible to contract out of s 31". However, there, and, so far as I have seen in most other relevant cases, the term "contract out" is used in circumstances where the contract relied upon is one, the performance of which, upon later insolvency, would adversely affect other creditors who were not parties to the contract. Viscount Dilhorne referred with approval at 805 to *dicta* of Hallett J. in *Victoria Products Ltd. v. Tosh & Co. Ltd.* (1940), 165 LT 78 where His Honour said that "... an attempt to leave outside that process some particular item is one which should be regarded as against the policy of the insolvency laws ..."
>
> Repeatedly, over the years, "the policy of the insolvency laws" has formed the basis of decision. That policy, as it appears to me, was never intended to alter the rights and obligations of parties freely entering into a contract, unless the performance of the contract would, upon insolvency, adversely affect the right of strangers to the contract. Authority for that proposition is to be found in *Ex parte Holthausen*; *Re Scheibler* (1874) LR 9 Ch App 722 at 726-7 (referred to by Lord Morris in his dissenting speech in *British Eagle* at 770-1).

[13] In *Canada Deposit Insurance Corporation v. Canadian Commercial Bank* (unreported decision of Wachowich J. CQBA released December 15, 1993), the governments of Canada and Alberta waived their Crown priority on insolvency in favour of all other unsecured creditors, reducing themselves to *pari passu* ranking. But the CDIC also waived any Crown priority that it may have arising from its status as an agent of the government of Canada and it also subordinated its claim in favour of some but not all of the other unsecured creditors (including trade creditors). As put by the Bayerische Landesbank group in their factum at para. 65:

> 65. Justice Wachowich correctly dismissed the objection made to him that the selective nature of the subordination offended the *pari passu* principle. He approved a distribution in which it was first determined what the ordinary shares of all unsecured creditors were and then the *pari passu* recovery by CDIC attributable to its claim was redirected to those creditors to whom CDIC (here, the [SP Debt] holders), the corresponding enhanced recovery went to those unsecured creditors who were intended to enjoy the benefit of the subordination covenant (here, holders of the Senior Indebtedness) and the effect on the other unsecured creditors (here, the trades) was neutral.

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[14] In the end result I do not see that there is any problem with the SP Debt being selectively subordinated to the Senior Indebtedness. This subordination to that "borrowed money" does not result in the SP Debt being subordinated to all the unsecured debt, Senior Indebtedness and non-Senior Indebtedness alike.

[15] With respect to the right to vote, I do not see that the fact that there is a subordination takes away or detracts from the right to vote by holders of the SP Debt. See *Menegon v. Philip Services Inc.*, [1999] OJ No. 4080 (SCJ) at paras. 38, 53. At para. 21 of *Uniforêt Inc. (In the Matter or the Arrangement of)*, [2003] QJ No. 9328 (SCJ), Tingley J. stated:

> 21. For a plan of arrangement to succeed, an insolvent company must secure the approval of all classes of its creditors, even those who have subordinated their claims to all other creditors, as is the case with the debenture holders.

[16] The Trade Creditors motion is dismissed.

[17] The issue of whether the AC Applicants can incorporate the terms of the subject settlement or some equivalent thereof in a Plan to be proposed is in my view a matter for them to decide, but in general, I see no impediment to their doing so provided that they take into account all relevant factors.

[18] That leaves the issue of the position of the DM Bonds in light of the fact that s. 8(2) of their Indenture does not refer to "reorganization" in the same way as the other issues of the SP Debt does. Again, one must look at this provision in context. Allow me to set out the provisions of s. 8(1)(2)(5) and (7):

> 8. Subordination and Status; Listing
>
> (1) The payment of principal and interest on the Bonds and Coupons is hereby expressly subordinated, to the extent and in the manner hereinafter set forth, in right of payment to the prior payments in full of all Senior Indebtedness of the Borrower. The term "Senior Indebtedness" shall mean all indebtedness, present or future, which is not expressly subordinated to or ranking *pari passu* with the Bonds, whether by operation of law or otherwise, in the event of a winding-up, liquidation or dissolution, whether voluntary or involuntary, whether by operation of law or by reason of insolvency legislation. The term "Indebtedness" shall mean the principal, premium, if any, and unpaid interest (including interest accrued after the commencement of any reorganization or bankruptcy proceeding) on any indebtedness of the Borrower for borrowed money, whether evidence by a bond, debenture, note or other evidence of indebtedness whether secured or unsecured,

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including indebtedness for borrowed money of others guaranteed by the Borrower and including the Bonds and Coupons contemplated hereby.

(emphasis added)

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(2) Upon any winding-up, liquidation or dissolution of the Borrower, whether in bankruptcy, insolvency, receivership or other proceedings including special Act of Parliament or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise,

(a) the holders of all Senior Indebtedness shall be entitled to receive payment in full of all sums on account of Senior Indebtedness (including payment of or provision for any unmatured, contingent or unliquidated Senior Indebtedness) before the holders of Bonds or Coupons are entitled to receive any payment of interest or principal; and

(b) any payment or distribution of assets of the Borrower of any kind or character, whether in cash, property or securities, to which the holder of Bonds or Coupons would be entitled except for the provisions of this § 8 shall be paid by the liquidation trustee or agent or other person making such payment or distribution, whether a trustee in bankruptcy, a receiver or liquidating trustee or otherwise, directly to the holders of Senior Indebtedness or their representative or representatives or to the trustee or trustees under any indenture under which any instrument evidencing any of such Senior Indebtedness may have been issued, rateably according to the aggregate amounts remaining unpaid on account of the principal of, premium, if any, and interest on the Senior Indebtedness, held or represented by each, to the extent necessary to make payment in full of all Senior Indebtedness remaining unpaid, after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness; and

(c) subject to the payment in full of all due Senior Indebtedness holders of Bonds or Coupons shall be subrogated *pro rata* (based on respective amounts paid for the benefit of the holders of Senior Indebtedness) with the holder of other Indebtedness to the rights of the holders of Senior Indebtedness to receive payments or distributions of cash, property or securities of the Borrower applicable to Senior

Indebtedness until the Bonds and Coupons shall be paid in full and no such payments or distributions to the holders of Bonds or Coupons of cash, property or securities otherwise distributable to the holders of Senior Indebtedness shall, as between the Borrower, its creditors other than the holders of Senior Indebtedness, and the holders of Bonds or Coupons be deemed to be a payment by the Borrower to the holders of Bonds or Coupons, or for their account. It is understood that the provisions of this § 8 are and are intended solely for the purpose of defining the relative rights of the holders of Bonds or Coupons and the holders of other *pari passu* Indebtedness, on the one hand, and the holders of Senior Indebtedness, on the other hand.

(5) No payment by the Borrower on the Bonds or Coupons (whether upon redemption or repurchase, or otherwise) shall be made if, at the due time o f such payment or immediately after giving effect thereto, (a) there shall exist a default in the payment of principal, premium, if any, sinking fund or interest with respect to any Senior Indebtedness, or (b) there shall have occurred an event of default (other than a default in the payment of principal, premium, if any, sinking fund or interest) with respect to any Senior Indebtedness, as defined therein or in the instrument under which the same is outstanding, permitting the holders thereof or any trustee under any such instrument to accelerate the maturity thereof, and such event of default shall not have been cured or waived or shall not have ceased to exist (except payments made if the Bonds are redeemed or acquired prior to the happening of such default or event of default).

(7) The Borrower undertakes vis-à-vis the Trustee for the benefit of the holders of Bonds and Coupons that until such time as the Bonds or Coupons have been completely repaid the Borrower will ensure that the Bonds rank and will rank *pari passu* with all unsecured and subordinated Indebtedness of the Borrower other than Indebtedness preferred by law.

[19] It is not instantly obvious as to which provision "hereafter" refers to as there is no specific section reference in the same way as is specified in sections 1(2), 2(1), 3(1), 3(2), 9(3) and 10(3) of the DM Bond terms. It was posited by the Bayerische Landesbank group that "hereafter" may refer to (i) the remainder of s. 8(1); (ii) s. 8(2); (iii) the entire subsequent balance of s. 8; or (iv) the entire balance of the DM Bond terms. As the balance of s. 8(1) consists of definitions of "Senior Indebtedness" and "Indebtedness", this would speak to the

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"extent" of the subordination of the DM Bonds but would not address the manner in which they are subordinated.

[20] Section 8 does contain a description of how distributions are to be applied as between holders of Senior Indebtedness and holders of the DM Bonds in the event of AC being wound-up, liquidated or dissolved and there is a distribution of its assets. Thus s. 8(2) can be read as addressing the "manner" of the subordination in those particular circumstances of such a winding-up, liquidation or dissolution. However is s. 8(2) the <u>exclusive</u> trigger in respect of subordination? It should be kept in mind that there is no "magic words or formula" to invoke a subordination. As well, as indicated above, there are other references to specific provisions of the terms so as to direct the reader to a specific spot. It should be observed that s. 8(2) is not the only provision in the balance of s. 8 which deals with the subject of subordination as s. 8(3), (4), (5), (6) and (7) contain additional procedural or other provisions addressing in some sense the "manner" of subordination. Is there a conflict with s. 8(5) or (7) if "hereafter" refers only to s. 8(1) and (2)?

[21] Section 8(5) provides that the subordination of the DM Bonds is effective if AC fails to make any payment to any holder of the Senior Indebtedness, when due, without any reference to whether or not this default in timely payment gives rise to, or occurs in the course of, any form of insolvency proceedings. There has been a default in the payment of interest due on the Senior Indebtedness since some time prior to the CCAA filing in April, 2003. The DM Bondholders assert that this default will be cured as it is expected that the amounts due on the Senior Indebtedness will be satisfied upon implementation of a Sanctioned Plan (and in this respect I note that there is no time limit for cure to take place contained in s. 8(5)). However this presupposes that the Plan mechanism would indeed cure the default. However in the context of s. 8(5), I do not see that such compromise of the right of holders of Senior Indebtedness to be paid acts as a cure which would otherwise inactivate the form of subordination which s. 8(5) provides. Thus it would seem to me that at the present time, the failure to pay amounts due on the Senior Indebtedness has caused a default which has triggered the subordination provisions of s. 8(5). This trigger aspect is not dependent upon there being a "reorganization".

[22] Section 8(7) provides that the DM Bonds are to rank *pari passu* with all unsecured subordination Indebtedness of AC which would include the other issues of SP Debt. If the DM Bonds were not to rank equally with the rest of the SP Debt, then s. 8(7) would be rendered meaningless.

[23] It therefore seems to me that the DM Bonds are to be treated at this time as SP Debt which is to be treated in the same way as the other issues of SP Debt which are all presently subordinated to the Senior Indebtedness.

[24] Orders to issue accordingly.

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J.M. Farley

Released: April 5, 2004

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TAB 2

COURT FILE NO.: 04-CL-5306
DATE: 20070809

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ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*	*Robert W. Staley, Derek J. Bell and Alan Gardner* for the Debentureholders
AND IN THE MATTER OF A PROPOSED PLAN OF COMPROMISE OR ARRANGEMENT WITH RESPECT TO STELCO INC. AND OTHER APPLICANTS	*Paul G. Macdonald, Andrew J.F. Kent and* Brett Harrison, for the Subordinated Noteholders
	Nancy Roberts and Tim Morgan, for 2074600 Ontario Ltd.
	Kyla Mahar, for the Monitor of the Applicants
	HEARD: July 17, 18, 19, 20 and 21, 2006

H.J.W. Siegel J.

REASONS FOR JUDGMENT

[1] This proceeding is the final chapter of the financial restructuring of Stelco Inc. ("Stelco") under the *Companies' Creditors Arrangement Act* (the "CCAA"). It involves competing claims of entitlement to a pool of cash, notes, shares, and warrants of Stelco known as the "Turnover Proceeds". The dispute is principally between the holders of two series of Stelco debentures, on the one hand, and the holders of subordinated notes, on the other. The Turnover Proceeds were paid under the plan of arrangement of Stelco ("the Plan") to the holders of notes of Stelco. The holders of the debentures submit that the subordination provisions pertaining to the notes were preserved under the Plan. They seek an order requiring the noteholders to pay the Turnover Proceeds to them in accordance with these provisions on the basis that their claims against Stelco

were not fully satisfied under the Plan. In addition, 2074600 Ontario Inc. ("2074600"), which is the assignee of a debt owed by Stelco to EDS Canada Inc. ("EDS") in the amount of $48,994,917 (the "EDS Claim"), seeks a declaration that it is also entitled to the benefit of the subordination provisions in respect of the EDS Claim and, therefore, is entitled to its *pro rata* share of the Turnover Proceeds.

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Background

[2] Stelco is a corporation amalgamated under the laws of Canada with its head office located in Hamilton, Ontario. Stelco is one of Canada's largest producers and marketers of rolled and manufactured steel products.

Outstanding Debt of Stelco

[3] Pursuant to a trust indenture between Stelco and Royal Trust Company dated as of November 30, 1989, as supplemented (the "10.4% Indenture"), Stelco issued debentures in the principal amount of $125,000,000 bearing interest at 10.4% per annum (the "10.4% Debentures"). Pursuant to a further trust indenture between Stelco and Montreal Trust Company of Canada dated February 15, 1999, as supplemented (the "8% Indenture" and collectively with the 10.4% Indenture the "Debenture Indentures"), Stelco issued debentures in the principal amount of $150,000,000 bearing interest at 8% per annum (the "8% Debentures"). The 10.4% Debentures and the 8% Debentures are herein collectively referred to as the "Debentures" and the holders thereof as the "Debentureholders".

[4] The Debentures are registered in the name of CDS & Co. and are beneficially owned by institutional holders and individuals. The Debentureholders are represented in this proceeding by a steering committee of six Debentureholders (the "Claimants"). Collectively, the Claimants say they hold $92,030,000 in principal amount of 10.4% Debentures and $93,229,000 in principal amount of 8% Debentures.

[5] Pursuant to a trust indenture between Stelco and CIBC Mellon Trust Company dated as of January 8, 2002, as supplemented by a first supplemental indenture dated as of January 21, 2002 (collectively "the "Note Indenture"), Stelco issued convertible unsecured subordinated debentures in the principal amount of $90,000,000 bearing interest at 9.5% per annum (the "Notes"). The holders of the Notes are herein referred to as the "Noteholders".

[6] Three corporations and one individual have identified themselves as Noteholders and are participating on their own behalf in this proceeding. They include Sunrise Partners Limited Partnership ("Sunrise") and Appaloosa Management L.P. ("Appaloosa"), both of which are also significant equity investors in Stelco under the Plan.

[7] Under the terms of the Note Indenture (specifically in the first supplemental dated as of January 21, 2002), the Noteholders expressly agreed to subordinate their right of repayment to payment in full of "Senior Debt". Senior Debt is defined in the Note Indenture as follows:

> "Senior Debt" means the principal of, the premium (if any) and interest on: (i) indebtedness, other than indebtedness represented by the [Notes], for money borrowed by the Corporation or for money borrowed by others for the payment of which the Corporation is liable; (ii) indebtedness incurred, assumed or guaranteed by the Corporation in connection with the acquisition by it or by others of any business, property, services or other assets excluding indebtedness incurred in relation to any such acquisitions made in the ordinary course of business; and (iii) renewals, extensions and refundings of any such indebtedness, unless, in any of the cases specified above, it is provided by the terms of the instrument creating or evidencing such indebtedness that such indebtedness is not to be superior in right of payment to the [Noteholders].

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[8] It is agreed that the Debentures constitute "Senior Debt" as defined in the Note Indenture. In this proceeding, 2074600 seeks a declaration that the EDS Claim also constitutes Senior Debt. This issue is addressed below.

[9] The provisions governing the subordination of the Notes are set out in Part VI of the first supplemental indenture dated as of January 21, 2002 (collectively the "Subordination Provisions"). The relevant sections of Part VI are set out in the Appendix. In particular the Debentureholders and 2074600 rely on section 6.1, which sets out the subordination covenant, and section 6.2, which addresses the operation of the subordination arrangements in the event of insolvency proceedings including a reorganization.

[10] In particular, subsection 6.2(2) contains a provision requiring any payment or distribution of assets in these circumstances to be paid to the holders of Senior Debt (herein referred to as "Senior Debt Holders") to the extent necessary to result in payment in full of the principal and interest owing to the Senior Debt Holders. The Debentureholders and 2074600 seek to enforce this covenant as third party beneficiaries. In addition, subsection 6.2(3) provides that any payments or distributions not made in accordance with subsection 6.2(2) are to be held in trust by the Noteholders for the benefit of the Senior Debt Holders. The Debentureholders and 2074600 assert that they are beneficiaries of this trust.

The EDS Claim

[11] 2074600 is a company that was organized to acquire the EDS Claim. It is a wholly owned subsidiary of TriCap Management Limited ("TML"), which was a significant equity investor in Stelco under the Plan.

[12] The EDS Claim related to an agreement between Stelco and EDS dated as of February 25, 2002 entitled the "Master Information Technologies Services Agreement" (the "MITSA").

The MITSA, and the nature of the EDS Claim, are described in greater detail below. EDS assigned its interest in the EDS Claim to 2074600 pursuant to an assignment agreement dated November 14, 2005.

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Insolvency Proceedings of Stelco

[13] On January 29, 2004 (the "Filing Date"), Stelco and certain of its subsidiaries filed for and obtained protection under the CCAA. Pursuant to an order of this Court dated January 29, 2004 (the "Initial Order"), Ernst & Young Inc. was appointed as a monitor (the "Monitor") over all of the applicant companies.

[14] In the course of Stelco's lengthy CCAA process, the Monitor oversaw a CCAA claims process through which unsecured creditors proved their claims against Stelco for voting and distribution purposes. The Monitor accepted unsecured creditor claims totaling approximately $546 million. If post-filing interest related to these claims is included, the total of the accepted unsecured creditor claims was approximately $640 million. These claims included the Debentureholders' claims, which totaled $282,629,761 as of the Filing Date and $342,655,664 as of the Plan Implementation Date (defined below), and the EDS Claim, which Stelco and EDS agreed was $48,994,917 as of the Filing Date.

[15] Throughout the latter part of 2004 and all of 2005, Stelco, the Monitor, and representatives of certain unsecured creditors, including representatives of the Debentureholders, were involved in various efforts to raise capital, sell assets, and negotiate a plan of arrangement or compromise. Ultimately, Stelco proposed its first plan of arrangement in October 2005 (the "Proposed Plan").

[16] The Proposed Plan treated the Debentureholders and the Noteholders, together with other unsecured creditors whose claims were accepted by the Monitor, as members of the same class, referred to in the Plan as the "Affected Creditors". The Noteholders brought a motion to challenge this classification. They sought alternative relief either (1) directing Stelco to include provisions in the Proposed Plan, and disclosure in the related information circular, reflecting the extinguishment of the Subordination Provisions on implementation of the Proposed Plan, or (2) directing Stelco to extend separate class treatment to the Noteholders. The Noteholders' position was based on the absence of privity of contract -- the fact that the Debentureholders were not parties to the Note Indenture.

[17] The Noteholders' motion was heard on November 9, 2005 by Farley J. In his Endorsement of the same date, Farley J. denied both items of the requested relief and dismissed the motion: see *Stelco Inc.(Re)* [2005] O.J. No. 4814 (Sup. Ct.). A subsequent appeal to the Court of Appeal was also dismissed. The significance of these decisions for the issues in this proceeding is addressed below.

[18] In response to a comment of Farley J. in his Endorsement of November 9, 2005, Stelco inserted a preliminary version of section 6.01(2) of the Plan in the draft plan to clarify its intentions with respect to the relationship between the Plan and the Subordination Provisions.

This provision was subsequently revised in the course of negotiations that commenced in early December 2005 involving Sunrise and Appaloosa. These negotiations were prompted by an offer by these parties to subscribe for equity in Stelco under the Proposed Plan at $5.50 per common share, which was higher than the price contemplated under the Proposed Plan.

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[19] The negotiations in early December 2005 involved, among other parties, TML, Sunrise, Appaloosa, Stelco and the Claimants on behalf of the Debentureholders. They resulted in a revised plan of arrangement that was announced on December 5, 2005.

[20] The final version of section 6.01(2) of the Plan is set out in the Appendix. The Debentureholders and 2074600 say that this provision preserves the rights of the Senior Debt Holders in respect of the Subordination Provisions. The Noteholders say it does not and that the Subordination Provisions were therefore extinguished on implementation of the Plan pursuant to its terms.

[21] In late 2005, Stelco's directors and management obtained reports from UBS Securities Canada ("UBS") and BMO Nesbitt Burns Inc. ("BMO") regarding the estimated enterprise value of Stelco. In addition, the Monitor received a similar report from Ernst & Young Orenda Corporate Finance Inc. ("E&y"). The ranges of enterprise value in these reports was as follows : UBS - $550 - $750 million using a discounted cash flow ("DCF") approach ; BMO - $580 - $780 million using a public trading approach and $615 - $785 using a DCF approach ; and E&Y - $635 - $785 million. The existing holders of Stelco common shares obtained a report from Navigant Consulting ("Navigant"), which concluded that Stelco had an enterprise value in the range of $1.1 - $1.3 billion.

[22] The Affected Creditors approved the revised plan on December 9, 2005. The revised plan was then submitted to the Court for its approval pursuant to the CCAA at a hearing held on January 17 and 18, 2006 (the "Sanction Hearing") and was approved by the Court pursuant to an order dated January 20, 2006 (the "Sanction Order"). As approved, the Stelco plan of arrangement is referred to as the "Plan". The decision of Farley J. approving the Plan is set out in his Endorsement of the same date: see *Stelco Inc. (Re)* [2006] O.J. No. 276 (Sup. Ct.) No appeal was taken from that decision.

[23] The Plan became effective on March 31, 2006 (the "Plan Implementation Date") at the "Effective Time", which was defined under the Plan as "the last moment on the Plan Implementation Date". On the Plan Implementation Date, articles of reorganization of Stelco were filed implementing the various steps in the Plan including the Distributions (as defined below) and the equity subscriptions of the equity sponsors of the Plan.

Treatment of the Parties Under the Plan

[24] Under the Plan, on the Plan Implementation Date, each Affected Creditor received, in respect of its proven claims under the Plan, its *pro rata* share of each of:

(a) the principal amount of the U.S. dollar equivalent (rounded up to the nearest US $1,000) of $275 million of secured fixed rate notes (the "FRNs");

(a) a cash pool of a minimum of $108,548,000 and a maximum of $137,500,000, depending upon the number of Common Shares acquired pursuant to the Share Election (defined below) (the "Cash Pool"), funded by concurrent equity subscriptions of TML, Sunrise and Appaloosa;

(b) 1.1 million new common shares of Stelco (the "Common Shares"); and

(c) warrants to purchase 1,418,500 common shares of Stelco at $11 per share at any time prior to 2013 ("the Warrants").

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Pursuant to section 2.07 of the Plan, each Affected Creditor could elect to receive all or any part of its entitlement to cash from the Cash Pool in Common Shares at a subscription price of $5.50 per share, subject to prorating in the event that more than 5,264,000 Common Shares were elected, which occurred. This right is referred to herein as the "Share Election". The securities actually distributed to the Affected Creditors, taking this election into account, are collectively referred to as the "Distributions".

[25] The Distributions received by the Debentureholders under the Plan in satisfaction of their claims against Stelco were as follows:

(a) FRNs having an aggregate US$121,486,000. Assuming an exchange rate of 1.167 as of March 31, 2006, the aggregate face value of the FRNs was Cdn. $141,774,162;

(b) $52,189,293.52 and US$46,477.83 in cash. Assuming an exchange rate of 1.167 as of March 31, 2006, the aggregate cash received was $52,243,533.15;

(c) 4,004,829 of Common Shares; and

(d) 733,311 Warrants.

[26] Valuing the FRNs at par, the Common Shares at $5.50, and the Warrants at $1.44, the Debentureholders value these Distributions at $216,044,254.65, resulting in a deficiency claim of $125,611,499.35 (including post-filing interest), which exceeds the value of the Turnover Proceeds. Using a valuation of the FRNs of $105.25, of the Common Shares of $20.50 and of the Warrants of $14.73, the Noteholders value these Distributions at $294,361,504, resulting in a deficiency claim on the same basis of $48,294,160, which represents 53.7% of the Turnover Proceeds.

[27] The Distributions received by the Noteholders under the Plan in full satisfaction of their claims against Stelco were as follows:

(a) FRNs having an aggregate face value of US $40,522,000. Using the same exchange rate assumptions, the aggregate face value of the FRNs was Cdn. $47,289,174;

(b) $20,075,359 in cash;

(c) 849,325 Common Shares; and

(d) 244,528 Warrants.

These assets constitute the "Turnover Proceeds" and were delivered to the Monitor to be held in trust pending resolution of this litigation pursuant to the provisions of section 6.02(a) of the Plan.

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Subsequent Events

[28] Trading in the Common Shares, Warrants and FRNs on the Toronto Stock Exchange (the "TSE") began at the opening of business on Monday April 3, 2006, although there were no trades in the FRNs recorded until April 5, 2006. The FRNs also traded in the over-the counter market for which data was not made available to the Court.

[29] On the first day of trading, 2,043,049 Common Shares were traded. The high and low prices for the Common Shares on that day were $19.49 and $15.00, respectively, with the closing price being $19.49. On the same day, 2,496 Warrants were traded. The high and low prices for the Warrants on that day were $12.00 and $10.00, respectively, with the closing price being $12.00.

[30] The volume weighted average price (the "VWAP") of the Common Shares and the Warrants during the five-day period of April 3, 2006 to April 7, 2006 were $20.5049 and $14.7324, respectively. A total of 5,965,531 Common Shares and 91,579 Warrants were traded during that period. The Court was not provided with the VWAP calculation for the Common Shares and the Warrants for trading on April 3, 2006.

The MITSA

[31] The MITSA provided for the transfer from Stelco to EDS of responsibility for all of Stelco's IT needs. In this connection, 205 of Stelco's 212 IT employees were transferred to EDS. In addition Stelco sold to EDS the vast majority of the hardware, equipment, and other assets involved in the provision of Stelco's IT needs. The MITSA also contemplated a major overhaul of Stelco's legacy systems through the development and implementation of three new enterprise planning systems ("ERPs). The ERPs contemplated three projects: (i) a synchronous manufacturing system (the "SMS"), that was completed but not implemented due to concerns for the implementation risk; (ii) an asset management system for Stelco's plants at Hilton Works and Lake Erie; and (iii) a human resources, payroll and financial management system.

[32] The MITSA provided for payment of two types of fees. Operational fees, which were the significant majority of the fees, related to the operation and maintenance of the legacy systems

and the transition to the applications and infrastructure implementing the ERPs. Project fees related specifically to the costs of developing and implementing the ERPs. Total costs over the 10-year term of the MITSA were expected to be approximately $320 million. As Stelco required flat annual payments to EDS, the MITSA was structured to provide that Stelco would incur indebtedness in the early years of the relationship, when the fees payable by Stelco would exceed the flat payments, and would retire that indebtedness over the remaining life of the contract, when the flat payments would exceed the fees payable to EDS. Interest was payable on most, but not all, of the outstanding indebtedness in order to make the debt assignable by EDS, although this became impossible due to Stelco's deteriorating credit rate.

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[33] The outstanding indebtedness at the time of Stelco's filing under the CCAA constitutes the EDS Claim. Stelco treated the EDC Claim as long-term indebtedness for financial reporting purposes. Substantially all of this indebtedness was treated as representing project fees for the ERPs. This resulted from Stelco's accounting practice of allocating the flat payments made by Stelco against the operational fees. EDS, however, appears to have treated a substantial portion of the indebtedness as operational fees.

This Proceeding

Procedural Matters

[34] On March 7, 2006, Farley J. issued an order (the "Scheduling Order") setting out the procedure by which entitlement to the Turnover Proceeds would be resolved. The Scheduling Order, as supplemented, governs the current proceeding.

[35] Pursuant to that Order, the Claimants, on behalf of the Debentureholders, and 2074600 filed claims in respect of the Turnover Proceeds on March 17, 2006. Subsequently, the Noteholders filed a defence to these claims and the Claimants and 2074600 filed replies to that defence. In addition, the Claimants filed a dispute to the claims of 2074600 to which 2074600 also filed a response.

Issues

[36] There are eight separate issues in this proceeding as follows:

1. the Noteholders submit that the claims of the Debentureholders should be dismissed because the Debentureholders have failed to provide evidence that they held Debentures at the relevant times;
2. the Noteholders submit that the Subordination Provisions were cancelled on implementation of the Plan and, therefore, cannot be relied upon by the Senior Debt Holders;

3. the Noteholders submit that all debt, including the claims of the Debentureholders and 2074600, was extinguished on implementation of the Plan so there can be no Senior Debt for purposes of the Note Indenture;

4. the Noteholders submit that any claims of the Debentureholders and 2074600 in respect of the Subordination Provisions are limited to their claims as of the date of Stelco's filing under the CCAA and do not include any post-filing interest;

5. the Noteholders submit that the Claimants are not parties to the Note Indenture and therefore cannot enforce its terms;

6. the Noteholders submit that there is no evidence that any of the Debentureholders or 2074600 suffered any deficiency on account of any Debentures held by them at the applicable time or the EDS Claim, as applicable, by virtue of the value of the Distributions received by each of them under the Plan;

7. 2074600 submits that the EDS Claim is Senior Debt; and

8. the Noteholders argue that, to the extent that 2074600 is otherwise entitled to the benefit of the Subordination Provisions as Senior Debt, it has failed to mitigate its damages.

The Debentureholders and 2074600 oppose the positions of the Noteholders in items 1 to 6 inclusive above. The Debentureholders and the Noteholders oppose the position of 2074600 in item 7.

I will discuss each of these issues in turn.

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Analysis and Conclusions

Requirement for Proof of Holdings of Debentureholders

[37] The Noteholders accept that the Claimants have been duly authorized to pursue the claims asserted by them in this proceeding on behalf of all Debentureholders. However, they argue that the claims of the Debentureholders should be dismissed because they have not introduced evidence regarding the holdings of individual Debentureholders on and after March 31, 2006 and the extent of their individual deficiency claims.

[38] I do not accept this submission for two reasons.

[39] First, as a procedural matter, I am satisfied that, by virtue of the inherent jurisdiction of the Court under the Plan and the CCAA as well as the specific procedural provisions of the Scheduling Order, the Court has the authority to convene a second hearing in this proceeding if it determines that further issues must be addressed to determine the quantum of the deficiency claims of any or all of the Debentureholders. In this connection, I note that the Court of Appeal

upheld the Scheduling Order on the basis that the jurisdiction of this Court over the CCAA restructuring process extends at least to continued process-related matters concerning the rollout of the Plan in accordance with its provisions.

[40] Pursuant to this authority, I indicated in my earlier Endorsement dated July 18, 2006 that the hearing this week is being treated as a motion for a declaration as to certain matters of law within the proceeding established by the Scheduling Order. If the Court's determination with respect to these issues does not constitute a final determination of the claims of the Debentureholders, the claims of the Debentureholders can be determined at a trial of the remaining factual issues.

[41] Second, and more substantively, for the reasons addressed below under "Approach to the Determination of the Extent of the Deficiency Claims of the Senior Debt Holders", I have concluded that any deficiencies of the Debentureholders should be addressed on a collective rather than an individual basis. Accordingly, given the other determinations in these Reasons, there is no need for a further hearing by the Court to determine the deficiency claims of the Debentureholders except to the limited extent addressed below.

Survival of the Subordination Provisions

[42] The provisions of section 6.01(2) of the Plan are a complete answer to the Noteholders' submission that the Subordination Provisions were terminated on the Plan Implementation Date. Section 6.01(2) could have been drafted to express this purpose more directly. However, the only reasonable interpretation of section 6.01(2) is that the substantive rights and obligations of the Senior Debt Holders and the Noteholders in respect of the Subordination Provisions are not affected in any manner by the implementation of the Plan.

[43] Conceptually, the result is that, while all of the provisions of the Note Indenture respecting the rights and obligations of Stelco and the Noteholders were extinguished on the Plan Implementation Date, the provisions of Part VI of the Note Indenture continue in full force insofar as they relate to the rights and obligations of the Senior Debt Holders vis-à-vis the Noteholders in respect of Distributions made on the Plan Implementation Date. This approach is consistent with both the provisions of the Plan and with the scope of the CCAA.

[44] With respect to the Plan, the Noteholders argue that the proper interpretation of section 6.01(2) is that it preserves the right to assert claims and defences but, as a substantive matter, it does not preserve the Subordination Provisions to the extent that they would otherwise be extinguished by the terms of the Plan on the Plan Implementation Date. I do not accept this position. The Noteholders do not suggest that this provision is susceptible of any other interpretation other than one that renders it meaningless. I agree with the Senior Debt Holders that, as a matter of contract law, the Court should strive to give effect to every provision in an extensively negotiated commercial document. I therefore conclude that the more reasonable interpretation of section 6.01(2) is that it preserves the substantive rights of the parties in respect of the Subordination Provisions.

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[45] The Noteholders also rely on the clause "subject to the operation of law" in the last sentence of subsection 6.01(2) of the Plan. However, that clause is preceded by a statement that the last sentence is not intended to limit the generality of the rest of the provision. Absent an express indication that the clause was intended to render meaningless the rest of the provision, I conclude the reference to the operation of law was not intended to extend to the extinguishment of the rights and obligations of the parties in respect of the Subordination Provisions.

[46] The Noteholders' position is essentially that it is not possible for Part VI of the Note Indenture to continue as an enforceable set of rights and obligations if the Note Indenture is otherwise extinguished. I do not think that this is necessarily so. To the extent that Part VI addresses rights and obligations of third parties that are enforceable by those parties, which is addressed below, there is no legal reason why these provisions cannot survive in full force and effect even if the remaining provisions of the Note Indenture are extinguished. Nor do I think that it is appropriate to characterize this result as rewriting the contract, as the Noteholders argue.

[47] With respect to the CCAA, it is clear that the CCAA does not purport to affect rights as between creditors to the extent they do not directly involve the debtor. Farley J. confirmed this principle in his Endorsement dated November 9, 2005 at paragraph [7]. To succeed, the Noteholders must demonstrate clear and unambiguous language in the Plan evidencing an agreement to extinguish such rights. Subsection 6.01(2) of the Plan does not satisfy that requirement.

[48] Based on the foregoing, I have therefore concluded that the Subordination Provisions were not extinguished on the implementation of the Plan.

[49] The Senior Debt Holders go further and argue that the issue of the survival of the Subordination Provisions is *res judicata* in light of the above-mentioned Endorsement of Farley J. and the decision of the Court of Appeal dated November 14, 2005 upholding his decision. Given my determination of this issue it may be unnecessary to address this argument.

[50] However, if it becomes relevant, I believe that the decision of Farley J. is limited to the principle set out above that, in the absence of any provision expressly extinguishing the Subordination Provisions in the Proposed Plan, neither the provisions of the CCAA nor the Proposed Plan would operate to extinguish the Subordination Provisions if the Proposed Plan were implemented. As there are no material differences between the Proposed Plan and the Plan that are relevant to this issue, apart from section 6.01(2), that principle also applies *prima facie* in the interpretation of the Plan in this proceeding. However, because the Proposed Plan did not include section 6.01(2) of the Plan, the decision of Farley J. did not address the legal effect of that provision with the result that the issue of the interpretation of section 6.01(2) is not technically *res judicata*.

[51] I should note that I also think it is clear that Farley J. did not determine the further issue of whether the Subordination Provisions were enforceable by the Senior Debt Holders. While he alludes to this issue in paragraphs [3] and [4] of his Endorsement, he does not express a

conclusion as to whether the Subordination Provisions are enforceable in the particular circumstances of this CCAA proceeding.

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Survival of the Senior Debt Holders' Claims

[52] As a related matter, the Noteholders also argue that, because the Plan extinguished the Senior Debt on the Plan Implementation Date, there is no longer any Senior Debt to which the Subordination Provisions apply. I do not accept this interpretation of the operation of the Subordination Provisions in respect of the Plan for the following reasons.

[53] First, this interpretation of the effect of the Plan robs section 6.2 of the Note Indenture of any meaning in the very circumstances in which it was intended to apply, as evidenced by the reference in the introductory clause to "insolvency or bankruptcy proceedings, or any in reorganization or similar proceedings relative to [Stelco]". For this reason alone, I would conclude that the parties to the Note Indenture cannot have intended the Subordination Provisions to operate in this manner.

[54] Second, I do not think this position is correct based on the language of section 6.2 of the Note Indenture. Subsections 6.2(1) and (2) require that a determination of whether the Senior Debt Holders continue to have outstanding claims shall be made concurrently with any particular payment or distribution to the Noteholders. If the Senior Debt Holders have outstanding claims, the Subordination Provisions operate with respect to such payment or distribution. The extinguishment of the outstanding claims of the Senior Debt Holders cannot affect the operation of the Subordination Provisions in respect of the particular payment or distribution that may be subject to those Provisions.

[55] Lastly, while I do not think it should be necessary to establish, as a technical matter, that the Senior Debt had not been extinguished at the precise moment at which the Distributions were received by the Noteholders, I think it is possible do so based on the sequencing of the transactions set out in section 5.04 of the Plan. Section 5.04 sets out an order in which the events described therein occur, including the separate distribution of each of the securities comprising the Distributions. Because the Senior Debt Holders' claims can only be extinguished after payment of all of the property comprising the Distributions in accordance with the Plan, I conclude that, notwithstanding the language of section 2.03 of the Plan, their claims were not extinguished until all of these transactions were completed and that the Distributions were completed immediately prior to such time.

Post-Filing Interest Claims

[56] The claim of the Senior Debt Holders in respect of post-filing interest involves two issues:

1. whether interest continues to accrue in respect of the claims of the Senior Debt Holders against Stelco notwithstanding Stelco's filing under the CCAA?

2. whether the Subordination Provisions extend to post-filing interest?

I will address the position of the Debentureholders and of 2074600 separately.

Post-Filing Interest Claims of the Debentureholders

[57] I am satisfied that interest continues to accrue on the Debentures after the Filing Date up to and including the Plan Implementation Date even though it was not payable by Stelco under the Initial Order. A filing by a debtor under the CCAA does not, as a matter of law, automatically terminate, or even suspend, the accrual of interest on its outstanding indebtedness. Suspension of the obligation of the debtor to pay interest is entirely based on the terms of any stay order issued by this Court in respect of the CCAA proceedings.

[58] There is no authority to the contrary apart from the decision in *Air Canada (Re)*, Decision of Claims Officer Stockwood, dated August 4, 2004. I think that the decision is incorrect and, in any event, is not binding on this Court. On the other hand, there is authority in support of the position that post-filing interest continues to accrue after a CCAA filing in the statement of Binnie J. in *Canada 3000 Inc., Re; Inter-Canadian (1991) inc. (Trustee of)*, [2006] S.C.J. 24 at para. 96.

[59] The Noteholders argue that the "Interest Stops Rule", which applies in bankruptcy and winding-up proceedings, should also apply in respect of CCAA proceedings. I do not see why this should be the case. There may be circumstances, such as an increasing equity value of an entity in CCAA proceedings, that would justify inclusion of some or all post-filing interest in the claims of creditors in the plan of arrangement implemented at the end of the CCAA proceedings. There is no reason why creditors should be prevented from receiving satisfaction of such claims by imposition of the Interest Stops Rule.

[60] The Noteholders also rely on the definition of "claim" in section 12 of the CCAA as "a debt provable in bankruptcy within the meaning of the [*Bankruptcy and Insolvency Act*]". They argue that, since a claim in bankruptcy includes interest only to the date of the assignment in bankruptcy, the Court should interpret the definition of "claim" in the CCAA analogously to limit interest claims to interest prior to the date of filing under the CCAA. I do not think this is a necessary implication of the definition of claim in the CCAA, which has meaning principally in the context of voting provisions.

[61] The last argument of the Noteholders is that the Debenture Indentures are not sufficiently explicit that interest continues to accrue after the institution of insolvency proceedings. I do not agree. I am satisfied that the provisions of the Debenture Indentures that provide that interest is payable after default are sufficient to continue the accrual of interest after the commencement of insolvency proceedings and imposition of a stay. The Noteholders point to more explicit wording in certain securities referred to in the *Air Canada* decision at page 33. However, the language to which they refer does not relate to the payment of interest but rather to the operation of subordination provisions. In that context, such language is not essential if the subordination

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provisions do not otherwise exclude the accrual of interest, although it is helpful in confirming the fact that the parties directly addressed the issue.

[62] With respect to the second question, the critical fact, as discussed above, is that the Subordination Provisions continue to operate independently of the Plan and are not affected by implementation of the Plan. Section 6.01(2) specifically preserves the rights of the Senior Debt Holders in respect of post-filing interest. While it also preserves any defences of the Noteholders, they assert none that are not based on the operation of the Plan. Accordingly, I conclude that the Subordination Provisions also extend to post-filing interest.

[63] I agree with the Senior Debt Holders that the legal result is analogous to the treatment of guarantees of entities that have filed under the CCAA. As illustrated in *Guardian Trust Co. v. Gaglardi* (1989), 64 D.L.R. (4th) 351 at 361, interest continues to accrue post-filing in respect of the obligation of a guarantor even if a stay is imposed under the CCAA in respect of the obligation of the debtor. In that situation, as in the present circumstances, the result flows from the existence of an independent contract or document between parties other than the debtor and the absence of language that excludes the accrual of post-filing interest.

[64] On the basis of the foregoing, I conclude that the holders of the Debentures are entitled to the benefit of the Subordination Provisions in respect of post-filing interest.

Post-Filing Interest Claims of 2074600

[65] As a holder of Senior Debt, 2074600 would also be entitled to the benefit of the Subordination Provisions in respect of post-filing interest if it could establish that interest had continued to accrue, as between EDS and Stelco. The Debentureholders and the Noteholders argue that the claim of 2074600 for post-filing interest was, however, extinguished by the provisions of a term sheet dated November 14, 2005 between EDS and Stelco (the "Term Sheet") immediately prior to the assignment of the EDS Claim to 2074600.

[66] In section 2(g) of the Term Sheet, EDS and Stelco agreed that the EDS claim in the CCAA proceeding would be $48,944,917 and specifically agreed that interest could not accrue after that date. 2074600 argues that the inference to be drawn from this provision is that nothing in the Term Sheet extinguished the accrual of interest prior to that date in respect of the EDS Claim. However, section 1 of the Term Sheet constitutes, among other things, an absolute release of all claims of EDS against Stelco as of November 14, 2005. There is nothing in section 2(g) that preserves any claim of EDS for interest accrued prior to that date.

[67] Accordingly, I conclude that the effect of the Term Sheet is to extinguish the obligation of Stelco to pay post-filing interest on the EDS Claim.

Enforceability of the Subordination Provisions by the Senior Debt Holders

[68] The Senior Debt Holders assert (1) that they are entitled to enforce the Subordination Provisions directly as third party beneficiaries and (2) that they are beneficiaries under a trust of

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the Turnover Proceeds established under subsection 6.2(3) of the Note Indenture. I will discuss each submission in turn.

Application of Third Party Beneficiary Rule

[69] The Debentureholders (through the Claimants) and 2074600 seek to enforce the covenants of the Noteholders in favour of Stelco in section 6.1 and subsections 6.2(1) and (2) of the Note Indenture as third party beneficiaries by virtue of their status as Senior Debt Holders. The Noteholders submit that the Senior Debt Holders cannot enforce the Subordination Provisions on their own. I will address the two arguments of the Noteholders on this issue in turn.

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[70] First, the Noteholders say that the Senior Debt Holders cannot enforce the covenants of the Noteholders in favour of Stelco in section 6.1 and subsections 6.2(1) and (2) of the Note Indenture because they are not parties to the Note Indenture. The Debentureholders and 2074600 argue that they are entitled to enforce the covenants on the basis of the principles articulated in *London Drugs Ltd. v. Kuehne & Nagel International Ltd.*, [1992] 3 S.C.R. 299 and *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*, [1999] 3 S.C.R. 108. The Noteholders say that the limited relaxation of the privity of contract rule permitted in these decisions does not extend to assertion of claims as a plaintiff but is limited to assertion of defences as a defendant in any action. In support of this position, they point to dicta in two recent British Columbia decisions: *Kitimat (District) v. Alcan, Inc.*, [2005] B.C.J. No. 58 and *R.D.A. Film Distribution Inc. v. British Columbia Trade Development Corp.*, [2000] B.C.J. No. 2550. On the basis of these decisions, they argue that the Senior Debt Holders can only enforce the covenants of the Note Indenture if Stelco had constituted itself a trustee of these covenants in favour of the Senior Debt Holders.

[71] I do not agree with the Noteholders for the following reasons.

[72] First, I am satisfied that the two-part test set out by Iacobucci J. at para. 32 in *Fraser River* is satisfied. There is no question that the benefit of the provisions extends to the Senior Debt Holders. Unlike the situations presented in *London Drugs* and *Fraser River*, the Senior Debt Holders are the only parties who benefit from these provisions. The second part of the test is satisfied insofar as the actions of the Debentureholders and 2074600 are limited to enforcing the covenants made in favour of Stelco that are intended to ensure that the Senior Debt Holders receive the benefit of the Subordination Provisions. In addition, because the policy concerns of multiplicity of actions and double recovery do not present themselves in the present action, there is no principled reason to refuse to extend the principle in *London Drugs* to the present action.

[73] The Noteholders' second argument is that the limited relaxation of the doctrine of privity of contract in *London Drugs* and *Fraser River* is limited to use by a third party beneficiary as a shield to defend an action rather than as a sword to initiate one. They rely on dicta of Ehrcke J. in *Kitimat* at para. 65 and of Newbury J.A. in *R.D.A. Film Distribution* at paras. 67 and 68 in

support of this position. The Debentureholders argue that the Noteholders are the real plaintiffs in this proceeding.

[74] I do not think it is possible, as the Debentureholders argue, to characterize their claims as a shield to prevent appropriation of assets by the Noteholders to which they are not entitled. While the circumstances of a debtor not enforcing subordination provisions directly may be novel, there is no question that the onus in this proceeding rests with the Debentureholders to establish that they are entitled to enforce the Subordination Provisions. However, there is a more fundamental reason why the decisions relied upon by the Noteholders are not applicable in the present circumstances.

[75] The conclusion of Ehrcke J., which is the clearer of the two statements relied upon by the Noteholders, is a deduction from the more general statement of Iaccobucci J. in *Fraser River* at para. 44 that the exception should be applied in an "incremental" manner. It is clear from that decision that the fundamental consideration in the determination of whether, in any particular circumstance, relaxation of the doctrine of privity can be characterized as "incremental" is the potential for double recovery and multiplicity of actions. I would note that these concerns were present in both *Kitimat* and *R.D.A. Film Distribution*. In the present proceeding where such concerns are not present, I believe the principle in *Fraser River* contemplates extension of the third party beneficiary principle regardless of whether it is being used as a shield or a sword.

[76] Accordingly, I conclude that, in the absence of enforcement by Stelco, the Senior Debt Holders are entitled to enforce section 6.1 and subsections 6.2(1) and (2) of the Note Indenture directly as third party beneficiaries.

Alleged Existence of Trust

[77] The Senior Debt Holders also submit that they are the beneficiaries of a trust of the Turnover Proceeds established in their favour in subsection 6.2(3) of the Note Indenture. The Noteholders make two arguments in denying that the holders of Senior Debt are entitled to rely on the trust language expressed in section 6.2(3).

[78] First, they say that this provision is remedial and, as such, is only enforceable to the extent that the Senior Debt Holders can enforce the provisions of section 6.1 and subsections 6.2(1) and (2) as a third party beneficiaries. Given the decision above, this requirement is satisfied. I am of the opinion in any event that the two issues are not related. In particular, a trust could be validly created in respect of property received by or on behalf of the Noteholders irrespective of whether the Senior Debt Holders were entitled to enforce these covenants of the Note Indenture as third party beneficiaries.

[79] In addition, the Noteholders argue that the pre-conditions to the establishment of a trust have not been satisfied. In particular they say that there has been no receipt of trust property by the Noteholders because the Distributions have been paid to the Monitor in accordance with the paragraph 6.01(2)(a) of the Plan. This is an argument of form over substance. The Monitor has no interest in the Distributions. For the purpose of this proceeding, payment to the Monitor

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satisfies the requirement of delivery of the corpus of the trust to the Noteholders. The only other possibility - that the Distributions were paid to the Senior Debt Holders - is, of course, denied by the Noteholders and would render consideration of this issue unnecessary.

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[80] In the course of oral argument, a third issue was raised – the revocability of the trust by the Noteholders, as trustees, without the consent of the Debentureholders, as beneficiaries. I conclude, however, that the possibility of revocation in these circumstances should not displace the existence of the trust for the following reasons. First, there is no question that the "three certainties" necessary to establish the existence of a trust have been demonstrated. Second, revocation of the trust was more a theoretical than a real possibility. The Noteholders could only revoke the trust with the consent of Stelco, as the other party to the Note Indenture. There was no realistic possibility that Stelco would have consented while Senior Debt was outstanding. In addition, if it had done so, there remains the possibility that the Debentureholders would have had a right to prevent the revocation based on principles of reliance or other applicable law.

[81] Accordingly, I conclude that the Senior Debt Holders are also entitled to the benefit of a trust of the Turnover Proceeds established in their favour pursuant to section 6.2(3) of the Note Indenture.

Approach to the Determination of the Extent of the Deficiency Claims of the Senior Debt Holders

[82] The most difficult issue for this proceeding is the approach to valuing the Distributions for purposes of determining the extent, if any, of the entitlement of the Senior Debt Holders to the Turnover Proceeds pursuant to the Subordination Provisions.

[83] The patires have suggested three different approaches. 2074600 argues that the Distributions should be valued as of the date of the Sanction Order. The Debentureholders argue that the Distributions should be valued as of the Plan Implementation Date. Both of these parties submit, however, that the Common Shares and the Warrants should be valued using the $5.50 subscription price for the Common Shares under the Plan, resulting in a modest value for the Warrants using the Black-Scholes model valuation. The Noteholders argue that the Court should use actual recoveries during the week of April 3, 2006, to the extent Senior Debt Holders sold any FRNs, Common Shares or Warrants during that period, and the volume weighted average sale price ("VWAP") for the week for any such securities held by the Debentureholders at the end of the week. The approach of the Debentureholders and 2074600 would calculate any deficiencies of the Senior Debt Holders on an aggregate basis. By contrast, the Noteholders argue that the deficiencies of the Senior Debt Holders must be calculated on an individual basis.

[84] There are, therefore, four interrelated issues to be addressed in determining this issue:

1. whether any deficiencies of the Senior Debt Holders are to be claimed collectively or individually;

2. whether deficiencies of the Senior Debt Holders should be valued taking into account actual recoveries in respect of any securities sold by the Debentureholders after the Plan Implementation Date;

3. the appropriate date or dates for valuing the Distributions received by the Senior Debt Holders; and

4. the appropriate value of the Common Shares, Warrants and FRN's received by the Senior Debt Holders, to the extent that recoveries are not to be taken into account in such determination.

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[85] The point of commencement for these questions is the principle of subordination set out in subsection 6.2(1) of the Note Indenture, which provides that "the holders of all Senior Debt will first be entitled to receive payment in full of [their claims] before the [Noteholders] will be entitled to receive any payment or distribution of any kind or character, whether in cash, property or securities, which may be payable or deliverable in any such event in respect of any of the [Notes]". The resolution of each of the four issues must be consistent with the principles embodied in section 6.2(1). I will address each issue in turn.

Are Deficiencies to be Claimed Collectively or Individually?

[86] The approach of the Noteholders requires the Court to approach the determination of the deficiency claims of the Debentureholders on an individual basis. As mentioned above, the Noteholders go further and submit that the failure of the Claimants to provide evidence of the actual deficiency claims of each of the Debentureholders is a fatal defect that should result in dismissal of their claims.

[87] I do not accept either of these propositions.

[88] The claims of the Debentureholders are based on the Subordination Provisions. While each claim for a deficiency is ultimately an individual claim, the Note Indenture generally, and section 6.2(1) thereof in particular, clearly contemplates treatment of these claims on a collective basis. In the ordinary course, the trustees under the Debenture Indentures (the "Trustees") would enforce the Subordination Provisions on behalf of all Debentureholders against Stelco in respect of all payments to Noteholders, whether cash or securities, in contravention of those Provisions. Any payments owing by the Noteholders would be paid to the Trustees for distribution *pro rata* among the Debentureholders. I do not believe that either the involvement of the Claimants or the disproportionate deficiency claims resulting from the exercise of the Share Election by Debentureholders changes the process for enforcement of the Subordination Provisions.

[89] The Claimants are duly authorized by special resolutions of the holders of each of the 10.4% Debentures and 8% Debentures. The substitution of the Claimants for the Trustees as representatives of the Debentureholders does not affect the authority of the duly authorized representatives to enforce the claims of the Debentureholders collectively.

[90] The fact that the claims of the individual Debentureholders will not be proportionate to their holdings of Debentures because of differing exercise of the Share Election by Debentureholders also does not affect the enforcement process in respect of their claims pursuant to the Subordination Provisions. The Noteholders have not argued that the differing exercise of the Share Election on its own requires, as a matter of law, that the Debentureholder claims that would otherwise be pursued collectively must now be pursued individually. In addition, I do not think that there are any practical difficulties in the determination of, or payment in respect of, the deficiency claims of individual Debentureholders that require that the claims be pursued individually.

[91] The aggregate deficiency claims of the Debentureholders can be determined by a comparison of the aggregate value of their claims on the Plan Implementation Date with the aggregate value of the Distributions actually received by the Debentureholders, collectively, after the exercise of the Share Election. If there is a deficiency, the Noteholders are required to deliver Turnover Proceeds having an aggregate value equal to the aggregate amount of the deficiency claims of the Debentureholders, *pro rata* according to their holdings of Notes. The parties are agreed that this would proceed by payment of a percentage of each category of the Turnover Proceeds equal to the percentage that the aggregate deficiency claim of the Senior Debt Holders represents of the total value of the Turnover Proceeds. Such delivery will satisfy the Noteholders' obligations under the Subordination Provisions. Determination of the entitlement of individual Debentureholders to those Proceeds is entirely a mechanical exercise to be conducted outside of this proceeding by the Trustees, who have the responsibility of allocating the Turnover Proceeds, or the cash proceeds thereof if sold by the Trustees, to the Debentureholders *pro rata* in accordance with their respective deficiencies. As a practical matter, there is nothing in this process that requires that the individual deficiency claims of the Debentureholders be established in this proceeding if the aggregate deficiency claims of the Debentureholders are ascertainable.

[92] I would note, as well, that the Noteholders' position on this issue is closely related to, but distinct from, their position that actual recoveries of the individual Debentureholders must be taken into consideration in the determination of the aggregate deficiency claims of the Debentureholders. This issue is addressed further below.

Are Recoveries to be Considered in the Determination of Debentureholder Deficiencies?

What is the Appropriate Date for Valuing the Distributions?

[93] As these two issues are closely related, I propose to deal with them in the same section.

[94] The Noteholders submit that the determination of the value of the Distributions received by the Senior Debt Holders should take into account the actual recoveries of individual Debentureholders who sold securities in the market after the Plan Implementation Date.

[95] I do not think, however, that the "actual recoveries" approach of the Noteholders is consistent with the principles embodied in section 6.2(1) of the Note Indenture. The Note Indenture does not expressly provide any mechanism for valuing securities or other property

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received in payment of Senior Debt claims. In these circumstances, I think it necessarily follows that:

1. the valuation must be made as of the time the Noteholders became legally entitled to the Distributions, which was the Plan Implementation Date; and

2. the valuation must be determined independently of any actual recoveries by Senior Debt Holders arising from subsequent sales transactions.

I will address each issue in turn.

[96] First, I reach the conclusion that the valuation must be made as of the time the Noteholders became legally entitled to the Distributions for the following reasons. Most importantly, the language of section 6.2(1) specifically refers to deferral of the entitlement of the Noteholders to receive any distribution otherwise payable or deliverable to them until the Senior Debt Holders shall have received payment in full of their claims. The reference to "payment in full" requires a valuation of any payment, including property, made to the Senior Debt Holders at or before at the time of receipt of any payment made to the Noteholders. There is no authority in section 6.2(1) for deferring the date as of which the value of any such payment to the Senior Debt Holders shall be determined beyond the time of receipt of the particular payment to the Noteholders. In this proceeding, the time of receipt is also the time at which the Noteholders became legally entitled to the Distributions, being the Plan Implementation Date, and the concepts are used interchangeably except where expressly indicated to the contrary.

[97] Second, the case law in this area, while dealing with a number of different circumstances, does exhibit a presumption that, absent special circumstances, securities will be valued as of the date on which a party becomes legally entitled to them. In the present circumstances, the Senior Debt Holders became entitled to the Distributions paid to them on the Plan Implementation Date. Accordingly, in order to succeed in their argument, the Noteholders must demonstrate an intention to displace this presumption in the provisions of the Note Indenture. They have failed to do so.

[98] Third, in circumstances where the valuation exercise relates to a receipt of publicly-traded securities, rather than a compulsory sale, the valuation exercise should proceed as of the date of receipt, or as nearly as possible to the date of receipt, to reflect the fact that the recipients are in a position to realize the value of the securities in the market on that date if they so decide, subject, of course, to issues related to their ability to obtain the market price of the shares.

[99] Fourthly, it must be presumed that the parties would not have intended to place any undue risk upon the Noteholders. In particular, I do not think that the parties to the Note Indenture would have intended at the date of its execution to provide for a deferral of the date as of which a valuation is to be made to provide greater certainty of the quantum of the claims of the Senior Debt Holders. Despite the actual trading experience, such an approach was at least as

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likely to increase the quantum of such deficiency claims and thereby increase the loss of the Noteholders.

[100] Lastly, implementation of the approach of the Noteholders requires resolution of a number of issues for which there is no legal standard in the Note Indenture. For example, any determination of value based on actual recoveries requires a decision as to which sales will be considered and which will not. The Noteholders choose all sales during the first trading week after the Plan Implementation Date. There is, however, no principle based in the Note Indenture that justifies selection of this period rather than any shorter or longer period. There is also no presumption in the case law from which it can be inferred that the parties intended such an approach. Appeals to general considerations of fairness also fail. What the Noteholders regard as fair the Senior Debt Holders regard as unfair, given the fluctuations in market prices.

[101] More fundamentally, the absence of any applicable legal standard in the Note Indenture is a strong indication that, in substance, the Court is being asked by the Noteholders to rewrite the Subordination Provisions rather than to interpret the intentions of the parties to the Note Indenture with respect to these Provisions. It is being asked to impose a regime that is not contemplated in any manner by the Note Indenture. In the absence of a clear indication that the parties to the Note Indenture intended such a regime, or provided broad authority to this Court to impose a valuation regime, I do not think the Court should engage in such an exercise.

[102] A separate but related issue is the submission of 2074600 that the proper date for valuation should be the date of the Sanction Order on the basis that, in its view, the Senior Debt Holders became legally entitled to the Distributions to be paid to them as of that date. This argument is also rejected for the following reasons in addition to the reasons set out above.

[103] First, as a matter of law, I do not think that the Senior Debt Holders were legally entitled to the Distributions as of the date of the Sanction Order. Implementation of the Plan was subject to satisfaction of a considerable number of conditions set out in section 5.03 of the Plan. There was no certainty that these conditions would be satisfied. There was therefore no legal entitlement to the Distributions until the Plan Implementation Date. Until that time, the Senior Debt Holders had only a conditional right to receive the securities.

[104] Second, in any event, section 6.02(1) mandates a determination of the value of any payments received by the Senior Debt Holders as of the date of receipt of the Distributions by the Noteholders. As mentioned, this determination must be made as of the date that the Senior Debt Holders are in a position to sell any securities received by them. Otherwise, the Senior Debt Holders would bear the risk of a decline in value prior to the date of receipt of the securities. There is no evidence of any market for the securities included in the Distributions prior to the Plan Implementation Date. Accordingly, even if the Senior Debt Holders had become legally entitled to receive the Distributions as of the date of the Sanction Order, the determination of the amount or value of the payment could only be made as of the Plan Implementation Date because the payment of the Distributions did not occur until that date.

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Valuation of the Distributions to the Senior Debt Holders

[105] The issue for the Court can therefore be put simply: did the Senior Debt Holders receive Distributions on the Plan Implementation Date having a value that constituted "payment in full" of their claims and, if not, what is the extent of their deficiency? For this purpose, the Court must determine the value of the payments received by the Senior Debt Holders. For the reasons set out above, I have concluded that the payments were received by the Senior Debt Holders at the Effective Time on March 31, 2005 and must be valued as of that time. There is, however, no provision in either the Note Indenture or the Plan that specifically addresses the proper approach to the valuations of the property received in reorganization. Accordingly, the issue for the Court is the most appropriate evidence of the value of the Distributions received by the Senior Debt Holders on March 31, 2006.

[106] The Court is not, of course, to conduct its own inquiry into the value of the securities. The Court must determine, instead, the best evidence of the value of the Distributions based on the evidence before it. For this purpose, I am of the opinion that "value" means the price for the securities that the Senior Debt Holders could have received if they had sold their securities in an open market at the Effective Time on March 31, 2006. This reflects the fact that, at that time, the Senior Debt Holders were in a position to realize the value of the securities paid to them by selling them in the market. Accordingly, the Court must determine the market price for the securities at the Effective Time. For this purpose, therefore, "value" does not mean the "fair market value", the "fair value" or the "intrinsic value", if those terms mean something other than the price of the securities in an open market. In particular, the issue is not whether the Senior Debt Holders received fair value, but rather what value should be ascribed to the Distributions received by the Senior Debt Holders. I would observe that this is not an exercise in the determination of the fair market value of securities pursuant to a statutory right provided to minority shareholders and, accordingly, the case law that has developed dealing with such valuations is not helpful in the present proceeding.

[107] For the reasons set out above, I have rejected the approach proposed by the Noteholders that would use actual recoveries during the first week of trading and the VWAP for securities retained after the first week. The alternative argument of the Noteholders is that the securities should nevertheless be valued on the basis of market prices for the securities, disregarding recoveries. They propose using either the VWAP for the entire week or the VWAP for the first day of trading in each of the securities, although the Noteholders argued the latter with less enthusiasm. I will address the appropriateness of the use of VWAP data for the first trading week before considering the merits of the two approaches to value before the Court.

Appropriateness of Determination of Value Based on Trading Data for the First Week of Trading

[108] I do not think that the VWAP data for the first week of trading in the securities is an appropriate reflection of the value of the securities on March 31, 2005 for three reasons.

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[109] First, there is no principled basis for establishing a trading period exceeding the day closest to the date of receipt of the securities. I accept that, if there were market imperfections on the first day of trading that were eliminated in the course of the week, there could be a basis for such an approach. However, there is no evidence of any such imperfections. Nor are there any market considerations relating to trading in the following weeks, when apparently market prices fell, that would justify exclusion of such later period. In these circumstances, selection of trading for the week could legitimately be characterized as "averaging up" the market price even if that were not the intention.

[110] Second, there are no legal precedents brought to the attention of the Court for the Noteholders' approach to the determination of the value of publicly traded securities. There is, instead, a marked preference in the case law for selection of a single date as the date for determination of the value of publicly traded securities.

[111] Lastly, any such approach necessarily invites use of the actual recoveries of the Senior Debt Holders during the period, which has been rejected for the reasons set out above. The longer the period selected, the larger the amount of such recoveries and, correspondingly, the less the integrity of weighted average trading data for the period as the determinant of value of the securities received by the Senior Debt Holders.

[112] Accordingly, I have rejected the VWAP data for the first week of trading of the Common Shares as the determinant of the value of those shares. I have, however, considered the volume weighted average price of trading in the securities on the first trading day after the Plan Implementation Date. In the case of the Common Shares and Warrants, the first trading day was April 3, 2006. In the case of the FRNs, the first trading day on the TSE was April 5, 2006 although, as addressed below, it may be that the FRNs traded in the over-the-counter market as early as April 3, 2006.

<u>Preliminary Issues Regarding the Position of the Senior Debt Holders</u>

[113] I will deal next with two arguments of the Debentureholders and 2074600 that, if accepted, would dispose entirely of the issue of the determination of value.

[114] First, the Debentureholders and 2074600 argue that, in his Endorsement dated January 20, 2006 approving the Plan, Farley J. approved the $5.50 value of the Common Shares as fair and reasonable for all purposes relating to the Plan, including the operation of the Subordination Provisions. I do not think that this is a correct reading of the decision of Farley J.

[115] Reading the reasons of Farley J. in their entirety, it is clear that the issue before Farley J. relating to value was whether the Plan was unfair to the holders of equity in Stelco at that time because their common shares had value. This is clear from paragraph [37] of the Endorsement, which sets out his only finding relative to value:

> The end result is that given the above analysis, I have no hesitation in concluding that it would be preferable to rely upon the analysis of UBS, BMO Nesbitt Burns

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> and Ernst & Young Orenda, both as to their direct views as to the enterprise value of existing Stelco and as to their criticism of the Navigant and MBR reports concerning Stelco. Therefore, I conclude that the existing shareholders cannot lay claim to there being any existing equity value....

On the basis of a number of factors including the valuations before the Court and the history of negotiations regarding the Plan, Farley J. found that the enterprise value of Stelco was not sufficient to attribute any value to the existing common shares. His conclusion in this paragraph does not, however, constitute a determination of the actual enterprise value of Stelco from which a finding as to the value of the Common Shares could be inferred, nor is there such a finding elsewhere in his Endorsement. He also made no separate finding regarding the fairness of the subscription price of $5.50 per Common Share. I would add that the Endorsement also does not address any issues relating to the Subordination Provisions.

[116] Second, the Debentureholders argue that the transactions effected on the Plan Implementation Date evidence a real market for the Common Shares on that date in which shares were effectively traded at $5.50 per Common Share. The transactions to which they refer are: (1) the equity subscriptions under the Plan by TML, Sunrise and Appaloosa; (2) the exercise of the Share Election by Affected Creditors; and (3) the issue and allotment of Common Shares and Warrants to purchase Common Shares to the new president of Stelco at a subscription price, and a strike price, of $5.50 per Common Share.

[117] I also do not accept the submission that an open market for the Common Shares existed on the Plan Implementation Date from which the Court can conclude that the value of the Common Shares was $5.50. None of the transactions to which the Senior Debt Holders refer were entered into on the Plan Implementation Date. The equity subscriptions by TML, Sunrise and Appaloosa were agreed to prior to the meetings of the stakeholders to approve the Plan held on December 9, 2005. The subscription price for the Share Election had also been agreed by that time and the actual elections by individual Debentureholders were made well in advance of the Plan Implementation Date. Similarly, the issue price of the Common Shares, and the strike price of the warrants to purchase additional Common Shares that were issued to the new president of Stelco, were the result of negotiations that began in January and were completed well before the Plan Implementation Date. Completion of these transactions on the Plan Implementation Date is insufficient to establish the existence of a market for the Common Shares and Warrants of Stelco on that date. The Debentureholders must demonstrate sales of these securities or the FRNs, as applicable, by the recipients of these securities in these transactions, including the Affected Creditors, to establish the existence of a market on March 31, 2006. There is no such evidence.

Alternative Approaches to Determination of the Value of the Securities

[118] There are therefore two alternatives before the Court proposed by the parties as the best evidence of the value of the securities received by the Senior Debt Holders on the Plan Implementation Date. The Debentureholders and 2074600 say that the most appropriate evidence

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of the value of the Common Shares and Warrants is the subscription price of $5.50 per Common Share used in respect of subscriptions for Common Shares under the Plan. They also suggest that the FRNs should be valued at their face value. The Noteholders argue that the market prices of these securities are the best indications of the actual value of the securities even though the trading took place after the Plan Implementation Date. As mentioned, I have limited consideration of this approach to a valuation of the securities based on the market prices on the first trading after the Plan Implementation Date for each of the securities.

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[119] Neither approach is entirely satisfactory. I will state my concerns with each before setting out my conclusions.

Approach of the Senior Debt Holders

[120] Under the Plan, Common Shares were issued to the equity investors and Affected Creditors who exercised the Share Election at a subscription price of $5.50 per share. This implied an enterprise value of Stelco of $816.6 million. The Debentureholders and 2074600 argue that the Common Shares should be valued at $5.50 because this is the only value established for the Common Shares on and prior to March 31, 2006.

[121] In support of this position, they submit that this price was the outcome of negotiations among the major stakeholders in Stelco. They also point to the fact that this subscription price was used in respect of the transactions with the incoming president of Stelco and was determined to represent the fair market value of the Common Shares by the incoming board of directors of Stelco on March 31, 2006 for purposes of all issues of Common Shares on that date.

[122] In further support of their position, the Debentureholders and 2074600 rely upon the UBS, BMO and E&Y valuations, which Farley J. preferred to the Navigant valuation in approving the Plan. These valuations determined a range of enterprise values for Stelco based on a discounted cash flow approach using EBITDA projections for Stelco generated in late 2005. The BMO valuation included a second range based on a multiple of projected EBITDA reflecting BMO's estimate of appropriate multiples of EBITDA based on the market multiples of other publicly traded steel companies. As set out above, the ranges of enterprise value in these reports was as follows: UBS - $550 - $750 million; BMO - $580 - $780 million using a market multiple approach and $615 - $785 using a DCF approach; and E&Y - $635 - $785 million.

[123] In addition, the Debentureholders obtained a further dated June 19, 2006 from Deloitte & Touche LLP (the "Deloitte Report") that calculated the enterprise value of Stelco at March 31, 2006 to be in the range of $910 to $956 million resulting in a value per Common Share of $5.93 to $7.70 after deduction of Stelco's post-reorganization debt at that date of $755 million. Deloitte was not asked to determine its best estimate of the value of the securities at that date. Instead, it was specifically mandated to assume that $5.50 represented the fair market value of the Common Shares at January 20, 2006 and to approximate the fair market value of the Common Shares on the Plan Implementation Date by "reflecting the impact of the changes in

major value drivers" of that value, an exercise described as "rolling forward" the $5.50 value to March 31, 2006.

[124] I have four principal difficulties with the approach of the Debentureholders and 2074600.

[125] First, while the subscription price of $5.50 per Common Share was the result of protracted negotiations, I do not think the Court can rely on that fact alone as establishing the value that the Senior Debt Holders would have received on the Plan Implementation Date if they had been able to sell their shares in the open market on that date. Without an extensive analysis of the interests of each of the parties in the negotiations, as well as the history and dynamic of the negotiations, which is beyond the role and capability of the Court on the evidence before it in this proceeding, the Court cannot conclude that the outcome represented the value that the Common Shares would have obtained in the market at December 9, 2005, when the price was finalized, if it had been possible to sell the shares at that time. In any event, there is no way of establishing that the same negotiations conducted in March 2006 would have arrived at the same result. In fact, it is probable that developments since December 2005 would have resulted in a higher price, as indicated in the Deloitte Report, although it is not possible to say whether the difference would have been large or small.

[126] Second, the four valuations upon which the Debentureholders and 2074600 rely are estimates of the enterprise value of Stelco as a whole rather than of the market values of the Common Shares, the Warrants or the FRNs. While the estimates of enterprise value in the UBS, BMO and E&Y reports play an important role in the determination of the relative contributions to value of the various creditor groups, there is no suggestion in these valuations that they also address the value of the Common Shares in an open market on the Plan Implementation Date. The utility of these reports is further diminished by developments in the market and otherwise since December 2005. For these reasons, there is no direct relationship between the estimates of the enterprise value of Stelco in late 2005 and the market values of the Common Shares, Warrants and FRNs on or about the Plan Implementation Date.

[127] Third, there are also specific reservations identified by the Noteholders pertaining to each of the UBS, BMO and E&Y valuations. Among other things, each is based on information and projections that have been superceded. In addition, the BMO and UBS valuations are not based on the capital structure of the Plan as they pre-date it. More significantly, each is subject to limitations expressed in the valuations that limit their usefulness as an estimate of the value of the Common Shares.

[128] Fourth, there are a number of qualifications expressed in the Deloitte Report that limit its usefulness as a valuation of the Common Shares as of the Plan Implementation date.

[129] First, insofar as the Report does not review the validity of the $5.50 valuation as at January 20, 2006 but merely considers the extent to which developments since that date would impact value, it is difficult to assess the utility of its conclusions. In addition, the Report

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specifically states that it does not constitute a comprehensive valuation report as to the fair market value of the securities as of the Plan Implementation Date.

[130] Second, the author of the Report did not have access to the new management team at Stelco or full access to the prior management team. In addition, the most recent forecast made available to Deloitte was dated November 18, 2005, even though Stelco management has prepared more current forecasts. The Report also indicates that it was not possible to fully assess the credit risk of Stelco and the debt facilities without a current cash flow forecast. This casts doubt on the conclusion in the Report that the FRNs should be valued at their face value.

[131] Third, statements in the Deloitte Report suggest that it attempts to do more than is required or is appropriate for the issue before the Court in this proceeding. The Report uses a definition of fair market value that assumes, among other things, that the parties have full access to information about Stelco and its future prospects. It states that, in the view of its author, "it is doubtful that public market investors had sufficient knowledge of the new [Stelco] on which to make the kind of fully informed investment decision contemplated by the definition of fair market value". It also states that "the definition of fair market value contemplates a number of assumptions or valuation principles not applicable to actual market price."

[132] In the present proceeding, however, it is irrelevant that the market price of the securities may not reflect full information or that the market price of the securities may have exceeded the fair market value of the securities as determined by Deloitte based on an estimation of the enterprise value of Stelco. The issue for the Court is the determination of the prices that the Senior Debt Holders could have obtained for their securities if it had been possible to trade the securities at the Effective Time on the Plan Implementation Date.

[133] Lastly, while the Deloitte Report suggests that the valuation approach of the Noteholders based on the VWAP of the securities for the first trading week incorporates "elements of information, circumstances and future expectations that were not known or foreseeable at the [Plan Implementation Date]", the Report does not specify what these elements were. Nor is there any evidence before the Court of any such matters that should be considered in assessing the reliability of the market data. In addition, it does not reconcile its calculations of the fair market value of the Common Shares with the market prices of the Common Shares immediately after the Plan Implementation Date.

[134] On the other hand, I have three concerns with the approach of the Noteholders based on the use of the trading data before the Court.

[135] First, the data relates to a period after the Plan Implementation Date and is therefore being used with the benefit of hindsight. More significantly, the Court must be satisfied that there were no events between the Plan Implementation Date and the first day of trading in the securities that invalidates use of this data as evidence of value.

[136] Second, the market prices for the securities can only be used if the evidence demonstrates that the market was sufficiently deep to have absorbed all of the securities of the

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Senior Debt Holders without a reduction in price if they had chosen to sell their securities on the first trading day. If, in fact, Senior Debt Holders would have incurred a significant discount if they had sold rather than retained their securities on that day, the Court cannot use the market prices as evidence of the value of the securities. The materials before the Court indicate that this was not considered by the expert engaged by the Noteholders whose report was provided to the Court. However, I think the onus of demonstrating that the market was not a reliable indication of value rests with the Senior Debt Holders.

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[137] Third, the evidence with respect to the Warrants and the FRNs is not as complete or persuasive as the evidence with respect to the Common Shares. Only a small number of Warrants, representing a very small percentage of the Warrants issued under the Plan, traded on August 3, 2006. None of the FRNs traded on the TSE until August 5, 2006, when a relatively small proportion of the FRNs traded. In an affidavit included in the materials before the Court, the financial advisor to Sunrise states that a larger number of trades took place in the over-the-counter market. However, no data is before the Court with respect to the prices or volumes of over-the-counter trading in the FRNs commencing April 3, 2006.

Conclusions

[138] Although I have reservations regarding the issue of the market data before the Court, I have concluded that it represents better evidence of the value of the Common Shares, the Warrants and the FRNs than the $5.50 subscription price for the Common Shares used in respect of transactions in the Plan. I will set out my reasons dealing separately with each of the securities.

[139] As mentioned, the principal issues relate to the Common Shares. I conclude that the VWAP for April 3, 2006 should be used to determine the value of the Common Shares for the following reasons.

[140] First, and most importantly, it more closely reflects the conceptual approach of the Court to the valuation exercise before it than an approach based on an estimation of the enterprise value of Stelco. In the case of publicly traded securities, a recipient of securities is in a position to realize the value of the securities by selling them in the market. In such circumstances, and the securities should therefore be valued using the market prices as of the date of receipt. If the securities had been freely tradable on and prior to March 31, 2006, the securities would have been valued on such basis. In the absence of a market on that date, the Court must determine the best evidence for the market prices of the securities if such a market had existed. For this purpose, the VWAP for the first trading day of the securities is a more appropriate indication of the price at which the Senior Debt Holders could have sold their Common Shares on March 31, 2006 than the subscription price of $5.50 under the Plan. While the market for the Common Shares did not begin until two days after the Plan Implementation Date, there is no evidence that the market price levels would have been different if trading had commenced at the Effective Time or that the market prices did not reflect the possibility that all Senior Debt Holders could have sold their security positions on the first day of trading.

[141] In particular, there were no events between the Effective Time and April 3, 2006 that cast doubt on the validity of the price on April 3, 2006. Nor is there any evidence of market imperfections that were eliminated later in the week that indicate that the trading on April 3, 2006 should be excluded. While there was bound to be uncertainty in the market, particularly at the opening of trading of a new security, I do not think that is relevant where the question of value reduces to the issue of the price that the Senior Debt Holders could have received for their Common Shares if they had sold them on April 3, 2006.

[142] A more significant issue is the suggestion in the Deloitte Report that a sale of all of the Senior Debt Holders' Common Shares would have attracted a block discount. This opinion of the author of the Report is not, however, supported by any evidence. It assumes that trading in the Stelco shares during the first week was in relatively small blocks. While this may be true, I do not think there is any evidence to this effect. Second, it does not explain why trading on the first day would not have been influenced by the possibility that other Affected Creditors, including the Debentureholders, were free to sell at any time and, apart from Sunrise and Appaloosa, were not naturally long-term holders of the Common Shares.

[143] Second, there is no conceptual basis on which it can be argued that the $5.50 subscription price of the Common Shares under the Plan represents reliable evidence as to the value of the Common Shares as of the Effective Time. There is no necessary relationship between the use of the $5.50 price in the Plan, representing the outcome of negotiations between the stakeholders in late 2005, and the market price for the Common Shares as of the Plan Implementation Date. As mentioned, there is also no necessary connection between the enterprise value of Stelco as a whole calculated in late 2005, from which a value of $5.50 can be derived as an arithmetic calculation, and the market price of the Common Shares as of the Plan Implementation Date. The issue is the value of the Common Shares, independently of the enterprise value of Stelco, except to the extent that it is possible to demonstrate a direct relationship based on the operation of the market. There are circumstances in which the market price for the equity of an entity is materially higher or lower than the price indicated by enterprise value calculations. This is clearly one of those situations. In the absence of an explanation of this divergence that casts doubt on the reliability of the market prices for the Common Shares and demonstrates the credibility of the $5.50 subscription price as the market price for the Common Shares of the Senior Debt Holders, I conclude that the VWAP of the Common Shares on April 3, 2006 is a more credible indication of the value received by the Senior Debt Holders.

[144] With respect to the Warrants, the reasons for using the trading data for the Common Shares compel use of similar data to determine the price of the Warrants.

[145] The use of a value of $5.50 for the Common Shares results in a modest value for the Warrants using the Black-Scholes model. If, however, a substantially higher value is ascribed to the Common Shares, the Warrants necessarily have a substantially increased value. The only evidence of that increased value is the market trading data. While the volume of trading in the Warrants on April 3, 2006 is limited, the pricing information derived from those

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trades has reasonable credibility as the prices of the Warrants are closely related to the prices at which the Common Shares are trading at the time.

[146] Accordingly, in the absence of evidence that the prices at which the Warrants traded were outside the expected range given the concurrent market prices of the Common Shares, I conclude that the VWAP of the Warrants for April 3, 2006 should be used to determine the value of the Warrants.

[147] Valuation of the FRNs under either approach is more problematic. The Senior Debt Holders suggest there is no reason to use a value in excess of par but provide no support for this position. The Noteholders rely instead on market data, which their own advisor states is inadequate because much of the trading was conducted privately in the over-the-counter market and is therefore not available.

[148] I am of the opinion that the prices at which the FRNs traded on the first trading day after the Plan Implementation Date should be the determinant of the value of these securities. In the absence of data for April 3 and April 4, 2006, the VWAP for trades on the TSE on April 5, 2006 is the best available evidence of the value of the FRNs on March 31, 2006. However, before making that determination, I think it appropriate to permit the parties to make representations on this issue based on any additional evidence of trading activity that may be available. I will convene a telephone conference with counsel shortly to establish a process for such representations unless the parties are able to agree among themselves on the value to be ascribed to the FRNs based on the principles set out above.

[149] Finally, I wish to state that, in reaching the determinations set out above, I am not suggesting that the value ascribed to the Common Shares in the Plan and found to be the fair market value by the board of directors of Stelco is not valid in the context in which it was used by the stakeholders in the Stelco reorganization and by the board of directors. My conclusion is simply that the market price of the securities is the best evidence of the value of the securities for the purposes of determining the value received by the Senior Debt Holders on the Plan Implementation Date and the amount of their deficiency claim for the purposes of the Subordination Provisions on that date.

Is the Indebtedness In Respect of the MITSA Senior Debt?

[150] The Supreme Court of Canada has held that there is no comprehensive definition of the term "ordinary course of business" and that the Court must consider the circumstances of each case in order to determine how to characterize any particular transaction: *Pacific Mobile Corp (Trustee of) v. American Biltrite (Canada) Ltd.*, [1985] 1 S.C.R. 290 at 291. In this proceeding, it is necessary to interpret this term in the context of the definition of "Senior Debt" in the Note Indenture, which includes indebtedness incurred in connection with the acquisition by Stelco of any "business, property, services or other assets *excluding indebtedness incurred in relation to any such acquisitions made in the ordinary course of business*" (italics added).

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[151] 2074600 argues that the indebtedness incurred by Stelco pursuant to the deferred payment arrangements under the MITSA is Senior Debt because it was not incurred in connection with the acquisition of property and services made in the ordinary course of business. 2074600 points to a number of factors specific to Stelco that it submits demonstrate that the transaction was unusual for Stelco and therefore out of the ordinary course of business for it. These include the following: (1) the transaction was, in its view and in the view of Stelco representatives, complex, far-reaching in terms of its impact on Stelco's operations, and significant in terms of its day-to-day operations; (2) the Stelco board of directors approved the transaction; (3) the transaction was the subject of a Stelco press release; and (4) it was an isolated transaction arising out of special and particular circumstances related to the need to address replacement of Stelco's legacy systems to meet modern needs and a knowledge drain as employees knowledgeable in these legacy systems retired. 2074600 also argues that the transaction contemplated by the MITSA could not be characterized as being in the ordinary course of business within Stelco's industry as there were no similar agreements entered into by any of the other major Canadian steel producers. Similarly, it argued that the MITSA was not a typical outsourcing arrangement for EDS and was therefore out of the ordinary course of business for EDS.

[152] The transaction envisaged by the MITSA was a unique outsourcing transaction. It is not disputed that the transaction contemplated by the MITSA was both comprehensive in terms of the scope of Stelco's IT requirements and was also significant to Stelco, because a failure by EDS to perform adequately would be costly. The issue for the Court, however, is whether the acquisition transaction contemplated by the MITSA was out of the ordinary course of business for Stelco.

[153] The cases cited by 2074600 regarding the meaning of "ordinary course of business" deal with dispositions of assets, rather than acquisitions, in circumstances in which the applicable covenant or legislation is directed toward fair treatment of, or protection of, creditors: see for example *Pacific Mobile*, which deals with an alleged fraudulent preference; *Roynat Inc. v. Ron Clark Motors Ltd.* (1991), 1 P.P.S.A.C. (2d) 191 (Ont. Ct. J. (Gen. Div.)), which deals with a covenant in a floating charge; and *Rowbotham v. Nave* (1991), 1 P.P.S.A.C. (2d) 206 (Ont. Ct. J. (Gen. Div.)), which deals with bulk sales legislation. I do not find them to be helpful in the present circumstances. They do not deal with the concept of non-ordinary course transactions involving the purchase of assets or services by a solvent company. It is therefore necessary to start with a consideration of the purpose or intention of the definition of Senior Debt.

[154] That definition has three parts – indebtedness for borrowed money; indebtedness incurred in connection with the acquisition of any business, property, services or other assets other than indebtedness incurred in relation to any such acquisitions made in the ordinary course of business; and renewals or refinancings of qualifying Senior Debt.

[155] The first part of the definition contemplates new indebtedness, because refinancing of existing indebtedness is treated separately. The indebtedness permitted by this

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clause could be incurred to finance day-to-day operations, or more broadly ordinary course transactions, as well as acquisitions out of the ordinary course. There is no restriction on the source of such financing, which could include banking facilities as well as debt instruments placed in public or private financings. There is also no limit on the aggregate amount of any such indebtedness. As a result, this clause provides sufficient flexibility to Stelco to finance all of its activities, including all acquisitions, using Senior Debt.

[156] The second part of the definition, which is operative in this proceeding, requires a consideration of whether the indebtedness in question was incurred in relation to an acquisition that was made in the ordinary course of business. The issue is therefore whether the acquisition transaction giving rise to the indebtedness was made in the ordinary course of business. It is not immediately obvious why this limitation was imposed on acquisition-related indebtedness when any direct borrowings for acquisition purposes are unrestricted. The type of indebtedness contemplated is clear however. The clause addresses indebtedness that is incurred on an acquisition, such as vendor take-back financing, or that is assumed or guaranteed in order to complete the transaction, in each case rather than raised separately to fund a particular acquisition. However, the intended breadth of this part of the definition depends on the scope of the concept of an acquisition made in the ordinary course of business of Stelco as an on-going business enterprise.

[157] I am of the opinion that, for this purpose, the concept of an ordinary course acquisition should be interpreted broadly and, accordingly, a non-ordinary course acquisition should be given a narrow scope. The concept of an acquisition in the ordinary course of business goes beyond transactions with trade creditors. The reference to "*business, property,* services *or other assets*" (emphasis added) suggests that the principal focus of the clause is the acquisition of businesses or assets. The reference to the acquisition of services, while included in the list, is secondary and suggests that it was included to reflect the possibility that an acquisition could include a service component, rather than the possibility of a 'services only' transaction. This reading of the definition of an ordinary course transaction suggests that the intention was to narrow transactions that qualified as non-ordinary course transactions to those that are material to Stelco in terms of both the amount of the indebtedness incurred or assumed and in terms of their impact on Stelco' business and operations. Accordingly, I think the clause implicitly requires demonstration that the acquisition will have the effect of significantly changing the nature of the business conducted, being the goods and services produced and sold, the scale of operations, the manner of manufacturing or distributing the products sold by Stelco, or the anticipated financial results of Stelco.

[158] While I do not think that the clause contemplates transactions in which services are the principal subject matter, I accept, however, that such acquisitions could qualify as Senior Debt if it can be demonstrated that the transaction will have an effect on Stelco that is described by the test set out above. In particular, if a service contract, for which the most obvious candidate would be an outsourcing contract such as the MITSA, materially changes the manner in which Stelco manufactures or distributes its products, or its financial prospects, the contract can be said

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to envisage a transaction that is analogous to a non-ordinary course acquisition of a business, property or assets.

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[159] I have concluded, however, that the transaction contemplated by the MITSA does not satisfy this test for the following three reasons.

[160] First, considering all of the elements of the transaction contemplated by the MITSA collectively, the transaction contemplated by the agreement will not significantly change the nature of Stelco's business or the scale of its operations. Nor will it change either the products manufactured and sold by Stelco over this period or Stelco's manufacturing or distribution activities.

[161] The principal result of the transaction contemplated by the MITSA is an increase in operating efficiencies in the conduct of Stelco's business. This is evidenced, for example, in the Stelco press release announcing the transaction, dated February 25, 2002. The press release focussed on the ERPs stating that implementation of the ERPs will "generate significant production and operational efficiencies for Stelco". This reflects the reality that, as an outsourcing contract, the day-to-day IT functions will be carried on largely as might have been anticipated if the contract had not been entered into with EDS.

[162] Second, I think that it is necessary to separate the components of the MITSA into ordinary course elements and non-ordinary elements. EDS assumed two very separate functions under the MITSA. When these components of the MITSA are analysed separately in terms of the test, the characterization of the MITSA as a non-ordinary course transaction is much weaker.

[163] The initial and principal agreement of the parties under the MITSA involved the transfer the IT division of Stelco, including its assets and employees, to EDS, and its commitment to carry on the business in the same manner as before, subject to performance standards. By itself, this does not meet the standard set out above for a non-ordinary course transaction.

[164] Over the longer term, the transaction contemplates the development and implementation of new IT systems in three projects – the ERPs. However, while beyond Stelco's in-house capabilities and more extensive than any other projects undertaken by the other major Canadian steel producers, the ERPs do not significantly change any of the nature of Stelco's business, the scale of its business activities, or the nature of its manufacturing or distribution activities.

[165] Based on the information before the Court, the SMS comes closest to satisfying this test. The other two ERPs deal with service functions. There is, however, insufficient evidence before the Court to demonstrate that the SMS, even if implemented, would so materially change the manner of Stelco's manufacturing and distribution activities that the contract for the SMS, by itself, could constitute an acquisition of services out of the ordinary course of business.

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[166] Finally, while the total fees anticipated over the ten-year term of the MITSA are undoubtedly significant, there is no evidence that the transaction contemplated by the MITSA was material to the projected annual financial performance of Stelco. While a press release was issued, it does not appear that the transaction was treated as constituting a material change under applicable securities legislation. The annual expenditures involved under the MITSA were not materially greater than under other outsourcing arrangements to which Stelco is a party. The Stelco press release indicated that Stelco believed that the transaction would be neutral in terms of its impact on costs, with realized cost savings financing the additional costs, particularly of the ERPs.

[167] In addition, the largest portion of the fees under the MITSA related to the operation and maintenance of the existing IT systems of Stelco. Stelco expensed the operational fees for these services as incurred rather than capitalizing them as would be appropriate for a non-ordinary course acquisition. On the other hand, it treated the indebtednesss relating to the project fees for the ERPs as long-term indebtedness under the deferred payment arrangements provided for under the MITSA. However, neither this indebtedess, and in particular the indebtedness relating specifically to the SMS, nor the total of project fees over the life of the MITSA, are sufficiently large to satisfy the test of materiality for a non-ordinary course transaction.

[168] Based on the foregoing, I conclude that the EDS Claim does not constitute Senior Debt for purposes of the Subordination Provisions.

Alleged Failure of 2074600 to Mitigate

[169] In light of the determination that the EDS Claim is not Senior Debt, it is unnecessary to address the following submission. I have set out my conclusion on this issue in case I have erred in reaching the prior conclusion.

[170] The Noteholders allege that 2074600 failed to mitigate its damages. While acknowledging that there was a limit on the number of Common Shares for which TML was prepared to subscribe, or for which TML was allowed to subscribe by the other stakeholders, they argue that TML should have negotiated greater flexibility in its subscription arrangements. Specifically, they argue that TML should have required that 2074600 retain the right to elect Common Shares in lieu of cash from the Cash Pool, reducing the number of shares TML received as an equity sponsor correspondingly. The Noteholders argue that, had it done so, the recovery of 2074600 would have been increased, although the TML recovery as an equity sponsor would have been correspondingly reduced. This imaginative argument fails on at least two counts.

[171] First, I doubt that TML was subject to any such duty to mitigate in the negotiations or otherwise. Even if there were such a duty, there cannot have been a breach in the absence of unequivocal evidence in advance of the election date that the Common Shares would

have a market value in excess of $5.50. There is no such evidence before the Court. For this purpose, the subsequent trading history is totally irrelevant.

[172] Second, the argument envisages a different plan of arrangement from what was agreed by the Stelco stakeholders. As was acknowledged by counsel for the Noteholders, the assumptions underlying this argument imply a plan with a smaller Cash Pool as a result of a reduced equity subscription by TML. There is no evidence that this plan of arrangement could have succeeded.

[173] Third, and more technically, while the Noteholders assert that 2074600 failed to mitigate, their claim is actually asserted against TML, as the parent of 2074600.

[174] In the absence of both a conceptual basis for this position in the Plan as negotiated and a legal basis for the duty of mitigation in the circumstances, this argument fails.

Conclusions

[175] Based on the foregoing, I make the following determinations:

1. the Distributions received by the Debentureholders are to be valued as of March 31, 2006;

2. for such purpose, the Common Shares and Warrants shall be valued using the volume weighted average prices at which the Common Shares and Warrants traded on the Toronto Stock Exchange on April 3, 2006;

3. in the absence of agreement, the Debentureholders and the Noteholders shall be entitled to make representations regarding the trading of FRNs on the first trading day in respect thereof, including any additional evidence of trading activity that may be available;

4. after determination of the valuation of the FRNs, pursuant to the Subordination Provisions, the Noteholders shall pay to the Trustees on behalf of the Debentureholders Turnover Proceeds having a value equal to the amount of the aggregate Debentureholder deficiency claim as of March 31, 2006 against Stelco, including post-filing interest, pro rated against each of the four classes of property comprising the Turnover Proceeds in the manner agreed to and described above; and

5. the claims of 2074600 are denied.

Costs

[176] The parties shall have 30 days from the date of these reasons to make written submissions with respect to the disposition of costs in this matter, and a further fifteen days from

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the date of receipt of the other parties' submissions to provide the Court with any reply submissions they may choose to make. Any such submissions seeking costs shall include the costs outline required by Rule 57.01(6) of the *Rules of Civil Procedure*, R.R.O. 1990, Reg. 194, as amended. To the extent not reflected in the costs outline, such submissions shall also identify all lawyers on the matter, their respective years of call, and rates actually charged to the client, and shall include supporting documentation as to both time and disbursements.

H.J.W. Siegel J.

Released: August 9, 2006

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APPENDIX A

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Excerpts from Subordination Provisions of the Note Indenture

6.1 Agreement to Subordinate.

The Corporation covenants and agrees, and each Debentureholder, by his acceptance thereof, likewise agrees, that the payment of the principal of and of any interest on the Debentures is hereby expressly subordinated, to the extent and in the manner hereinafter set forth, in right of payment to the prior payment in full of all Senior Debt whether outstanding on the date of this First Supplemental Indenture or thereafter incurred.

6.2 Distribution on Insolvency or Winding-up.

In the event of any insolvency or bankruptcy proceedings, or any receivership, liquidation, reorganization or other similar proceedings relative to the Corporation, or to its property or assets, or in the event of any proceedings for voluntary liquidation, dissolution or other winding-up of the Corporation:

(1) the holders of all Senior Debt will first be entitled to receive payment in full of the principal thereof, premium (or any other amount payable under such Senior Debt), if any, and interest due thereon, before the Debentureholders will be entitled to receive any payment or distribution of any kind or character, whether in cash, property or securities, which may be payable or deliverable in any such event in respect of any of the Debentures;

(2) any payment by, or distribution of assets of, the Corporation of any kind or character, whether in cash, property or securities (other than securities of the Corporation or any other company provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in this Article 6 with respect to the Debentures, to the payment of all Senior Debt, provided that (i) the Senior Debt is assumed by the new company, if any, resulting from such reorganization or readjustment and (ii) without prejudice to the rights of such holders with respect to any such plan (including without limitation as to whether or not to approve same and on what conditions to do so), the rights of the holders of Senior Debt are not altered adversely by such reorganization or readjustment) to which the Debentureholders or the Trustee would be entitled, except for the provisions of this Article 6, will be paid or delivered by the Person making such payment or distribution, whether a trustee in bankruptcy, a receiver, a receiver-manager, a liquidator or otherwise, directly to the holders of Senior Debt or their representative or representatives or to the trustee or trustees under any indenture under which any instruments evidencing any of such Senior Debt may have been issued, rateably according to the aggregate amounts remaining unpaid on account of the Senior Debt held or represented by each, to the extent necessary to make payment in full of all Senior Debt remaining unpaid after

giving effect to any concurrent payment or distribution (or provision therefor) to the holders of such Senior Debt; and

(3) subject to Section 6.6, if, notwithstanding the foregoing, any payment by, or distribution of assets of, the Corporation of any kind or character, whether in cash, property or securities (other than securities of the Corporation as reorganized or readjusted or securities of the Corporation or any other company provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in this Article 6 with respect to the Debentures, to the payment of all Senior Debt, provided that (i) the Senior Debt is assumed by the new company, if any, resulting from such reorganization or readjustment and (ii) without prejudice to the rights of such holders with respect to any such plan (including without limitation as to whether or not to approve same and on what conditions to do so), the rights of the holders of Senior Debt are not altered adversely by such reorganization or readjustment), is received by the Trustee or the Debentureholders before all Senior Debt is paid in full, such payment or distribution will be held in trust for the benefit of, and will be paid over to the holders of such Senior Debt or their representative or representatives or to the Trustee or trustees under any indenture under which any instruments evidencing any of such Senior Debt may have been issued, rateably as aforesaid, for application to the payment of all Senior Debt remaining unpaid until such Senior Debt has been paid in full, after giving effect to any concurrent payment or distribution (or provision therefor) to the holders of such Senior Debt.

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Excerpts from the Plan of Arrangement

5.04 **Implementation**

(1) As soon as practicable after satisfaction (or waiver, if applicable) of each of the conditions to the implementation of the Plan as set out in Section 5.03, Stelco will cause to be posted to the Website a notice confirming that each of the conditions to the implementation of the Plan as set out in Section 5.03 has been satisfied (or waived, if applicable) and thereafter Stelco will file the Articles of Reorganization and seek to obtain the Certificate of Amendment. The Plan will become effective at the Effective Time. All the agreements and other instruments that have to be entered into or executed and all other actions that have to be taken in order for the transactions and agreements to be completed and occur or be effective at the Effective Time will be entered into, executed, taken and completed in escrow prior to the Effective Time. At the Effective Time, the transactions and agreements contemplated by the Plan set out below will be completed and be deemed to occur or be effective in the order set out below:

(a) the Articles of Reorganization will be effective and the New Redeemable Shares and New Common Shares to be issued under Section 2.03(c) will be validly issued;
(b) the New ABL Facility will be effective;
(c) the New Secured Revolving Term Loan Agreement will be effective;
(d) the New Platform Trust Indenture and the Supplemental Indenture will be effective and the New Secured FRNs to be issued in connection with this Plan will be validly issued;
(e) the New Inter-creditor Agreedment will be effective;
(f) the Pension Agreement will be effective;
(g) the New Warrant Indenture will be effective and the New Province Note, the New Province Warrants and the New Warrants to be issued in connection with this Plan will be validly issued;
(h) the New Common Shares to be issued to the Equity Sponsors under the Plan Sponsor Agreement will be validly issued; and
(i) the New Common Shares to be issued to Electing Affected Creditors, and to the Standby Purchasers under the Plan Sponsor Agreement, will be validly issued.

(2) Upon receipt of the Certificate of Amendment, the Applicants will deliver to the Monitor, and file with the Court, a copy of a certificate stating that each of the conditions set out in Section 5.03 has been satisfied or waived, the Articles of Reorganization have been filed and have become effective as of the date set out in the Certificate of Amendment and the transactions set out in Section 5.04(1) have been completed and occurred.

6.01 **Effect of Plan Generally**

(1) At the Effective Time, the treatment of Affected Claims and the determination of Proven Claims will be final and binding on the Applicants, the Affected Creditors and the trustees under the trust indentures for the Bonds (and their respective heirs, executors, administrators and other legal representatives, successors and assigns), and this Plan will constitute: (a) full, final and absolute settlement of all rights of the Affected Creditors against Stelco; (b) an absolute release and discharge of all indebtedness, liabilities and obligations of or in respect of the Affected Claims against Stelco, including any interest and costs accruing thereon; (c) an absolute assignment to Stelco of all indebtedness, liabilities and obligations of or in respect of the Affected Claims against Subsidiary Applicants, including any interest and costs accruing thereon (whether before or after the Filing Date), and an absolute release and discharge of any rights of Affected Creditors in respect thereof (excluding, for greater certainty, any rights assigned to Stelco); and (d) a reorganization of the capital and change in the number of directors of Stelco in accordance with the provisions of Article 3 and the Articles of Reorganization.

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(2) For greater certainty, notwithstanding any of the other provisions herein, nothing in the wording of Section 6.01(1) or any other language in this Plan will bar or prejudice or be deemed to bar or prejudice the ability of any holder of Senior Debt (as defined in the Subordinated 2007 Bond Indenture) or any trustee in respect of the Senior 2006 Bonds or Senior 2009 Bonds to maintain or pursue claims or other remedies, including any third party beneficiary claims or remedies they may have, against holders of Subordinated 2007 Bonds or their trustee under the Subordinated 2007 Bond Indenture (including claims against or to distributions under this Plan that otherwise would be made to the holders of Subordinated 2007 Bonds or their trustee) or bar or prejudice or be deemed to bar or prejudice the ability of any holders of Subordinated 2007 Bonds or their trustee to raise any defences in respect of such claims or other remedies. In that regard, without restricting the right of the holders of Subordinated 2007 Bonds to exercise the Share Option, and subject to any Order confirming the following process or providing for a different process:

(a) all New Secured FRNs, New Common Shares, New Warrants and cash from the Cash Pool (collectively, the "Turnover Proceeds") to be issued to the holders of the Subordinated 2007 Bonds or to their trustee will be delivered to the Monitor, to be held by the Monitor in trust; and

(b) the Monitor will, before or within 30 days after the Plan Implementation Date, bring a motion to the Court on no less than 10 days' notice to each of the Affected Creditors that has filed a Notice of Appearance in the CCAA Proceedings and each of the trustees in respect of the Senior 2006 Bonds, Senior 2007 Bonds and Subordinated 2007 Bonds, seeking directions in respect of a process to determine on a timely basis entitlements to the Turnover Proceeds.

For greater certainty, and without limiting the generality of the foregoing, all rights of holders of Senior Debt to assert and require that the rights and claims of holders of Subordinated 2007 Bonds and their trustee are subordinated to the prior payment in full of the Senior Debt under the provisions of the Subordinated 2007 Bond Indenture or otherwise or the rights and claims of the holders of Subordinated 2007 Bonds or their trustee to raise any defences in respect of such claims and other remedies are not intended to be diminished, impaired or prejudiced by the wording of this Plan. Specifically, but without limiting the generality of the foregoing, but subject to the operation of applicable law, the fact that the Plan provides that the calculation of the quantum of Claims and Affected Claim [sic]is limited to principal, plus interest accrued to the Filing Date and that the Plan contains releases in favour of Stelco and other Persons, and provides for full satisfaction of Affected Claims against Stelco and other Persons, is not intended to bar or prejudice any entitlement of holders of Senior Debt (as defined in the Subordinated 2007 Bond Indenture) to make a claim for the full benefit of subordination against the holders of the Subordinated 2007 Bonds and their trustee in respect of *all* amounts owing to them or

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that would have been owing to them had the CCAA Proceedings and the Plan never been implemented, even amounts in excess of their Claims or Affected Claims for purposes of the Plan or the rights and claims of the holders of the Subordinated 2007 Bonds or their trustee to raise defences in respect of such claims and other remedies.

For greater certainty, nothing in this Section 6.01(2) is intended or shall be construed as derogating from any provision in this Plan that provides that all Proven Claims determined in accordance with the Claims Procedure Order are final and binding on Stelco, the Subsidiary Applicants and all Affected Creditors.

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COURT FILE NO.: 04-CL-5306
DATE: 20060809

2006 CanLII 27117 (ON SC)

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

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

AND IN THE MATTER OF A PROPOSED PLAN OF COMPROMISE OR ARRANGEMENT WITH RESPECT TO STELCO INC. AND OTHER APPLICANTS

PAUL MACDONALD, ANDREW J.F. KENT and BRETT HARRISON, for the Subordinated Note holders

ROBERT W. STALEY, DEREK J. BELL and ALAN P. GARDNER, for the Senior Debenture holders

NANCY ROBERTS and TIM MORGAN, for 2074600 Ontario Ltd.

GYLA MAHAR for the Monitors of the Applicants

REASONS FOR JUDGMENT

H.J.W. Siegel J.

Released: August 9, 2006

CITATION: Stelco Inc. (Re) , 2007 ONCA 483
DATE: 20070628
DOCKET: C46248, C46258, C46266 & C46916

COURT OF APPEAL FOR ONTARIO

O'CONNOR A.C.J.O., GOUDGE and BLAIR JJ.A.

BETWEEN:

RE: IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED AND IN THE MATTER OF A PROPOSED PLAN OF COMPROMISE OR ARRANGEMENT WITH RESPECT TO STELCO INC. AND THE OTHER APPLICANTS LISTED ON SCHEDULE "A" APPLICATION UNDER THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

Jeffrey Leon, Robert Staley and Derek Bell for the Debenture Holders

Dan Macdonald and Erin Cowling for Sunrise Partners Limited Partnership, Appaloosa Management L.P., TD Securities, A Division of The Toronto Dominion Bank and Irving Wortsman

Joseph M. Steiner and Nancy Roberts for 2074600 Ontario Inc.

Kyla Mahar for Ernst & Young, in its capacity as Monitor

Sean Dunphy and Ellen Snow for Aurelius Capital Management, LP [representing the Cash-Elect Debentureholders]

Charles F. Scott, M. Paul Michell and Michael J. Sims for Catalyst Capital Group Inc. and David Kempner Capital Management LLC [representing the Share-Elect Debentureholders]

Brendan Y.B. Wong for CIBC Mellon Trust Co.

Heard: March 27, 2007 and May 2, 2007

On appeal from the orders of Justice Herman J.W. Siegel of the Superior Court of Justice, dated October 31, 2006 and March 6, 2007, with reasons reported at [2006] O.J. No. 3219, [2006] O.J. No. 5430, and [2007] O.J. No. 808.

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BY THE COURT:

I. OVERVIEW

[1] These reasons concern four appeals arising from proceedings involving Stelco Inc. under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "*CCAA*").

[2] In January 2004, Stelco filed for protection under the *CCAA*. At the time, it owed almost $550 million to various creditors. (With post-filing interest, the amount increases to approximately $640 million.) In January 2006, after two years of efforts to raise capital, sell assets, and negotiate a compromise, a plan of arrangement and reorganization was sanctioned by Farley J. as fair and reasonable, thereby putting in motion the process by which Stelco would emerge from restructuring with its debt reorganized. In simple terms, the creditors agreed to release and discharge all claims against Stelco in exchange for a distribution of cash and new securities. These appeals concern how those assets are to be distributed amongst classes of the creditors, and include disputes over the ranking of priorities, the characterization of debt, and the value to be attributed to the new securities.

[3] In these reasons, we summarize the facts most relevant to the appeals. The motion judge reviewed the facts in greater detail in his reasons for judgment released on August 9, 2006, and on March 6, 2007, which are reported at 20 B.L.R. (4th) 286 and [2007] O.J. No. 808, respectively.

II. THE NOTEHOLDERS' APPEAL (C46248)

(a) Facts

[4] When Stelco filed for protection under the *CCAA* on January 29, 2004 (the "Filing Date"), it had two principal debt obligations:

(1) Debentures: There were two classes of senior debentures: 10.4% Debentures issued in 1989 in the principal amount of $125,000,000 and 8% Debentures issues in 1999 in the principal amount of $150,000,000.

(2) Notes: There was one class of unsecured subordinated debentures issued in 2002 in the principal amount of $90,000,000 and bearing an interest rate of 9.5% per annum.

In these reasons the parties representing the holders of the Debentures will be referred to as the "Debentureholders" and the parties representing the holders of the Notes will be referred to as the "Noteholders".

[5] In the Note Indenture, the Noteholders agreed to subordinate their entitlement to repayment in full of the "Senior Debt" (the "Turnover Provisions"). It is agreed that the Debentures constitute Senior Debt as defined in the Note Indenture.

[6] Article 6.2 of the Note Indenture specifically addresses the operation of the Turnover Provisions in the event of insolvency proceedings. Article 6.2(2) requires any payment or distribution of assets to the Noteholders in such circumstances be paid to the holders of Senior Debt to the extent necessary to result in payment in full of the principal and interest owing to them after giving effect to any concurrent payment or distribution to the holders of Senior Debt. Article 6.2(3) provides that if any payment or distribution is paid to the Noteholders it shall be held in trust for the Senior Debt Holders until the principal of and interest on the Senior Debt shall be paid in full.

[7] On January 20, 2006, Farley J. approved a plan of arrangement or compromise (the "Plan") to reorganize Stelco's debt obligations. The Plan became effective on March 31, 2006 (the "Effective Date") at 11:59 p.m. (the "Effective Time").

[8] In accordance with the Plan, the Debentureholders filed proofs of claim totalling $342,655,664. On the Effective Date, they received an initial *pro rata* share of the Plan distribution in the form of cash, New Common Shares, New Warrants, and New Floating Rate Notes (the "New FRNs") (collectively, the "Distributed Assets"). The Distributed Assets were comprised of $52,243,533 in cash, US$121,486,000 in New FRNs, 4,004,829 New Common Shares, and 733,311 New Warrants. Pursuant to the terms of the Plan, the New Common Shares were issued at a price of $5.50 per share. Based on that price per share, the New Warrants would be worth $1.44 per warrant using the Black-Scholes Model.

[9] The Plan also provided for a distribution of $20,075.359 in cash, US$40,522,000 in New FRNS, 849,325 New Common Shares and 244,528 New Warrants to the Noteholders (the "Turnover Proceeds"). The Plan required that the Turnover Proceeds be held in trust by the Monitor pending the determination of entitlement to the Turnover Proceeds pursuant to the Turnover Provisions.

[10] The difference between what the Debentureholders claim to have received from the Distributed Assets and the resulting balance remaining from their claims, if any (the "Deficiency"), is payable to them out of the Turnover Proceeds.

[11] On March 7, 2006, Farley J. issued an order as to how the litigation over the Turnover Proceeds was to be conducted. Pursuant to that order, the Debentureholders filed a claim stating that they were entitled to the Turnover Proceeds. 2074600 filed a claim stating that the debt owed to it was Senior Debt and had priority over the amount owing to the Noteholders. (This claim is the subject of a separate appeal and is discussed below.) The Noteholders responded with a counterclaim denying the existence of any

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Deficiency and insisting that they were entitled to the entire Turnover Proceeds. The hearing took place before the motion judge on July 17 through 21, 2006.

[12] In a ruling released on August 9, 2006, and formally entered on October 31, 2006, the motion judge made the following findings that are relevant to the Noteholders' appeal:[1].

(1) The Senior Debt Holders are entitled to enforce the Turnover Provisions as third-party beneficiaries of the provision. They are also entitled to enforce the Provisions as the beneficiaries of the trust in which the Turnover Proceeds are currently held;

(2) The implementation of the Plan did not cancel the Turnover Provisions in the Note Indenture;

(3) It was not necessary for Senior Debt Holders to prove individually the actual amount of their deficiencies after receiving the Distributed Assets under the Plan; and

(4) The Senior Debt Holders were entitled to be paid post-CCAA-filing interest on their outstanding amounts.

[13] The Noteholders appeal each of these findings.

(b) Enforcement of the Turnover Provisions

[14] The Noteholders appeal the finding of the motion judge that the Debentureholders as holders of Senior Debt[2] are entitled to enforce the Turnover Provisions contained in the Note Indenture despite the fact that they are not parties to that Indenture.

[15] The motion judge found that the Senior Debt Holders are entitled to do so both as third party beneficiaries and as the beneficiaries of the trust established in their favour by the Indenture.

[16] For the reasons that follow, we agree with the motion judge that while they are not parties to the Note Indenture between Stelco and the Noteholders, the Senior Debt Holders can rely on trust principles to provide an exception to the privity of contract

[1] He made other findings that are addressed below in our reasons relating to the appeals by 2074600 Ontario Inc. and the Debentureholders.
[2] The "Senior Debt Holders" include the Debentureholders and, given that we conclude below that the EDS claim constitutes Senior Debt, 2074600 Ontario Inc.

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doctrine, entitling them to enforce the Turnover Provisions in the Note Indenture that constitutes the Noteholders trustees of the Turnover Proceeds for the Senior Debt Holders once the Noteholders receive those Proceeds. It is therefore unnecessary for us to decide whether the trial judge erred in allowing the Senior Debt Holders to enforce the Indenture as third party beneficiaries by extending to this case the principled exception to privity of contract found in *Fraser River Pile & Dredge Ltd. v. Can-Dive Services Ltd.*, [1999] 3 S.C.R. 108.

[17] Needless to say, our approach to this issue is premised on our conclusion, explained below, that the Turnover Provisions of the Note Indenture survive the implementation of the Plan and are not extinguished by it.

[18] It is helpful to begin by reproducing the Turnover Provisions in the Note Indenture, noting that they refer to the Indenture as the "Debenture" and the Noteholders as the "Debenture Holders". These are Article 6.1 and Article 6.2(1), (2) and (3), of which the last is the most important for the trust issue. They read as follows:

ARTICLE 6 – SUBORDINATION OF DEBENTURES

6.1 Agreement to Subordinate.

The Corporation covenants and agrees, and each Debentureholder, by his acceptance thereof, likewise agrees, that the payment of the principal of and of any interest on the Debentures is hereby expressly subordinated, to the extent and in the manner hereinafter set forth, in right of payment to the prior payment in full of all Senior Debt whether outstanding on the date of this First Supplemental Indenture or thereafter incurred.

6.2 Distribution on Insolvency or Winding-up.

In the event of any insolvency or bankruptcy proceedings, or any receivership, liquidation, reorganization or other similar proceedings relative to the Corporation, or to its property or assets, or in the event of any proceedings for voluntary liquidation, dissolution or other winding-up of the Corporation:

(1) *the holders of all Senior Debt will first be entitled to receive payment in full of the principal* thereof, premium (or any other amount payable under such Senior Debt), if any, *and interest due thereon, before the Debentureholders will be entitled to receive any payment* or distribution of any kind or character, whether in cash, property or securities, which may be payable or deliverable in any such event in respect of any of the Debentures;

(2) *any payment by, or distribution of assets of the Corporation* of any kind or character, whether in cash, property or securities (other than securities of the Corporation or any other company provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in this Article 6 with respect to the Debentures, to the payment of all Senior Debt, provided that (i) the Senior Debt is assumed by the new company, if any, resulting from such reorganization or readjustment, and (ii) without prejudice to the rights of such holders with respect to any such plan (including without limitation as to whether or not to approve same and on what conditions to do so), the rights of the holders of Senior Debt are not

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> altered adversely by such reorganization or readjustment) *to which the Debentureholders or the Trustee would be entitled, except for the provisions of this Article 6, will be paid or delivered by the Person making such payment or distribution,* whether a trustee in bankruptcy, a receiver, a receiver-manager, a liquidator or otherwise, *directly to the holders of Senior Debt* or their representative or representatives or to the trustee or trustees under any indenture under which any instruments evidencing any of such Senior Debt may have been issued, rateably according to the aggregate amounts remaining unpaid on account of the Senior Debt held or represented by each, *to the extent necessary to make payment in full of all Senior Debt remaining unpaid* after giving effect to any concurrent payment or distribution (or provision therefore) to the holders of such Senior Debt; and
>
> (3) subject to Section 6.6, *if, notwithstanding the foregoing, any payment by*, or distribution of assets of, *the Corporation* of any kind or character whether in cash, property or securities (other than securities of the Corporation as reorganized or readjusted or securities of the Corporation or any other company provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in this Article 6 with respect to the Debentures, to the payment of all Senior Debt, provided that (i) the Senior Debt is assumed by the new company, if any, resulting from such reorganization or readjustment and (ii) without prejudice to the rights of such holders with respect to any such plan (including without limitation as to whether or not to approve same and on what conditions to do so), the rights of the holders of Senior Debt are not altered adversely by such reorganization or readjustment), *is received by the Trustee or the Debentureholders before all Senior Debt is paid in full, such payment or distribution will be held in trust for the benefit of, and will be paid over the holders of such Senior Debt or their representative* or representatives or to the Trustee or trustees under any indenture under which any instruments evidencing any of such Senior Debt may have been issued, rateably as aforesaid, for application to the payment of all Senior Debt remaining unpaid *until such Senior Debt has been paid in full*, after giving effect to any concurrent payment or distribution (or provision therefore) to the holders of such Senior Debt. [Emphasis added.]

[19] It is also helpful to review a number of the provisions of the Plan approved by the court on January 20, 2006, effective March 31, 2006.

[20] Article 2.03 provides that once the Plan is effective, each Affected Creditor (including both the Senior Debt Holders and the Noteholders) will receive in full satisfaction of its claim against Stelco its *pro rata* share of the pool of assets provided by Stelco, consisting of cash, New FRNs, New Common Shares and New Warrants.

[21] As noted above, Article 6.01(2) provides that the Turnover Proceeds will be delivered to the Monitor, who will hold the proceeds in trust pending the outcome of this litigation over the Proceeds. The Monitor was to seek directions of the court about the process to be used to determine that entitlement, so that this trust can be fully implemented.

[22] The Senior Debt Holders claim that they are entitled to rely on the Turnover Provisions in Article 6.2(3) of the Note Indenture because of the trust exception to the privity of contract doctrine and that they are ultimately entitled to the Turnover Proceeds.

[23] In response, the Noteholders assert that the Senior Debt Holders have no right to enforce those Provisions, and that therefore the Monitor holds the Turnover Proceeds in trust for the Noteholders and not for the Senior Debt Holders.

[24] At first instance the Noteholders did not contest the trust exception to the privity of contract doctrine. Nor do they do so in this court. They accept the well-known proposition that parties to a contract can constitute one party a trustee for a third party of a right under the contract and thereby confer on the third party a right enforceable by it in equity. See *Greenwood Shopping Plaza Ltd. v. Beattie*, [1980] 2 S.C.R. 228 at 239.

[25] Rather, their principal argument below was that the Senior Debt Holders could not rely on Article 6.2(3) of the Note Indenture because the Turnover Proceeds have been paid to the Monitor under the Plan and have not therefore been "received" by the Noteholders for the purposes of the Article. Thus no trust has arisen and the Senior Debt Holders have no beneficial interest to enforce. The motion judge dismissed this argument as follows:

> This is an argument of form over substance. The Monitor has no interest in the Distributions. For the purpose of this proceeding, payment to the Monitor satisfies the requirement of delivery of the corpus of the trust to the Noteholders. The only other possibility – that the Distributions were paid to the Senior Debt Holders – is, of course, denied by the Noteholders and would render consideration of this issue unnecessary.

[26] The Noteholders raise the same argument in this court. We would give the same response, with the following elaboration.

[27] The Plan, approved by court order, creates a trust in which the Monitor holds the Turnover Proceeds in trust pending determination by the court of whether the Senior Debt Holders or the Noteholders are ultimately entitled to them.

[28] Subject to any right of subordination available to the Senior Debt Holders, the Noteholders are ultimately entitled to the Turnover Proceeds, pursuant to the terms of the Plan. In other words, the Noteholders hold the beneficial interest in the Turnover Proceeds but that interest is not unfettered. It is subject to the rights of the Senior Debt Holders if the court should so order. As a consequence, the Noteholders cannot be said to have the entire equitable interest in the Turnover Proceeds. The Senior Debt Holders' interest gives them the right to engage the assistance of the court to effect the full implementation of the trust created by the Plan.

[29] In relying on Article 6.2(3) of the Note Indenture to accomplish this full implementation, the Senior Debt Holders effectively ask the court:

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> (a) to order that the Turnover Proceeds be paid to the Noteholders who, on receipt, are obliged by Article 6.2(3) to hold the proceeds in trust for the Senior Debt Holders and to pay those proceeds over to them until they are paid in full, and
>
> (b) to enforce their right as beneficiaries of the arrangement set up by Article 6.2(3) to this payment.

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[30] We agree that the court below was correct to so order. The payment to the Noteholders is ordered simply as a step in the full implementation of the arrangement, and once these steps are taken, the Noteholders are to be held to the terms of the trust that results. The Senior Debt Holders are entitled to have the court ensure that the proper beneficial interests in both trusts are respected.

[31] On appeal, the Noteholders raise two additional arguments.

[32] First, they rely on *Greenwood Shopping Plaza, supra,* to argue that unless the Senior Debt Holders can establish that Stelco was contracting as trustee for them in entering into the Note Indenture, they cannot rely on the trust exception to privity of contract so as to enforce Article 6.2(3).

[33] We do not agree. As we read *Greenwood Shopping Plaza*, the fundamental question is whether Article 6.2(3) can be shown to create a trust in favour of the Senior Debt Holders once property flows. While evidence that Stelco contracted with that intention would point to that conclusion, here the language of the Article itself is so explicit that it is more than enough to show the establishment of the trust contended for by the Senior Debt Holders.

[34] Second, the Noteholders argue that the Indenture could have been amended without notice to or consent from the Senior Debt Holders and that this is inconsistent with Article 6.2(3) providing for the trust contended for by the Senior Debt Holders.

[35] Again, we disagree. Not only has there been no such amendment, but Article 6.8 of the Note Indenture provides that Stelco cannot act to impair any subrogation rights of the Senior Debt Holders. Moreover, *Greenwood Shopping Plaza* makes clear that whether the parties can change the contractual terms creating the trust is but one test (although a common one) to determine whether a trust has been created. As we have said, in this case, the language of Article 6.2(3) is enough to make it crystal clear that that has happened.

[36] In summary, on this issue we agree with the motion judge. The Senior Debt Holders are entitled to the benefit of the trust established in their favour pursuant to Article 6.2(3) of the Note Indenture.

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(c) Cancellation of the Turnover Provisions

[37] The Noteholders argue that the motion judge erred in failing to conclude that because the Plan cancelled the Note Indenture on implementation, it necessarily cancelled the Turnover Provisions which were included in the Note Indenture. Thus, the Senior Debt Holders are no longer entitled to enforce their subordination rights that are embodied in the Turnover Provisions.

[38] Article 4.01 of the Plan provides for the cancellation on implementation of Stelco debentures which include the Note Indenture. The relevant part of that Article reads:

> [A]ll debentures … subject to Section 6.01(2) will be cancelled and null and void, and all debentures … will not entitle any holder thereof … to any compensation or participation other than as expressly provided for in this Plan[.]

[39] The motion judge rejected the Noteholders' argument. He held that section 6.01(2) of the Plan was the complete answer. That section provides as follows:

> [N]othing in the wording of Section 6.01(1) or any other language in this Plan will bar or prejudice or be deemed to bar or prejudice the ability of any holder of Senior Debt (as defined in the Subordinated 2007 Bond Indenture) … to maintain or pursue claims or other remedies, including any third party beneficiary claims or remedies they may have, against holders of the [Notes].

[40] The Noteholders argue that s. 6.01(2) does not preserve the substantive rights of Senior Debt Holders contained in the Turnover Provisions. Rather, they say that the section provides only that the Plan would not preclude the Senior Debt Holders from advancing other claims not based on the Note Indenture or the Noteholders from raising defences to such claims.

[41] We do not agree that s. 6.01(2) should be read in this manner. We agree with the motion judge that the most reasonable interpretation of s. 6.01(2) is that implementation of the Plan would not affect the substantive rights and obligations of the Senior Debt Holders and the Noteholders in respect of the Turnover Provisions. While the language of s. 6.01(2) does not explicitly refer to the Turnover Provisions, it does preserve "the ability of [Senior Debt Holders] to maintain or pursue claims or remedies, including any third party beneficiary claims or remedies, they may have against the [Noteholders]". The plain meaning of this language would protect all of the then-existing rights of the

Senior Debt Holders against the Noteholders which unquestionably include the rights embodied in the Turnover Provisions.

[42] Moreover, there is nothing in the language of s. 6.01(2) or elsewhere in the Plan to suggest that the Senior Debt Holders intended to forego their rights of subordination found in the Turnover Provisions. Indeed, there does not appear to be any commercial basis that would have led the Senior Debt Holders to vote in favour of a Plan that had the effect of removing the priority accorded to them by those provisions.

[43] We read s. 6.01(2) as providing a method by which the parties could proceed with implementing the Plan without having to await the resolution of possible disputes between the Senior Debt Holders and the Noteholders with respect to the Turnover Provisions. The potential delay in awaiting such a resolution could be lengthy, as the present litigation has shown, and possibly fatal to the implementation of the Plan. From a commercial and practical standpoint, the approach adopted in s. 6.01(2) made a good deal of sense.

[44] We note that this approach of delaying the resolution of inter-creditor disputes is not inconsistent with the scheme of the *CCAA*. In a ruling made on November 10, 2005, in the proceedings relating to Stelco reported at 15 C.B.R. (5th) 297, Farley J. expressed this point (at para. 7) as follows:

> The *CCAA* is styled as "An Act to facilitate compromises and arrangements between companies and their creditors" and its short title is: *Companies' Creditors Arrangement Act*. Ss. 4, 5 and 6 talk of compromises or arrangements between a company and its creditors. There is no mention of this extending by statute to encompass a change of relationship among the creditors *vis-à-vis* the creditors themselves and not directly involving the company.

[45] Thus, we agree with the motion judge's interpretation of s. 6.01(2). The result of this interpretation is that the Plan extinguished the provisions of the Note Indenture respecting the rights and obligations as between Stelco and the Noteholders on the Effective Date. However, the Turnover Provisions, which relate only to the rights and obligations between the Senior Debt Holders and the Noteholders, were intended to continue to operate.

(d) Proof of Deficiencies

[46] The Noteholders submit that the motion judge erred in failing to require each of the Senior Debt Holders to prove by evidence the amount of its actual Deficiency after receiving the distribution under the Plan.

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[47] The Note Indenture creates the Senior Debt Holders' subrogated rights against the Noteholders. Article 6.2, which is reproduced above, provides that in the event of insolvency or bankruptcy proceedings, the holders of all Senior Debt are entitled to be paid in full before the Noteholders are entitled to receive any payment or distribution. It further provides that any payment or distribution made to the Noteholders will be paid to or held in trust for the Senior Debt Holders to the extent necessary to make payment of all Senior Debt remaining after giving effect to any concurrent payment or distribution to the Senior Debt Holders. The Noteholders argue, therefore, that the motion judge should have required the Senior Debt Holders to prove the amount outstanding on their debts after receiving and disposing, if that is what occurred, of the Distributed Assets.

[48] The thrust of the Noteholders' argument is that some Senior Debt Holders sold their securities in the new Stelco during the days or weeks immediately following the Effective Date at prices well in excess of the subscription price paid for those securities under the Plan. Others who did not sell at the higher prices could have done so. Thus the Noteholders argue the motion judge should have required each Senior Debt Holder to call evidence to prove its individual deficiency. In effect, the Noteholders ask for an accounting by each Senior Debt Holder at some point after receipt of their securities in the new Stelco.

[49] The Noteholders argue that failure to call this type of evidence resulted in a failure to prove the individual claims of the Senior Debt Holders and for that reason the deficiency claims based on the subrogation right should have been dismissed.

[50] The motion judge rejected this argument and proceeded by calculating the amount of the Deficiency on a collective rather than an individual basis. The amount owing to the Senior Debt Holders before implementation of the Plan was not in dispute. From this amount, the motion judge deducted the total amount of cash paid to the Senior Debt Holders together with the value he placed on the securities received by them as of the Effective Time. Below, we deal with the issue of whether or not the motion judge erred in the way that he valued the Distributed Assets. For present purposes, we need only concern ourselves with the general approach adopted by the motion judge, not the actual amounts resulting from that process.

[51] In our view, the motion judge adopted the correct approach in calculating the Senior Debt Holders' Deficiency. It was not necessary for him to assess each claim on a collective, rather than an individual, basis. Both the Note Indenture and the Debenture Indentures contemplate claims being made on a collective basis.

[52] The evidence about the amount owing to the Senior Debt Holders collectively was not in dispute, nor was the evidence about the distributions made to the Senior Debt Holders under the Plan. The only question was what value should be attributed to the securities being received by the Senior Debt Holders on implementation. The question

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was not: What did the Senior Debt Holders do with the securities after implementation or what could they have done?

[53] Article 6.2(2) of the Note Indenture is clear that in the event of bankruptcy or insolvency proceedings, the Noteholders are required to make payment in full of the Senior Debt remaining unpaid after giving effect to any concurrent payment or distribution to the Senior Debt Holders. The exercise required under this provision is to look at the payment or distribution to the Senior Debt Holders in order to ascertain what remains unpaid. To complete this exercise it was not necessary for the Senior Debt Holders to call evidence to establish what they did with the securities they received after implementation.

[54] The Senior Debt Holders assumed the market risks, benefits and burdens, after they received the securities. The Noteholders are not entitled to benefit in market increases realized by the Senior Debt Holders after the implementation of the Plan.

[55] Thus, we agree that the motion judge correctly proceeded with the Senior Debt Holders deficiency claim on a collective rather than individual basis. We also agree that he did not err in not requiring the Senior Debt Holders to prove their individual claims by calling evidence about what securities were sold or at what prices securities could have been sold after implementation.

(e) Post-Filing Interest

[56] The Noteholders submit that the trial judge erred in concluding that the Senior Debt Holders were entitled to post-CCAA-filing interest on their outstanding amounts. The Noteholders make two arguments.

[57] First, the Noteholders say that under the Plan, interest is only payable to creditors up to and including the filing date. They base this argument on the definition of a claim in the Plan which is as follows:

> [A]ny right of any Person against one or more of the Applicants in connection with any indebtedness, liability or obligation of any kind of any one or more of the Applicants in existence on the Filing Date and any interest thereon and costs payable in respect thereof to and include the Filing Date[.]

[58] The Noteholders submit that any claim the Senior Debt Holders have for interest must be based on a "claim" they have against Stelco for such interest. If the Senior Debt does not include post-filing interest, there can be no claim against the Noteholders for such amounts.

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[59] We do not accept the Noteholders' argument. We note that the Debentures were not cancelled until the implementation of the Plan on March 31, 2006. Section 6.01(2) of the Plan specifically contemplates that the Senior Debt Holders will be able to claim interest against the Noteholders up to the point at which they are paid in full. For convenience, we repeat the relevant language of s. 6.01(2) here:

> [T]he fact that the Plan provides that the calculation of the quantum of Claims and Affected Claim[s] is limited to principal, plus interest accrued to the Filing Date .... is not intended to bar or prejudice any entitlement of holders of Senior Debt (as defined in the Subordinated 2007 Bond Indenture) to make a claim for the full benefit for subordination against the holders of the Subordinated 2007 Bonds and their trustee in respect of *all* amounts owing to them or that would have been owing to them had the CCAA Proceedings and the Plan never been implement, even amounts in excess of their Claims or Affected Claims for purposes of the Plan[.] [Emphasis in original.]

[60] In our view, a fair reading of the Plan as a whole indicates that the definition of "claim" in the Plan was not intended to limit the Senior Debt Holders' claims for interest on outstanding debt after the filing date. The definition of a claim relied upon by the Noteholders was intended only to form the basis upon which the amounts of claims against the company can be fixed for voting purposes in order to allow the company's affairs to be administered in the *CCAA* proceedings.

[61] The question then becomes whether the Debentures provide that interest would accrue after the institution of the *CCAA* proceedings. We are satisfied that they do. The Debentures specify that Stelco would pay principal and interest accrued thereon, including in the case of default, interest on the amount of the default, so long as any Debentures remain outstanding. The Debentures remained outstanding after the filing in the *CCAA* proceedings until the Plan was implemented on March 31, 2006. Clearly, the Debentures contemplated that interest would continue to accrue post-filing.

[62] Moreover, nothing in the Note Indenture limits the Senior Debt Holders' entitlement to interest as of filing under a *CCAA* Plan. Parties to the Note Indenture expressly addressed the possibility of the insolvency of Stelco and established the Turnover Proceeds process. In doing so, the Note Indenture did not limit the Senior Debt Holders to pre-filing interest claims. On the contrary, the Noteholders agreed that they would not receive any payment from Stelco until after all Senior Debt had been paid in full. Senior Debt was defined as "the principal of the premium (if any) and interest ...".

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[63] Thus, we do not accept the Noteholders' argument that the Plan limited the Senior Debt Holders' claim to pre-filing interest.

[64] The Noteholders' second argument is that the Senior Debt Holders are not entitled to post-filing interest because of an "Interest Stops Rule". According to this argument, interest would only be paid up to the filing date in all bankruptcy, winding up and related proceedings, including restructurings under the *CCAA*. The policy reasons for the rule are that one creditor's *pro rata* share of the debtor's filings should not increase faster than another's and also that claims in a *CCAA* proceeding should be fixed and not subject to continual recalculation for interest.

[65] The Noteholders point out that the *CCAA* defines a claim as "any indebtedness, liability or obligation of any kind that, if unsecured, would be a debt provable in bankruptcy within the meaning of the *Bankruptcy and Insolvency Act*." Post-filing interest cannot be claimed under the *BIA*.

[66] The trial judge rejected these arguments, correctly in our view.

[67] To start, there is no persuasive authority that supports an Interest Stops Rule in a *CCAA* proceeding. Indeed, the suggested rule is inconsistent with the comment of Justice Binnie in *Re Canada 3000 Inc.*, [2006] 1 S.C.R. 865 at para. 96, where he said:

> While a *CCAA* filing does not stop the accrual of 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*.

[68] Justice Binnie's comment highlights the point that not all companies emerge from *CCAA* proceedings. Some are converted into *BIA* proceedings. When that happens, claims under the *BIA* include interest up to the date of the bankruptcy and, therefore, could include claims after a *CCAA* filing.

[69] In our view, the definition of claim in the *CCAA* is not intended to limit payments to creditors. Indeed, the Noteholders accept that Plans can and sometimes do provide for payments in excess of claims filed in the *CCAA* proceeding. That fact argues against an interpretation of the definition of a claim in the *CCAA* that would limit payments to the creditors.

[70] In our view, the definition of claim in the *CCAA* is intended to set a date in order to crystallize a point in time at which claims against the company can be fixed for voting purposes in order that the estate may be administered. It has nothing to do with the amount of payments to the creditors. As we set out above, s. 6.01(2) of the Stelco Plan contemplated the continuation of accrual of interest to the Senior Debt Holders after the

CCAA filing date. We do not accept that there is a "Interest Stops Rule" that precludes such a result.

(f) Disposition

[71] Accordingly, for the reasons set out above, the Noteholders' appeal is dismissed.

III. THE 2074600 ONTARIO INC. APPEAL (C46258)

[72] 2074600 Ontario Inc. is the assignee of a claim against Stelco by EDS Canada Inc. ("EDS"). The EDS Claim arises out of a Master Information Technologies Services Agreement entered into between Stelco and EDS in February 2002 (the "MITSA"). Under that Agreement, Stelco outsourced and transferred to EDS all of its information technology ("IT") services and needs. Stelco's anticipated costs for operational and project fees over the ten-year period contemplated by the MITSA were approximately $320 million. At the time of the CCAA filing Stelco's indebtedness to EDS was fixed at $48,994,917.

[73] The issue before us is whether Stelco's indebtedness to EDS places 2074600, as assignee, amongst the class of Senior Debt Holders and therefore entitles 2074600 to its *pro rata* share of the Turnover Proceeds. The answer to this question depends upon whether the EDS indebtedness falls within the definition of "Senior Debt" in the Note Indenture.

[74] "Senior Debt" is defined in the Indenture as follows:

> "Senior Debt" means the principal of, the premium (if any) and interest on: (i) indebtedness, other than indebtedness represented by the [Noteholders], for money borrowed by [Stelco] or for money borrowed by others for the payment of which [Stelco] is liable; (ii) indebtedness incurred, assumed or guaranteed by [Stelco] in connection with the acquisition by it or by others of any business, property, services or other assets *excluding indebtedness incurred in relation to any such acquisitions made in the ordinary course of business*; and (iii) renewals, extensions and refundings of any such indebtedness, unless, in any of the cases specified above, it is provided by the terms of the instrument creating or evidencing such indebtedness that such indebtedness is not to be superior in right of payment to the [Noteholders.] [Emphasis added.]

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[75] In short – as all counsel agreed the motion judge properly asked himself – the issue is whether the acquisition transaction contemplated by the MITSA was out of the ordinary course of business for Stelco. 2074600 says it was. The Debentureholders and the Noteholders (aligned in interest on this issue) say it was not. The motion judge agreed with the Debentureholders and the Noteholders. He held that the EDS Claim did not constitute "Senior Debt".

[76] Respectfully, we disagree.

[77] The motion judge began his consideration of the EDS Claim by observing that the Supreme Court of Canada has held that there is no comprehensive definition of the term "ordinary course of business" and that the Court must consider "the circumstances of each case in order to determine how to characterize any particular transaction": see *Pacific Mobile Corp. (Trustee of) v. American Biltrite (Canada) Ltd.*, [1985] 1 S.C.R. 290 at 291. He therefore correctly determined that he must interpret the term in the context of the definition of "Senior Debt" and the circumstances of this case.

[78] Having reviewed the three-part definition of "Senior Debt", the motion judge set out the substance of his decision as to the approach to be taken:

> I am of the opinion that, for this purpose, the concept of an ordinary course acquisition should be interpreted broadly and, accordingly, a non-ordinary course acquisition should be given a narrow scope. The concept of an acquisition in the ordinary course of business goes beyond transactions with trade creditors. The reference to " *business, property,* services *or other assets*" (emphasis added) suggests that the principal focus of the clause is the acquisition of businesses or assets. The reference to the acquisition of services, while included in the list, is secondary and suggests that it was included to reflect the possibility that an acquisition could include a service component, rather than the possibility of a 'services only' transaction. This reading of the definition of an ordinary course transaction suggests that the intention was to narrow transactions that qualified as non-ordinary course transactions to those that are material to Stelco in terms of both the amount of the indebtedness incurred or assumed and in terms of their impact on Stelco's business and operations. Accordingly, I think the clause implicitly requires demonstration that the acquisition will have the effect of significantly changing the nature of the business conducted, being the goods and services produced and sold, the scale of operations, the manner of manufacturing or distributing the

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> products sold by Stelco, or the anticipated financial results of Stelco.
>
> While I do not think that the clause contemplates transactions in which services are the principal subject matter, I accept, however, that such acquisitions could qualify as Senior Debt if it can be demonstrated that the transaction will have an effect on Stelco that is described by the test set out above. In particular, if a service contract, for which the most obvious candidate would be an outsourcing contract such as the MITSA, materially changes the manner in which Stelco manufactures or distributes its products, or its financial prospects, the contract can be said to envisage a transaction that is analogous to a non-ordinary course acquisition of a business, property or assets.

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[79] The motion judge then went on to find that the MITSA did not satisfy his test for essentially three reasons. First, he concluded that the transaction contemplated by the MITSA "will not significantly change the nature of Stelco's business or the scale of its operations. Nor will its change either the products manufactured and sold by Stelco over this period or Stelco's manufacturing or distribution activities". Secondly, he found it necessary to separate the components of the MITSA into its "ordinary course elements" and its "non-ordinary elements", and he decided that the former outweighed the latter. Finally, while the total fees anticipated over the ten-year term of the MITSA were "undoubtedly significant", the motion judge found that the annual expenditures involved were not materially greater than those under other outsourcing arrangements Stelco had entered into and that there was "no evidence that the transaction contemplated by the MITSA was material to the projected annual financial performance of Stelco".

[80] The Debentureholders and Noteholders stress that this court has emphasized on a number of occasions that Commercial List judges, particularly those supervising a *CCAA* proceeding, are entitled to considerable deference: see *Stelco Inc. (Re)* (2005), 75 O.R. (3d) 5 (C.A.) at para. 63; *Stelco Inc. (Re)* (2006), 21 C.B.R. (5th) 157 (Ont. C.A.) at 160; and *BNY Capital Corp. v. Katotakis*, [2005] O.J. No. 623 (C.A.) at para. 8. They also submit that a determination of whether a transaction falls within "the ordinary course of business" of an enterprise is an issue of fact: see *McDonic v. Hetherington (Litigations Guardian of)* (1997), 31 O.R. (3d) 577 (C.A.) at 583; and *Public Trustee v. Mortimer* (1985), 49 O.R. (2d) 741 (H.C.J.) at 750. Accordingly, they argue that we should not interfere with the findings of the motion judge – an experienced Commercial List judge interpreting a commercial contract – as he made no palpable and overriding error and is entitled to deference.

[81] Determining whether a transaction occurs in the ordinary course of business entails more than simply the finding of facts and the drawing of inferences from those facts, although the fact finding exercise is clearly a central part of the process. "Ordinary course of business" is a legal notion and the decision as to whether a certain set of facts falls within that category, or does not, has generally been arrived at by courts through an examination of various factors associated with the notion – about which we will have more to say later. In this sense, we prefer the approach taken by the Alberta Court of Appeal in *Gainers Inc. v. Pocklington Holdings Inc.* (2000), 271 A.R. 280 (C.A.), namely that such a determination is a question of mixed fact and law. As Fruman J.A. noted at para. 23:

> While a reviewing court will defer to a trial judge's fact findings, a determination that a transaction was in the ordinary course of a company's business is a mixed question of fact and law. A failure to consider the appropriate factors constitutes reviewable error.

[82] We do not read Justice Doherty's comments in *McDonic Estate, supra*, to mandate any different conclusion. There, the court was dealing with whether a law firm was vicariously liable for the actions of a partner who had invested funds deposited in the firm's trust account on behalf of the plaintiffs. The answer depended on whether the partner's actions fell within the scope of his implied authority, which they did if they fell within the ordinary course of business of the law firm. The meaning of the legal norm was not in issue. Doherty J.A. observed that the question was a factual one – without focusing on whether it was a question of fact alone or of mixed fact and law – and noted that the trial judge's finding that the partner's activities did not fall within the scope of the firm's ordinary course of business "must stand unless tainted by an error of law, a serious misapprehension of the evidence, or a failure to consider relevant evidence". This conclusion is not inconsistent with the approach taken by the Alberta Court of Appeal in *Gainers*.

[83] The Supreme Court of Canada recognized the importance of "the constant interplay between law and fact" in *Pacific Mobile, supra*, at 291, adopting the comments of Monet J.A. in the Quebec Court of Appeal in that case: (1983), 44 C.B.R. (N.S.) 190 at 205. And in *Housen v. Nikolaisen*, [2002] 2 S.C.R. 235 at paras. 32-36, the Supreme Court of Canada also recognized that, although the findings of a judge of first instance on issues of mixed fact and law will generally be entitled to deference on the "palpable and overriding error" standard, where the judge has erred in applying a "readily extricable" legal principle in making those findings the review will be conducted in accordance with a less stringent standard. A failure to consider appropriate factors or an error in determining the factors to be applied will fall into this latter category.

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[84] In our view, the motion judge fell into such error here. We say this for a number of reasons.

[85] First, his approach to the resolution of the ordinary course of business issue was grounded in his view that the concept of an "ordinary course" acquisition in the definition of Senior Debt in the Note Indenture should be interpreted broadly and that of a "non-ordinary course" acquisition, narrowly. This approach was driven by his view of the terms of the Note Indenture, particularly the definition of "Senior Debt" and his perception that the reference to the acquisition of "services" in the definition was secondary – included "to reflect the possibility that an acquisition could include a service component, rather than the possibility of a 'services only' transaction." We do not understand why, as the motion judge said (reasons, para. 157), "the reference to '*business, property,* services *or other assets*' [emphasis added by the motion judge] suggests that the principal focus of the clause is the acquisition of businesses [the first item mentioned] or assets [the last mentioned]" rather than on "services" (the third item mentioned). We can see no basis for singling out "services" from the list and assigning it a lower level of significance. These are not matters of fact; they are matters of contractual interpretation.

[86] Secondly, while the motion judge acknowledged, and found, that the MITSA transaction "was a *unique* outsourcing transaction" and that it "was both *comprehensive* in terms of the scope of Stelco's IT requirements" and also "*significant* to Stelco, because a failure by EDS to perform adequately would be costly" [emphasis added], he gave these important factors little, if any, consideration in making his ordinary course of business determination.

[87] Thirdly, in establishing the criteria that he did for resolving the issue, he set the bar so high that a non-ordinary course of business acquisition in relation to services is practically impossible. This stems, at least in part, from his conclusion that an acquisition in relation to "services" does not rank at the same level as other types of acquisitions. On our reading of the Note Indenture, this interpretation is inconsistent with the intention of the parties to it.

[88] Finally, the motion judge erred, in our view, by entirely discarding the factors taken into account in the existing jurisprudence concerning what may constitute a transaction out of the ordinary course of business. He did so on the basis that the cases relied upon by 2074600 "dealt with the disposition of assets, rather than acquisitions, in circumstances in which the applicable covenant or legislation is directed toward fair treatment of, or protection of, creditors", and that "[t]hey do not deal with the concept of non-ordinary course transactions involving the purchase of assets or services by a solvent company". The cases referred to are *Pacific Mobile, supra* (a fraudulent preference case); *Roynat Inc. v. Ron Clark Motors Ltd.* (1991), 1 P.P.S.A.C. (2d) 191 (Ont.Ct. J. (Gen.Div.)) (covenant in a floating charge); and *Rowbotham v. Nave* (1991), 1 P.P.S.A.C.

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(2d) 206 (Ont. Ct. J. (Gen. Div.)) (bulk sales legislation). But see also, *Fairlane Boats Ltd. v. Leger* (1980), 1 P.P.S.A.C. 218 (Ont. H.C.) (whether sale of a boat by a dealer was in the ordinary course of business); *Gainers Inc. v. Pocklington Holdings Inc., supra* (sale of shares of a subsidiary company); *Canadian Broadcasting Corp. Pension Plan v. BF Realty Holdings Ltd.* (2002), 214 D.L.R. (4th) 121 (Ont. C.A.) (sale of all or substantially all of assets outside of the ordinary course of business in a dissenting shareholder rights context); and *Aubrett Holdings Ltd. v. Canada*, [1998] G.S.T.C. 17 (T.C.C.).

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[89] Respectfully, we do not understand the significance of the distinction drawn by the motion judge between circumstances involving the disposition of assets and those involving acquisitions for these purposes. When the Supreme Court of Canada observed that it is unwise "to give a comprehensive definition of the term 'ordinary course of business' for all transactions" (*Pacific Mobile, supra* at 291), the court did not mean that there were no recognizable indicia or factors to be considered; it simply meant that no single criterion or set of criteria was suitable for all cases. While there may be different considerations in situations involving fraudulent preferences, bulk sales transactions, tax cases or dissenting shareholders' rights cases, the factors taken into account by the courts in such circumstances may nonetheless be of assistance here because they help shed light on what courts have looked to in various contexts in order to decide whether a transaction is one that is in the ordinary course of business.

[90] In our view, the foregoing errors by the motion judge moderate the deference to which his decision on a question of mixed fact and law would otherwise be entitled and permit us to reconsider the ordinary course of business analysis afresh.

[91] In that regard, we start with the observation that the intention of the Note Indenture is clear: the Noteholders' claims are to be subordinated to *all* Senior Debt, as defined in the Indenture. Article 2.9 (Rank and Subordination) provides that "payment of the principal of and interest on the Debentures is expressly subordinated to the prior payment in full of Senior Debt, as provided in Article 6." Article 6 (Subordination of Debentures) opens with the declaration in 6.1 that:

> [Stelco] covenants and agrees, and each [Noteholder], by his acceptance thereof, likewise agrees, that the payment of the principal of and of any interest on the Debentures is hereby *expressly subordinated*, to the extent and in the manner hereinafter set forth, in right of payment *to the prior payment in full of all Senior Debt whether outstanding on the date of this First Supplemental Indenture or thereafter incurred.* [Emphasis added.]

[92] The definition of "Senior Debt" is cited above. In substance, it encompasses all borrowings of a general nature and all borrowings for purposes of acquisitions (except

acquisitions in the ordinary course of business), together with the refinancing of such borrowings. In our opinion, this concept of Senior Debt is quite broad and is intended to be so.

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[93] Accordingly, we see no reason why ordinary course acquisitions should be viewed broadly and non-ordinary course acquisitions addressed narrowly. Having regard to the purpose of Article 6.1 of the Note Indenture and the definition of Senior Debt, we think the contrary is the case. The purpose and intent of the Indenture was to ensure that creditors providing financing to Stelco, other than ordinary course of business creditors, would have priority over the Noteholders, who accepted that they were taking subject to such "Senior Debt".

[94] It does not advance the case to argue – as the Debentureholders do – that because of the impact on other creditors' rights (namely, those of the Noteholders) the concept of non-ordinary course transactions should be interpreted narrowly and ordinary course transactions broadly. The only issue here is what "creditors' rights" are to be affected? We can see no basis for interpreting the Note Indenture in favour of one group of creditors over another simply because of what group they fall into. A reading of the definition of Senior Debt supports the view that debtholders who were creditors for "moneys borrowed" by Stelco – whether it be free-standing borrowing or indebtedness incurred in connection with the acquisition of business, property, *services* or assets – were to have priority over the Noteholders. The only exceptions were ordinary course of business acquisitions. Given this scheme, it is the exception that ought to be construed narrowly, not the principal provision.

[95] The motion judge's opinion that the factors considered by other courts to be pertinent to the determination of what constitutes a transaction in the ordinary course of business, together with his view that non-ordinary course transactions should be narrowly construed in the circumstances of this case, led him to postulate his own test. In doing so, he set the bar very high. To qualify as a transaction out of the ordinary course of business, he concluded that an acquisition must have the effect of *significantly changing* either (a) the nature of the business conducted by Stelco (the goods and services it produced or sold, the scale of its operations, the manner of manufacturing or distributing the products it sold) and/or (b) the financial results of Stelco.

[96] The motion judge cited no authority for such a prohibitive test, and we are aware of none. Undoubtedly, an acquisition that met those criteria would be a non-ordinary course of business transaction, but we do not read anything in the Note Indenture or in the jurisprudence that requires a transaction that is out of the ordinary course of business to be of such a corporate landscape-changing nature.

[97] In *Gainers, supra*, Fruman J.A. noted (at para. 21) that:

> The analysis is to be achieved through an objective examination of the usual type of activity in which the business is engaged, followed by a comparison of that general activity to the specific activity in question. *The transaction "must fall into place as part of the undistinguished common flow of business carried on, calling for no remark and arising out of no special or peculiar situation"*: Aubrett Holdings Ltd. v. Canada, [1998] G.S.T.C. 17 (T.C.C.). [Emphasis added.]

[98] In *Roynat Inc. v. Ron Clark Motors Ltd., supra*, at 197, Herold J. cited *Re Bradford Roofing Industries Property Ltd.*, [1966] 1 N.S.W.R. 674 – a decision of the New South Wales Supreme Court – to the same effect:

> The transaction must be one of the ordinary day to day business activities, having no unusual features, and being such as a manager of a business might reasonably be expected to be permitted to carry out on his own initiative without making prior reference back or subsequent report to his superior authorities such as, for example, to his board of directors.

[99] These observations are consistent with dictionary explanations. *The Shorter Oxford English Dictionary*, 3rd ed., defines "ordinary" as being "of common occurrence, frequent, customary, usual" and "of the usual kind, not singular or exceptional". It defines "course" as meaning "habitual or ordinary manner of procedure; way, custom, or practice". *Black's Law Dictionary*, 6th ed., describes "ordinary course of business" in the following fashion:

> The transaction of business according to the common usages and customs of the commercial world generally or of the particular community or (in some cases) of the particular individual whose acts are under consideration. … *In general, any matter which transpires as a matter of normal and incidental daily customs and practices in business*. [Emphasis added.]

[100] Given these parameters, it is hard to appreciate why a transaction that is not in the ordinary course of business should be required to meet such a high threshold as that ascribed to it by the motion judge in the circumstances of this case – particularly keeping in mind the purposes and intent of the Turnover Provisions in the Note Indenture.

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[101] A number of helpful benchmarks may be gleaned from a review of the authorities and the citations referred to above for purposes of determining whether the MITSA transaction constitutes an acquisition of services in the ordinary course of Stelco's business. They include a consideration of whether the transaction:

a) is distinguishable from the normal course of the company's operations because of its particular complexity or its far-reaching or otherwise unusual nature;

b) arose out of some special or peculiar situation;

c) required approval from the company's shareholders or board of directors;

d) was given special notice by the company;

e) was an unusual or isolated undertaking as opposed to a routine one; or,

f) is reflective of standard practice in the relevant industry.

[102] The motion judge was not unmindful of all of these factors. As we have indicated, however, he weighed those that he did consider against what we take to be an unsuitably high standard.

[103] In our view, the transaction envisaged in the MITSA was not a transaction in the ordinary course of Stelco's business. We say that having regard particularly to a number of factors and characteristics.

[104] First, as the motion judge found, the MITSA was a uniquely comprehensive and significant transaction for Stelco. The evidence was that no outsourcing transaction in Stelco's history was comparable to it. It contemplated a total amount payable by Stelco over its ten-year term of more than $320 million.

[105] The MITSA involved the total transition of Stelco's IT assets and virtually all business applications and IT employees from Stelco to EDS and the complete transfer from Stelco to EDS of all responsibility for Stelco's IT needs. As well as providing for the transfer of IT assets from Stelco to EDS and from EDS to Stelco, and for the provision of all services in relation to Stelco's IT needs, the MITSA provided for the integration, through a series of enterprise resource planning systems ("ERPs"), of all aspects of Stelco's business from procurement or materials to shipping of finished products. The ERPs consisted of three projects: (i) a synchronous manufacturing system, (ii) an asset management system, and (iii) human resources and financial management

systems. The effect was to overhaul and change completely Stelco's manufacturing, asset management, human resource and financial management systems.

[106] As Mr. Steiner put it in his factum and in oral argument on behalf of 2074600: "If this extraordinary contract for services … is not out of the ordinary course of business for Stelco, what possible contract for services could be?"[3].

[107] Second, the MITSA was a one-time transaction – isolated, unusual, and far from routine in the course of Stelco's business.

[108] Third, the MITSA was the subject of a special public announcement by Stelco. The Debentureholders and the Noteholders argue that it is the content – or, rather, what is missing in the content – of the press release that is significant, not the public announcement itself. They say this because the press release made no specific mention of the fact that the MITSA indebtedness would constitute Senior Debt and therefore the market could not be expected to react on the basis that it did. In our view, however, the significant point is that Stelco felt the transaction was sufficiently important and unusual that public disclosure was necessary, a step the company rarely took when entering into a procurement contract. Stelco's indebtedness with regard to the MITSA was treated as long-term indebtedness, and was specifically mentioned on its financial statements. In short, the transaction – to adopt the language of *Aubrett Holdings, supra* – was not treated as one "calling for no remark". It received special notice.

[109] Fourth, the MITSA entailed complex provisions relating to financing that were unusual to Stelco and to EDS. Because the material and evidence filed on this issue contains confidential information and has been ordered sealed, no more need be said about it.

[110] Finally, the transaction was not one that could be carried out on management's own initiative. It required, and received, approval from Stelco's board of directors.

[111] The fact that others in the steel industry may be outsourcing their IT needs as well, and the fact that Stelco engaged in other outsourcing transactions itself, are indicative of the increasing popularity of this particular practice, but they are not dispositive of whether the transaction envisaged in the MITSA is an ordinary course of business transaction for Stelco. In the end, the transaction provided for in the MITSA involved a fundamental change to the way in which Stelco carried on its integral IT operations – and through that, its manufacturing operations – at a cost and in a fashion that was considered sufficiently significant to call for public disclosure, and which required and received board of director approval. It was characterized by unusual and complex financial arrangements. Even if the motion judge were correct in his conclusion that the MITSA

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[3] Factum of 2074600 Ontario Inc., para 72.

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did not effect a significant change in the nature of the business Stelco conducted – it continued to manufacture and distribute steel products – the transaction was not "one of the ordinary day to day business activities, having no unusual features" (*Re Bradford Roofing*), or "part of the undistinguished flow of business carried on, calling for no remark" (*Aubrett Holdings*, as adopted in *Gainers*). It did not transpire "as a matter of normal and incidental daily customs and practices in business" (*Black's Law Dictionary*).

[112] The property, services and assets provided for in the MITSA were not acquisitions made in the ordinary course of Stelco's business. Accordingly, the indebtedness incurred by Stelco to EDS (and therefore to 2074600, as assignee of EDS) constitutes "Senior Debt" within the meaning of the Note Indenture.

[113] 2074600 Ontario Inc. is a Senior Debt Holder and is entitled to its *pro rata* share of the Turnover Proceeds in that capacity. Its appeal in this regard is allowed.

IV. The Debentureholders' Appeal (C46266)

(a) Overview

[114] The Debentureholders and the Noteholders disagree on the value of the Distributed Assets. This has an effect on the value of the Deficiency (if any), which in turn determines how the Turnover Proceeds will be distributed amongst the parties. The Debentureholders assign a lower value to the Distributed Assets ($217,215,846) compared to the Noteholders' valuation ($294,497,863). This means that by the Debentureholders' calculation, the Deficiency is $125,439,818 whereas the Noteholders calculate the Deficiency to be much lower ($48,157,801).

(b) The Source of the Disagreement

[115] The Debentureholders adduced evidence from different sources that supported a finding that the value of the New Common Shares on the Effective Date was $5.50 per share. They also argued that the New FRNs should be valued at par (face value) and that the New Warrants should be valued at $1.44 per warrant.

[116] The Noteholders did not adduce conflicting evidence regarding the value of the shares on the Effective Date; instead, they adduced evidence by way of a report prepared by a derivatives expert who assigned a value to the Distributed Assets based on the volume weighted average price ("VWAP") of the securities during the first week of trading, beginning on April 3, 2006.

(c) The Motion Judge's Reasons

[117] The motion judge used a third set of figures and his own methodology to arrive at a different set of valuations. He did not agree with either party's position on valuation.

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He held that "value" means "the price for the securities that the Senior Debt Holders could have received if they had sold their securities in an open market at the Effective Time on March 31, 2006." The motion judge also held that the definitions of "fair market value", "fair value", and "intrinsic value" were not helpful to determine the definition of "value" to the extent that those terms mean "something other than the price of the securities in an open market", because the issue was not whether the Debentureholders had received "fair" value, but rather what value should be ascribed to the assets.

[118] The motion judge rejected the parties' positions on the grounds that neither method of valuation was an appropriate reflection of the value of the securities on the Effective Date. He then determined that the best evidence of the value of the Distributed Assets was the VWAP from the first trading day after the Effective Date. In the case of the New Common Shares and the New Warrants, the first day of trading was April 3, 2006; for the new FRNS, the first trading day was April 5, 2006. The motion judge did not take into account block discounts or a lack of liquidity in the marketplace to alter those values. He valued the Distributed Assets at a total of $276,487,090, leaving a Deficiency of $66,168,574.

[119] Both the Debentureholders and 2074600 appeal the motion judge's reasons with respect to his valuation methodology.

(d) Analysis

[120] A central issue on this appeal relates to the price to be attributed to the securities distributed by Stelco – in particular, the price of its New Common Shares – as part of the compromise of its debt. The issue arises because of the Subordinated Noteholders' obligation under the Note Indenture to make the Senior Debt Holders whole out of any proceeds they (the Notheholders) receive in an insolvency or reorganization. Only after the Senior Debt Holders have been paid in full are the Noteholders entitled to recover on their own account.

[121] Articles 2.9, 6.1 and 6.2 of the Note Indenture, which are cited in full elsewhere in these reasons, set out these obligations on the part of the Noteholders. For present purposes, the provisions that are most relevant are those set out in section 6.2(3)[4] which states that in the event of the insolvency or reorganization of Stelco, any payments received from Stelco by the Noteholders or the Trustee, whether in cash, property or securities, before the Senior Debt is paid in full, are to be held in trust,

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[4] Article 6.2(2) contains the identical operative language.

> and will be paid over to the holders of such Senior Debt ... for application to the payment of all Senior Debt remaining *until such Senior Debt has been paid in full, after giving effect to any concurrent payment or distribution (or provision therefore) to the holders of such Senior Debt.* [Emphasis added.]

[122] There is no dispute about the amount of the Senior Debt remaining unpaid as at the Effective Date ($342,655,664 plus the EDS Claim of $48,994,917). Thus, the central issue for determination is how to "[give] effect to any concurrent payment or distribution ... to the holders of [the] Senior Debt" in order to determine whether the Senior Debt Holders had been "paid in full" and, if not, the extent of the Deficiency to be made up through the Turnover Proceeds ("the Deficiency Claim").

[123] That is not the question the motion judge posed for himself, however. Both the Debentureholders and 2074600 argued that the New Common Shares and the New Warrants should be valued using the $5.50 subscription price for the New Common Shares under the Plan. The motion judge rejected this approach. Instead, he focused on the public markets and sought to determine what the "market value" was of Stelco's New Common Shares received in the distribution, as closely as that value could be determined to the Effective Time under the Plan.

[124] At paras. 105 and 106 of his Reasons he said:

> The issue before the Court can therefore be put simply: did the Senior Debt Holders receive Distributions on the Plan Implementation Date having a value that constituted "payment in full" of their claims and, if not, what is the extent of their deficiency? For this purpose, *the Court must determine the value of the payments received* by the Senior Debt Holders. For the reasons set out above, I have concluded that the payments were received by the Senior Debt Holders at the Effective Time on March 31, 2006 and must be valued as of that time. There is, however, *no provision in either the Note Indenture or the Plan that specifically addresses the proper approach to the valuations* of the property received in reorganization. Accordingly, the issue for the Court is the most appropriate evidence of the value of the Distributions received by the Senior Debt Holders on March 31, 2006.

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> The Court is not, of course, to conduct its own inquiry into the value of the securities. The Court must determine, instead, the best evidence of the value of the Distributions based on the evidence before it. *For this purpose, I am of the opinion that "value" means the price for the securities that the Senior Debt Holders could have received if they had sold their securities in an open market at the Effective Time on March 31, 2006.* This reflects the fact that, at that time, the Senior Debt Holders were in a position to realize the values of the securities paid to them by selling them in the market. *Accordingly, the Court must determine the market price paid for the securities at the Effective Time.* [Emphasis added.]

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Later, the motion judge concluded:

> The issue for the Court is the determination of the prices that the Senior Debt Holders could have obtained for their securities if it had been possible to trade the securities at the Effective Time on the Plan Implementation Date.

[125] Respectfully, however, the issue for the Court to determine was not the price the Senior Debt Holders could have obtained had they been able to trade their new securities at 11:59 p.m. on March 31, 2006 – their "market value" at that time. The issue was how to determine the "concurrent payment or distribution" received from Stelco by the Senior Debt Holders at the time of Stelco's emergence from *CCAA* protection at 11:59 p.m. on that date, and how to give effect to that concurrent payment or distribution for purposes of resolving whether the Senior Debt Holders had been paid in full, in the context of the Note Indenture and the Plan documents.

[126] To interpret how to give effect to the payment received by the Senior Debt Holders "concurrently" – that is, concurrently with the payments received by, or on behalf of, the Noteholders in the *CCAA* insolvency proceedings – it is necessary to construe the provisions of the Note Indenture in the context of the language of the Plan itself and the negotiations leading up to its approval by the stakeholders and sanction by the Court. That is the factual matrix within which the meaning of this contract must be determined.

[127] What, then, was the concurrent payment or distribution received by the Senior Debt Holders in exchange for the compromise of their claims on the emergence of Stelco from *CCAA* protection? The answer to that question is found in Article 2.03 of the Plan. What the Affected Creditors under the Plan – the Senior Debt Holders and the Noteholders included – received was their *pro rata* share of each of:

a) $275 million (U.S.) of the New Secured Floating Rate Notes ("FRNs");

b) the Cash Pool (subject to section 2.07 of the Plan);

c) 1.1 million New Common Shares; and

d) the New Warrants.

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[128] The argument on the appeal focused on the Senior Debt Holders' *pro rata* share of (b) and (c) above. The creditors were to receive a block of New Common Shares of Stelco as part of the compromise of their debt; they were prepared to invest and to take an equity position in the new Stelco to the extent of 1.1 million shares. They were also to receive a pool of cash which was to vary between $137.5 million and $108.5 million, depending upon the number of shares creditors elected to take up pursuant to Section 2.07 of the Plan, referenced in the caveat to (b) above.

[129] Section 2.07 is the "Share Election" provision in the Plan. It does two things. First, it permits each Affected Creditor to "elect to receive all or any part of its distribution from the Cash Pool in New Common Shares at $5.50 per share",[5] thus providing an opportunity for electing Affected Creditors to take a further risk, in effect by engaging in a new transaction and investing part of their cash proceeds in the future of the new Stelco. Second – and significantly from the perspective of resolving what the concurrent payment or distribution received by the Senior Debt Holders was – Section 2.07 makes it clear that the size of the Cash Pool to be received on distribution is to be reduced by $5.50 for each New Common Share that is elected to be taken. Hence, the amount of cash that Stelco would be required to pay to exit from the *CCAA* process varied in the range referred to above, depending upon the number of New Common Shares the creditors elected to acquire.

[130] All of this gives rise to the following questions. Viewed in the context of the Plan documentation and the negotiated compromise of the creditors' claims against Stelco, how should the words "give effect to any concurrent payment or distribution to the holders of such Senior Debt" in Articles 6.2(2) and (3) of the Note Indenture be interpreted? Leaving aside the FRNs and Warrants, was it the "concurrent payment or distribution" of cash and a bundle of $5.50 New Common Shares? Or was it the combination of cash and a bundle of shares distributed at the price they would fetch in the open market once trading commenced?

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[5] Subject to an aggregate of 5,264,000 shares, at which point the Share Elects are entitled to receive a *pro rata* share of that total.

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[131] These are not questions of fact. They are questions of interpretation of the Note Indenture and the Plan documentation. Importantly, these questions focus on the proper approach to "giving effect to" the distribution of securities to the Senior Debt Holders as part of the reorganization. The motion judge's decision is therefore entitled to less deference on appeal than would be the case if what was at issue were simply a question of fact or of inferences drawn from the facts. See paragraph 83 above, and *Housen v. Nikolaisen*, [2002] 2 S.C.R. 235 at para. 33.

[132] In our opinion – although the motion judge was correct in observing that marketable securities are normally valued on the basis of what they will bring in the open market – he erred in focusing on "market value" and rejecting the "plan value" approach urged upon him by the Debentureholders and 2074600 in the circumstances of this case. By doing so, he lost sight of the real issue for determination which, as mentioned above, is how to give effect to the concurrent payments or distribution received by the Senior Debt Holders in order to establish the extent of the Deficiency Claim. "Plan value" as opposed to "market value" is the touchstone for resolving that issue. Once this is recognized, much of the force in the motion judge's reasons for dismissing the criteria urged on him by the Debentureholders and 2074600 dissipates.

[133] On a proper interpretation of Article 6 of the Note Indenture, in the context of the Plan documentation, what was paid or distributed by Stelco to the Senior Debt Holders and Noteholders pursuant to Section 2.03 of the Plan – leaving aside again the FRNs and the Warrants – was cash together with $5.50 New Common Shares (either as part of the Share Elect component or as part of the general New Common Share component of the payment or distribution to Affected Creditors). We say this for several reasons.

[134] First, it makes sense that the "concurrent payment or distribution" to the Senior Debt Holders under the Note Indenture be determined by the Plan documents, since the Stelco reorganization is the source of the payment or distribution in question. The indicia of distribution price in the Plan documents point to $5.50 per share.[6]

[135] Significantly, the Equity Sponsors under the Plan received 19,737,000 New Common Shares in exchange for their infusion of $108.5 million ($5.50 per share). Sunrise and Appaloosa – the two Noteholders leading this appeal – are two of the three Equity Sponsors. Each contributed approximately $27 million to acquire their roughly 4,950,000 shares at that price. Equally significantly, Senior Debt Holders and Noteholders who elected to take shares pursuant to Section 2.07 of the Plan (the "Share

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[6] While there is provision in the Plan for market liquidation of the shares and distribution of the proceeds to the Affected Creditor, where the Affected Creditor is resident in a jurisdiction where there are restrictions on the distribution of the securities (Article 4.05(1)), we view this provision as simply creating a mechanism for dealing with a potential problem, rather than as an indication of the price of the securities for distribution purposes.

Elects") did so on the basis of accepting one New Common Share in lieu of $5.50 of their *pro rata* share of the Cash Pool.

[136] Secondly, other indicia point in the same direction. For instance, Stelco itself publicly valued the New Common Shares issued at $5.50 per share "upon its emergence from *CCAA*": see Stelco's First Quarterly Report, March 2006, at p. 15. In addition, Stelco's board of directors approved a compensation package for its incoming CEO on the Effective Date. This package included a grant of 1 million New Common Shares at a price of $5.50 per share and a grant of options to acquire an additional 1,044,000 New Common Shares at a strike price of $5.50 per share. This transaction was consummated at the Effective Time as well and could not have taken place without the approval of the TSX, which was obtained.[7]

[137] In the Amended Plan Sponsor Agreement, the Equity Sponsors (including Sunrise and Appaloosa) agreed (a) to inject new capital into Stelco in exchange for New Common Shares at a rate of $5.50 per share, and (b) to purchase any shares left over from the Share Election process at a price of $5.50. They also had a right to purchase any New Common Shares that a subscriber failed to purchase at the Effective Time for the same price.

[138] Finally, it is apparent from the foregoing that the deal which was struck as a result of the negotiations leading up to the Plan and the acceptance and sanctioning of the Plan contemplated the distribution of $5.50 New Common Shares at the Effective Time. The Noteholders, as well as the Senior Debt Holders, were integrally involved in what Farley J. referred to at the Sanction Hearing as the "direct protracted negotiations" and "hard bargaining" of sophisticated parties,[8] and voted in favour of the Plan. In short, everyone knew, understood, and had agreed, that this was to be the case.

[139] The notion of the "Effective Time" (11:59 p.m. on the Effective Date) is important. The entitlement of the Senior Debt Holders and the Noteholders to the payment or distribution only arises at that moment, which is when their claims are compromised and their debentures (subject to the Turnover Proceeds dispute) are cancelled. All other transactions relating to the emergence of Stelco from its insolvent state occur at, or as close as possible to, that moment as well.

[140] We note this because, in rejecting the "Plan value" approach, the motion judge placed considerable emphasis on the fact that the $5.50 price was negotiated at the time of the creditors' acceptance of the Plan in December 2005, and therefore was not

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[7] TSX approval is significant because TSX issuers may not grant options at less than the market price of the securities at the time the option was granted: see *TSX Company Manual*, s. 613(h)(i).
[8] Endorsement of Farley J. at the Sanctioning Hearing, January 20, 2006.

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necessarily an accurate benchmark of the value of the shares on March 31, 2006. Similarly, the share election under Section 2.07 had to be made by January 20, 2006. These factors are of little import in assessing the payment or distribution received by the Senior Debt Holders at the Effective Time, however. Those creditors who elected to exercise their option under Section 2.07 and take shares in lieu of $5.50 in cash ("the Share Elect Creditors"), were not entitled to receive and did not have the right to receive those shares prior to the Effective Time. Though these decisions were made prior to the Effective Time, they were made with a view to what everyone agreed was the price of the New Common Shares at the Effective Time. The same is true of others who acquired New Common Shares as part of the reorganization.

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[141] Stelco distributed its New Common Shares to the Equity Sponsors, the Share Elect Creditors (also including many Noteholders) and its new CEO at a price of $5.50 per share, effective 11:59 p.m. on March 31, 2006. The Equity Sponsors, Share Elect Creditors and the new CEO purchased the shares for that amount at the same time. It makes no sense to say that Share Elect Creditors received those shares – at the same time and for purposes of compromising their claims – at some different distribution price (the average market price three days later), all as part of the same reorganization process. Nor does it make any sense to differentiate between the distribution price of the Share Elect shares and that of the 1.1 million New Common Shares that were distributed generally as part of the payment to Affected Creditors. If all other New Common Shares that were being sold and acquired as part of the reorganization at the same Effective Time were being distributed at $5.50 per share, why would the New Common Share component of the payment to Senior Debt Holders and the other Affected Creditors be distributed at any other price?

[142] All of these factors – the provisions of Section 2.03 of the Plan itself; the robust negotiations leading up to acceptance of the Plan; the $5.50 price paid at 11:59 p.m. on the Effective Date by the Senior Debt Holders, the Noteholders and the Equity Sponsors for their New Common Shares, and the price at which the New Common Shares and the options were issued to the new CEO at the same time – demonstrate clearly that the price which was accepted and agreed to by everyone involved in the reorganization for purposes of Stelco's payment or distribution upon emerging from the *CCAA* process was $5.50 per share.

[143] This was the payment or distribution price for purposes of "[giving] effect to [the] concurrent payment or distribution to the holders of [the] Senior Debt" called for in section 6.2(3) of the Note Indenture.

[144] Moreover, the foregoing interpretation makes commercial sense. Stelco and the Affected Creditors – including the Senior Debt Holders and the Noteholders – needed certainty in order to make the reorganization work. Stelco needed to know, with as much certainty as possible, how much it was going to have to pay to compromise its debt and

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emerge from the *CCAA* proceedings to start afresh. The Senior Debt Holders and Noteholders needed to know, again with as much accuracy as possible, how much they were going to be paid on account of their claims in order to decide whether to vote in favour of, or against, the Plan. These goals could not be achieved through an interpretation of the language in the Noteholders Indenture that would leave the quantum of the "concurrent payment or distribution" received by the Senior Debt Holders to the vagaries of the market after the distribution was completed.

[145] While the Affected Creditors as a whole were prepared to assume the risk of a relatively minor equity investment in the new Stelco – 1.1 million New Common Shares – as part of the price of arriving at a resolution of their claims – the Share Election provisions of Section 2.07 of the Plan provided a different opportunity. They gave creditors who were prepared to take the risk of a successful Stelco recovery a further opening to invest in that recovery by purchasing additional New Common Shares in what was, in effect, a second transaction following the distribution. The fact that Section 5.04 of the Plan notionally treats the subscriptions for shares pursuant to the Share Election under Section 2.07 as having occurred *after* the distributions to the Affected Creditors, lends support to this "second transaction" concept. For purposes of establishing the extent of the Deficiency Claim, what is distributed to the Senior Debt Holders as the Cash Pool is either cash or the share equivalent of $5.50 in cash.

[146] Although the foregoing analysis is limited to the Share Election shares, there is nothing in the Plan documentation or in the circumstances surrounding the reorganization – as we have mentioned above – to suggest that the New Common Shares as a whole should be treated on any different basis.

[147] The appeal must therefore be allowed in this regard and the order of the motion judge dated October 31, 2006, varied to provide that the New Common Shares were paid or distributed by Stelco under the Plan at a price of $5.50 per share. Based on the price per share, the New Warrants should be valued at $1.44 per warrant. Given our conclusion that Plan value is to govern, the FRNs should be valued as stated in the Plan.

[148] One further observation needs to be made. This decision should not be taken to have determined the value of the securities in the Turnover Proceeds to be used to provide "payment in full" of the Deficiency Claim. That issue was not before us.

V. The Share Elects' Appeal (C46916)

[149] We have before us an appeal from the order of the motion judge dated March 6, 2007. This appeal involves a dispute between the Debentureholders who elected to take shares under Section 2.07 of the Plan and those who did not, as to the appropriate method of allocating the Turnover Proceeds amongst themselves.

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[150] The dispute had its genesis in the motion judge's earlier decision – the subject of the foregoing appeal – to apply a market value approach to the distributions under the Plan for purposes of quantifying the Senior Debt Holders' Deficiency Claim. Using the $17.72 per share market price per share fixed by the motion judge in his earlier decision for purposes of determining the allocation as between the Share Elect and the Cash Elect creditors had the effect of skewing the allocation of the Turnover Proceeds in favour of the Cash Elects and depriving the Share Elects of the benefit of their decision to invest in the new Stelco. The motion judge resolved this issue by concluding that the Turnover Proceeds should be allocated amongst the Senior Debt Holders based upon their respective claims under the Plan using a price of $5.50 per share. He said that this approach was consistent with what would have been the outcome of the earlier motion regarding the quantum of the Senior Debt Holders' Deficiency Claim if that issue had been resolved by determining the distribution price of the shares before giving effect to the Share Election, and hinted – none too subtly – that he may have erred in not doing so.

[151] All counsel on the second appeal agreed, however, that if the first appeal were allowed with respect to the distribution price of the New Common Shares, and that price were fixed at $5.50 per share, this second appeal becomes moot. At a price of $5.50 per share, the Share Elects and the Cash Elects are treated equally on the allocation of the Turnover Proceeds. It is therefore unnecessary for us to decide the second appeal and it is dismissed as moot.

VI. Costs

[152] As to costs, we ask counsel to discuss and resolve the issues if at all possible. If they are unable to do so, those parties seeking costs may make written submissions of no more than five pages each (in addition to their draft bills of costs) before July 31, 2007. Those opposing the requests may respond in writing, again no more than five pages, before August 15, 2007. Brief replies, if necessary, may be filed before August 20, 2007.

"D. O'Connor A.C.J.O."
"S.T. Goudge J.A."
"R.A. Blair J.A."

RELEASED: June 28, 2007

TAB 3

Deloitte & Touche Inc., Liquidator of Shoppers Trust Corporation appointed pursuant to the Winding-up and Restructuring Act, R.S.C. 1985, c. W-11 v. Shoppers Trust Company

[Indexed as: Shoppers Trust Corp. (Liquidator of) v. Shoppers Trust Co.]

74 O.R. (3d) 652
[2005] O.J. No. 1081
Docket: C41924

Court of Appeal for Ontario,
Moldaver, Blair and LaForme JJ.A.
March 24, 2005

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Bankruptcy and insolvency -- Liquidation -- Priorities -- Winding up -- Distribution of surplus proceeds of liquidation of assets -- Fundamental principle of pari passu distribution -- Fundamental principle of insolvency law that in case of insolvent estate, all money being realized should be applied equally and rateably in payment of debts as they existed at date of winding-up -- Winding-up and Restructuring Act, R.S.C. 1985, c. W-11. [page653]

In the early 1990s, Shoppers Trust Corp., a loan and trust company, fell into financial difficulties and, in August 1992, an order was made under the Winding-up Act that it be liquidated with an effective winding-up date of July 31, 1992. For the purposes of the liquidation, the assets of Shoppers Trust were divided into a "Guarantee Fund" of moneys held for the benefit of depositors and the "Company Fund" of all other assets. The Company Fund was subject to the unsatisfied claims of the depositors and to the claims of the Crown, secured creditors, unsecured creditors, and the subordinated noteholders. The respondent Phillip Daniels, who held 75 per

cent of the shares of Shoppers Trust, held subordinated notes which were expressed to be "subordinated in right of payment to all other indebtedness of the corporation". In the winding-up proceedings, Houlden J. made an order on March 10, 1993, authorizing and directing Deloitte & Touche Inc. ("the Liquidator") to calculate interest due on provable claims to April 24, 1992. Houlden J. made this order based on the recommendation of the Liquidator and with the support of Canada Deposit Insurance Corporation ("CDIC"), which was subrogated to the rights of the insured depositors. In support of the motion leading to the March 10, 1993 order, the Liquidator filed a memorandum stating that if there was a surplus after all other claims on the Company Fund have been satisfied, then claims for interest accruing to July 31, 1992 would be considered. The Liquidator, however, did not expect there would be any surplus.

The Liquidator's expectation turned out to be incorrect. Because of delays in the administration of the estate, interest accumulated on the liquidated assets, and the Liquidator found itself with unanticipated extra funds of approximately $6 million available for distribution. The Liquidator moved for directions as to how the unanticipated extra funds should be distributed. On the motion, Ground J. accepted Daniels' argument that the Liquidator had in effect committed that it would not seek to pay interest to the Deposit Creditors and Ordinary Creditors to the date of the winding-up, unless it had been satisfied there was "a surplus after all other claims on the Company Fund". Ground J. concluded that there was no such "surplus" because the words "all other claims" must include the subordinated debt, and no amounts had yet been paid on those claims. Accordingly, he ruled that the March 10, 1993 order should not be varied. CDIC appealed.

Held, the appeal should be allowed.

The issues to be determined were whether, as a matter of law, the Deposit Creditors and Ordinary Creditors were entitled to prove their claims, including any interest component and, if so, whether the terms of the March 10, 1993 order precluded them from doing so in priority to the claims of the subordinated noteholders. The motion judge failed to address

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these questions, and this led him astray in three respects.

First, he erred in treating the proceeding before him as a motion to vary, governed by the provisions of rule 59.06 of the Rules of Civil Procedure, R.R.O. 1990, Reg. 194, rather than approaching it as the motion for directions.

Second, he was mistaken in viewing the right of a creditor to claim the full amount of principal plus interest due and owing to the date of the winding-up as a "usual practice" rather than as the governing principle of insolvency law that it is. The fundamental principle of insolvency law is that in the case of an insolvent estate, all the money being realized should be applied equally and rateably in payment of the debts as they existed at the date of the winding-up. The conclusion that the provisions of an order made ten years earlier "trumped" the governing principles of law at the time of the motion for directions -- particularly where circumstances had evolved that no one envisioned -- constituted an error in principle. The law is that claimants [page654] are entitled to prove their claims for principal and interest to the date of the winding-up. The law also is -- and the terms of the respondent's contract expressly provided -- that the claims of subordinate noteholders are subsidiary to all other claims in the insolvency. The respondent subordinated noteholder was not entitled to recover any of his principal or interest until those other claims had been paid in full.

Finally, Ground J. misconceived the effect of the memorandum filed by the Liquidator at the time of the motion before Justice Houlden; he placed too much emphasis on and misconstrued its wording. As a result, he failed to give effect to the fundamental principle of pari passu distribution underlying insolvency law. Further, he mistakenly treated the Liquidator's memorandum as if it were an agreement precluding the Liquidator from later proposing a different scheme of distribution regardless of the funds subsequently available and regardless of the priorities and legal principles governing that distribution.

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Cases referred to

Canada (Attorney General) v. Confederation Trust Co. (2003), 65 O.R. (3d) 519, [2003] O.J. No. 2754, 44 C.B.R. (4th) 198 (S.C.J.); Humber Ironworks & Shipbuilding Co., Warrant Finance Co.'s Case (Re) (1869), 4 Ch. App. 643, 38 L.J. Ch. 712, 20 L.T. 859, 17 W.R. 780; McDougall (Re), [1883] O.J. No. 63, 8 O.A.R. 309; Principal Savings & Trust Co. v. Principal Group Ltd. (Trustee of) (1993), 14 Alta. L.R. (3d) 442, 23 C.B.R. (3d) 1, 109 D.L.R. (4th) 390, [1994] 2 W.W.R. 723 (C.A.)

Statutes referred to

Corporations Act, R.S.O. 1990, c. C.38

Loan and Trust Corporations Act, R.S.O. 1990, c. L.25

Winding-up and Restructuring Act, R.S.C. 1985, c. W-11, ss. 5, 71(1) [as am.]

Rules and regulations referred to

Rules of Civil Procedure, R.R.O. 1990, Reg. 194, rule 59.06

APPEAL from the order of Ground J. dated January 30, 2004, made on a motion for directions, cited at [2004] O.J. No. 362, 3 C.B.R. (5th) 155 (S.C.J.).

Jeffrey Leon and Edmund Lamek, for appellant, Canada Deposit Insurance Company.

John B. Laskin and Cynthia Tape, for respondent, Phillip Daniels.

The judgment of the court was delivered by

BLAIR J.A.: --

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Background

[1] Shoppers Trust Corporation was a loan and trust company, incorporated under the Ontario Loan and Trust Corporations Act. [See Note 1 at the end of the document] [page655] It invested in mortgages, held and leased commercial real estate properties, and administered a portfolio of mortgage-backed securities. By 1992, it was the second-largest enterprise of its kind in Canada.

[2] Like many enterprises with a focus on real estate, however, Shoppers fell into financial difficulties in the early 1990s. On March 6, 1992, the Ontario Superintendent of Deposit Institutions took possession and control of its assets and it was shortly ordered to be wound up under the Ontario Corporations Act [See Note 2 at the end of the document]. When investigations confirmed that Shoppers Trust was insolvent, the Liquidator applied for an order under the federal winding-up legislation. On August 19, 1992, Mr. Justice Houlden granted an order under the Winding-up Act, now the Winding-up and Restructuring Act [See Note 3 at the end of the document], directing that the Corporation be liquidated, with an effective winding-up date of July 31, 1992.

[3] At the time of these events, everyone believed there would be insufficient funds from the liquidation of the assets of the Corporation to satisfy in full the claims of depositors, the Crown, and secured and unsecured creditors. That belief has turned out to be somewhat pessimistic, however. Because of various delays in the administration of the estate -- the reasons for which are not pertinent to this appeal -- a significant amount of interest has accumulated on the liquidated assets. The Liquidator finds itself with unanticipated extra funds of approximately $6 million available for distribution.

[4] At issue on this appeal is who is entitled to receive those funds.

[5] The appellant, Canada Deposit Insurance Corporation ("CDIC") -- which is subrogated to the rights of insured

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depositors whose claims it has paid -- asserts that the extra funds should be disbursed to the deposit creditors and ordinary creditors of the Corporation to the extent there is unpaid principal and unpaid interest outstanding to the date of the winding-up. The respondent, Mr. Daniels, submits that the additional moneys should be paid towards the principal outstanding on the sub debt held by him and other members of his family, notwithstanding that the claims of the subordinate noteholders rank behind the claims of all other creditors in the insolvency. Mr. Daniels makes this submission on the strength of an order made by Justice Houlden on March 10, 1993, authorizing and directing the Liquidator to calculate interest due on provable claims to April 24, 1992 [page656] (approximately three months before the effective winding-up date of July 31, 1992, set out in his earlier order of August 19, 1992).

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[6] In January 2004, the Liquidator applied to Justice Ground for directions regarding the distribution of the extra funds. Treating the motion as in substance a motion to vary the March 10, 1993 order of Justice Houlden, the motion judge declined to do so, and ruled in favour of Mr. Daniels. It is that order which is under appeal.

[7] Respectfully, in my view, Ground J. erred, and I would allow the appeal, for the reasons that follow.

Facts

The claimants and the scheme of distribution

[8] The respondent held 75 per cent of the shares of Shoppers; his brother, John Daniels, the remaining 25 per cent. These shares were held either directly or indirectly through family members and related corporations. The Daniels were issued subordinated notes by the corporation in exchange for advances totalling approximately $8 million. It is not disputed that this is a legitimate corporate debt. However, the notes specifically provide that the indebtedness evidenced by them "is subordinated in right of payment to all other indebtedness of the corporation".

[9] Because of the obligation of a loan and trust corporation to keep certain of its assets segregated as security for the moneys placed with it on deposit, the assets of Shoppers are divided into two categories for purposes of its liquidation, namely, a Guaranteed Fund and a Company Fund. The Guaranteed Fund consists of moneys held for the benefit of the corporation's depositors. The Company Fund consists of all other company assets and is subject to the claims of the Deposit Creditors (to the extent they are not satisfied from the Guaranteed Fund), the Crown, secured and unsecured creditors, and the subordinated noteholders.

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[10] In the liquidation, the administration of the Guaranteed Fund is substantially completed, and a final distribution was made from that fund in April 2000. The distribution was insufficient to satisfy the claims of the Deposit Creditors in full, leaving them with a shortfall claim (the "Shortfall Claim") against the Company Fund for $40,250,000, based on provable claims for principal as at July 31, 1992 (the date of the winding-up), with interest calculated as at April 24, 1992, pursuant to the order of March 10, 1993, referred to above.

[11] The Deposit Creditors consist of CDIC and a group of depositors whose claims exceed $60,000. CDIC is by far the largest claimant. It acquired that position in its subrogated capacity, [page657] having reimbursed the corporation's depositors -- up to $60,000 each -- in accordance with its guarantee obligations under the Loan and Trust Corporations Act. On April 24, 1992, CDIC paid a total of approximately $491.5 million to depositors, representing the insured portion of their claims. Its subrogated interest represents 99 per cent of the claims against the Shoppers Trust estate. In addition to CDIC's subrogated claim, a number of depositors whose claims exceeded the $60,000, also maintain claims in their own right for that excess. These uninsured depositor claims total approximately $5 million.

[12] Shoppers had trade creditors and other unsecured creditors (together, the "Ordinary Creditors") with claims totalling about $1.2 million. The claims of the Crown and of

the secured creditors are not pertinent to the issues on this appeal.

[13] As at December 31, 2002, the Liquidator had funds of $47,283,000 for distribution from the Company Fund. This constitutes an excess of approximately $6 million over the amounts necessary to pay the claims of the Deposit Creditors and the Ordinary Creditors, with interest calculated to April 24, 1992, in accordance with the March 10, 1992 order. The effect of calculating the quantum of those claims based on interest to the date of the winding-up is to eliminate the $6 million excess referred to above. The following chart illustrates this outcome:

	April 24, 1992	July 31, 1992
Guaranteed Fund Shortfall Claimants	$ 40,250,000	$ 53,636,000
Trade Creditors	$ 565,000	$ 577,000
Other ordinary Creditors	$ 5,000	$ 555,000
Subtotal:	$ 41,370,000	$ 54,768,000
Total Amount Available for Distribution	$ 41,283,000	$ 47,283,000
Less Claims by Shortfall Claimants and Other Unsecured Creditors:	$ 41,370,000	$ 54,768,000
Balance Available for Distribution	$ 5,913,000	$ 0

The March 10, 1993 order and the interest calculation date

[14] The March 10, 1993 order of Justice Houlden fixing an interest calculation date of April 24, 1992, was made -- on the recommendation of the Liquidator and with the support of CDIC -- for practical reasons. At the time, no one thought there

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would be sufficient funds in the insolvent estate to satisfy the claims of the Deposit Creditors and the Ordinary Creditors for principal and interest to the date of the winding-up. CDIC had made its [page658] payment to depositors based upon an interest calculation it had already done as at April 24, 1992. It was not worth the expense of re-calculating the interest amounts as at July 31 because doing so would not change the proportionate amounts that claimants would receive and the cost of the exercise would diminish the funds available for distribution.

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[15] In support of the motion leading to the March 10, 1993 order, the Liquidator filed a memorandum -- as Liquidators normally do in the course of such proceedings -- reporting on the status of the liquidation to that point and making various recommendations. At paras. 91 and 92 of the memorandum, the Liquidator said:

91. The major creditor claiming against the Company Fund is CDIC as to 98 per cent in Proposal One and as to 97 per cent in Proposal Two [See Note 4 at the end of the document]. Again, CDIC has agreed to accept April 24, 1992 as the interest calculation date for the purposes of any distribution of the proceeds of assets in the Company Fund.

92. If there is a surplus after all other claims on the Company Fund have been satisfied, then claims for interest accruing to July 31, 1992 will be considered. The Liquidator expects a recovery for unsecured creditors on the Company Fund assets of only 46 per cent under Proposal One and no recovery under Proposal Two and therefore does not expect there to be any surplus.

[16] The motion judge accepted the respondent's argument that the Liquidator had in effect committed that it would not seek to pay interest to the Deposit Creditors and Ordinary Creditors to the date of the winding-up, unless there was "a surplus after all other claims on the Company Fund" had been satisfied (emphasis added). He concluded that there was no such "surplus" on the facts before him because the words "all other claims" must include the subordinated debt, and no amounts had

yet been paid on those claims. Accordingly, he ruled that the March 10, 1993 order should not be "varied".

Analysis

[17] On behalf of the respondent, Mr. Laskin argues that the motion judge -- an experienced commercial list judge responsible for supervising the liquidation of Shoppers Trust -- exercised a discretion based on findings of fact and decided in the circumstances not to vary the earlier order of Justice Houlden. He submits that the judge's exercise of discretion is entitled to deference and that the appeal should be dismissed. [page659]

[18] In my view, however, the directions the motion judge was called upon to provide did not entail the exercise of discretion at all. Instead, he was required to determine whether, as a matter of law, the Deposit Creditors and Ordinary Creditors were entitled to prove their claims, including any interest component of those claims, to the date of the winding-up, and, if so, whether the terms of the March 10, 1993 order precluded them from doing so in priority to the claims of the subordinated noteholders. The motion judge failed to address his mind to these questions and, in my respectful opinion, this led him astray in three respects and resulted in a decision that must be set aside.

[19] First, the motion judge erred in treating the proceeding before him as a motion to vary, governed by the provisions of rule 59.06 of the Rules of Civil Procedure, R.R.O. 1990, Reg. 194, rather than approaching it as the motion for directions in the liquidation proceedings that it was. Secondly, and most significantly, he was mistaken in viewing the right of a creditor to claim the full amount of principal plus interest due and owing to the date of the winding-up as a "usual practice" rather than as the governing principle of insolvency law that it is. Finally, he misconceived the effect of the memorandum filed by the Liquidator at the time of the motion before Justice Houlden; he placed too much emphasis on and misconstrued its wording; and, as a result, he failed to give effect to the fundamental principle of pari passu distribution

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underlying insolvency law.

Motion for directions

[20] The motions judge was not faced with a motion to vary the March 10, 1993 order of Justice Houlden. He was faced with a motion by the Liquidator for directions as to how the unanticipated extra funds in the estate should be distributed in the circumstances. While the incidental effect of an order for directions in an insolvency proceeding might be to alter or vary a previous order made during the course of supervision of the proceedings, such a motion for directions is not governed by the same principles that apply to rule 59.06 motions to vary, in my opinion.

[21] The basis upon which an order may be set aside or varied under that rule is restricted to situations involving fraud or facts arising or discovered after the original order was made. Courts have traditionally taken a narrow approach to granting such relief. Where the ground asserted is that of fresh evidence or a change in circumstances -- the approach taken by the motion judge here -- the moving party must show that the new evidence (a) could not have been obtained through reasonable diligence [page660] prior to the order being made, (b) is apparently credible and (c) would probably have affected the outcome of the earlier hearing.

[22] Such an approach is inapposite to a motion for directions in a winding-up proceeding, where the emphasis is not so much on whether the subsequent change in circumstances would have affected the original order made, but rather is on what order should be made in the present circumstances based upon the governing legal principles, the objectives of the winding-up regime, and what is fair and reasonable in the circumstances. A motion for directions may or may not involve an exercise of discretion by the motion judge. In this case, it did not.

The law respecting the payment of interest in winding-up proceedings

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[23] At para. 37 of his reasons, the motion judge said:

I am not satisfied that the fact that claims of creditors in a liquidation normally include interest up to the Winding-Up Date is a basis for the court, in this case, exercising its jurisdiction to vary the Houlden Order. There was no provision in the WUA [See Note 5 at the end of the document] applicable at the date of the Houlden Order providing that claims were to be calculated as of the Winding-Up Date and interest payable up to the Winding-Up Date. The fact that that appears to have been the usual practice in liquidations at that time does not, in my view, override a specific provision of a judicial order that a different calculation date apply [sic] and a direction to calculate claims as of that date.

[24] Respectfully, the motion judge erred in concluding that a creditor's right to claim principal plus interest due to the date of the winding-up was simply "the usual practice" in liquidation matters. The creditor's right in that regard was not a matter of practice; it was, and remains, a matter of insolvency law. As Selwyn L.J. stated in Re Humber Ironworks & Shipbuilding Co.; Warrant Finance Co.'s Case (1869), 4 Ch. App. 643, 17 W.R. 780, at pp. 64-47 Ch. App.:

Now, it has been very properly admitted, on the part of the Appellant, that there can be no question as to any interest due at the time of the winding-up . . . because [the creditor's] interest due at the date of the winding-up is just as much a debt as the principal. . . . I think the tree must lie as it falls; that it must be ascertained what are the debts as they exist at the date of the winding-up, and that all dividends in the case of an insolvent estate must be declared in respect of the debts so ascertained.

[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, [page661] 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

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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 [See Note 6 at the end of the document], 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.

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[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. Any debate in the earlier authorities concerned the appropriate choice of an effective date for the winding-up. Should it be the date of presentation of the petition, or the date the winding-up order is actually made? There was never a debate over the right of creditors to prove their claims in full, including any interest component, as of that effective date, whatever it may be [See Note 7 at the end of the document].

[27] In giving the directions sought, in light of the unanticipated extra funds available to the Liquidator for distribution, the motion judge was obliged to give effect to the operative legal principles. His conclusion that the provisions of an order made ten years earlier in the liquidation proceeding "trumped" the governing principles of law at the time of the motion for directions -- particularly where circumstances had evolved that no one envisioned at the time -- constituted an error in principle. The law [page662] was, and continues to be, that claimants are entitled to prove their claims for principal and interest to the date of the winding-up. The law also was -- and the terms of the respondent's contract expressly provide -- that the claims of

subordinate noteholders are subsidiary to all other claims in the insolvency. The respondent subordinated noteholder is not entitled to recover any of his principal or interest until those other claims have been paid in full.

[28] Finally, in this regard, I note that Justice Houlden did not purport to alter the date for proving claims in the liquidation by his order of March 10, 1993, although his earlier order of August 19, 1992, providing for the liquidation of Shoppers Trust, had specifically provided for a winding-up date of July 31, 1992. The order provided only for an earlier date for calculation of interest, based upon the practical considerations outlined above. Had such an experienced insolvency judge as Justice Houlden intended to alter a date as fundamental as the effective date of the winding-up -- and, therefore, the date for the proving of claims -- for all purposes of the liquidation, regardless of subsequent developments, I would have expected him to say so specifically. He did not.

[29] I therefore conclude that the March 10, 1993 order was not intended to, and did not, set a proof of claims date which precluded creditors from proving their claims in full up to the winding-up date. To interpret the order otherwise would be to prevent creditors with interest-bearing claims from proving their full entitlement to pre-winding-up interest and to benefit the subordinate noteholders (whose claims are inferior to all other claims) unfairly, thus contravening the pari passu principle that is fundamental to insolvency law. Accordingly, the order does not operate as a bar, trumping the rights of the Deposit Creditors and the Ordinary Creditors to be paid out of the unanticipated extra funds in priority to the subordinated noteholders.

The liquidator's memorandum

[30] The motion judge's third error in principle also flowed from his approaching the proceedings as a motion to vary. He placed unwarranted emphasis on the wording of the memorandum filed by the Liquidator in support of the motion before Justice Houlden. Further, he mistakenly treated the memorandum as if it

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were, in effect, an agreement precluding the Liquidator from later proposing a scheme of distribution, which did not comply with his interpretation of para. 92, regardless of the funds subsequently available and regardless of the priorities and legal principles governing that distribution. [page663]

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[31] In considering whether the change in circumstances justified a variation of the March 10, 1993 order, he focused on whether the unanticipated extra funds constituted a "surplus" within the meaning para. 92 of the memorandum. He concluded there was no surplus in that sense because "all other claims" against the Company Fund -- that is, the claims of the subordinated noteholders -- had not yet been paid. Because he viewed the memorandum as a binding commitment on the part of the Liquidator not to seek to vary the order unless there was such a surplus, he decided that he should not exercise his discretion to vary the order in the circumstances.

[32] I see two problems with this approach.

[33] First, I do not read the memorandum to be anything other than what it purported to be, namely, a report by the Liquidator recommending a practical solution for the distribution of funds and the calculation of interest, based upon the then existing circumstances. I do not think it can reasonably be interpreted as a covenant on the part of the Liquidator -- and inferentially by CDIC -- to support a later distribution of then unanticipated extra funds in a fashion that contravenes both the legal principles governing provable claims and the premise of pari passu distribution that underlies insolvency proceedings. As an officer of the court responsible for the liquidation of the assets of Shoppers, the Liquidator could not make such a commitment without court approval, and, as I have noted above, if Justice Houlden had intended the order of March 10, 1993, to have had such an effect, he would have said so in it.

[34] Secondly, and in any event, while a literal reading of the words "all other claims against the Company Fund" in para. 92 of the memorandum might support the inclusion of the claims of subordinated noteholders, such an interpretation is

inconsistent with the language of the paragraph as a whole, and makes no practical sense in the context of the proposed procedure for distribution of the Guaranteed Fund and the Company Fund that was being put forward.

[35] Deposit Creditors have resort to the Guaranteed Fund. Their claims were not to be satisfied under either suggested proposal for distribution from the Guaranteed Fund, and the Deposit Creditors were therefore entitled to claim -- pari passu with other unsecured creditors -- against the Company Fund (the Shortfall Claims). Paragraph 91 of the memorandum notes that CDIC is the major creditor claiming against the Company Fund. Paragraph 92 then provides that "if there is a surplus after all other claims on the Company Fund have been satisfied, then claims for interest accruing to July 31, 1992 will be considered". [page664] That the reference to "all other claims" was intended to refer to the claims of all other unsecured creditors (i.e., the uninsured deposit creditors, the trade creditors and the other ordinary creditors) and not the subordinated noteholders, is apparent from the next sentence in para. 92, which states that "the Liquidator expects a recovery for u nsecured creditors on the Company Fund assets of only 46 per cent under Proposal One and no recovery under Proposal Two and therefore does not expect there to be any surplus" (emphasis added). The subordinated noteholders are not unsecured creditors. The reality of the context in which the memorandum was drafted is that no one contemplated the chance of any recovery whatsoever for the subordinated noteholders. I conclude the Liquidator did not intend to include them in the reference to "all other claims against the Company Fund" in para. 92 of the memorandum.

[36] In my view, therefore, there was a "surplus" as envisaged by para. 92 of the memorandum in the circumstances presented to the motion judge. The directions the Liquidator and CDIC were seeking from him were perfectly consistent with the Liquidator's recommendations in March 1993.

Disposition

[37] I therefore conclude that the appeal should be allowed,

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the order of Ground J. set aside, and in its place an order granted:

(a) authorizing the Liquidator to calculate the claims of (i) the Deposit Creditors who have Shortfall Claims, and (ii) the ordinary unsecured creditors, all of whom have claims against the Company Fund, including the interest component of such claims, as at the winding-up date of July 31, 1992 (the "Winding-up Date") and to admit such claims as of the Winding-up Date;

(b) authorizing the Liquidator to use an estimated average annual rate of interest in order to calculate the accrued interest component of the claims of depositors attributable to the period from April 24, 1992, to the Winding-up Date; and,

(c) authorizing the Liquidator to use the contractual rates of interest, if any, in order to calculate the accrued interest component of the claims of the other ordinary unsecured creditors of Shoppers attributable to the period from April 24, 1992, to the Winding-up Date. [page665]

[38] Counsel have agreed that, whatever the outcome of the appeal, there should be no order as to costs.

Order accordingly.

Notes

Note 1: R.S.O. 1990, c. L.25.

Note 2: R.S.O. 1990, c.38.

Note 3: R.S.C. 1995, c. W-11, as amended.

Note 4: The memorandum contained two proposals for the allocation of assets between trust claimants and ordinary creditors.

Note 5: The Winding-up and Restructuring Act, R.B.C. 1985, c.

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W-11.

Note 6: At common law, interest on provable claims stops at the commencement of the winding-up. No interest is payable on claims from that date forward, unless there is a surplus in the estate. In the event of a surplus, post-liquidation interest is payable first on debts in respect of which there is a right to interest prior to the liquidation date. See Canada (Attorney General) v. Confederation Trust Co., supra, at para. 21.

Note 7: Section 5 of the Winding-up and Restructuring Act, R.S.C. 1985, c. W-11, as amended, now fixes the date of presentation of the petition as the effective date of the winding-up.

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TAB 4

SUPERIOR COURT
(Commercial Division)

2014 QCCS 3135 (CanLII)

CANADA
PROVINCE OF QUÉBEC
DISTRICT OF MONTRÉAL
N°: 500-11-041305-117

DATE : June 30, 2014

PRESIDING : THE HONOURABLE MARK SCHRAGER, J.S.C.

IN THE MATTER OF THE PLAN OF COMPROMISE OR ARRANGEMENT OF :

HOMBURG INVEST INC.
HOMBURG SHARECO INC.
CHURCHILL ESTATES DEVELOPMENT LTD.
INVERNESS ESTATES DEVELOPMENT LTD.
CP DEVELOPMENT LTD.
NORTH CALGARY LAND LTD.

Debtors / Petitioners

And

HOMCO REALTY FUND (52) LIMITED PARTNERSHIP
HOMCO REALTY FUND (88) LIMITED PARTNERSHIP
HOMCO REALTY FUND (89) LIMITED PARTNERSHIP
HOMCO REALTY FUND (92) LIMITED PARTNERSHIP
HOMCO REALTY FUND (94) LIMITED PARTNERSHIP
HOMCO REALTY FUND (96) LIMITED PARTNERSHIP
HOMCO REALTY FUND (105) LIMITED PARTNERSHIP
HOMCO REALTY FUND (121) LIMITED PARTNERSHIP
HOMCO REALTY FUND (122) LIMITED PARTNERSHIP
HOMCO REALTY FUND (142) LIMITED PARTNERSHIP
HOMCO REALTY FUND (190) LIMITED PARTNERSHIP
HOMCO REALTY FUND (191) LIMITED PARTNERSHIP
HOMCO REALTY FUND (199) LIMITED PARTNERSHIP

Mises-en-cause

And

STICHTING HOMBURG BONDS

Mise-en-cause

And

TABERNA PREFERRED FUNDIND VI, LTD.
TABERNA PREFERRED FUNDIND VIII, LTD.
TABERNA EUROPE CDO I P.L.C.
TABERNA EUROPE CDO II P.L.C.

Mises-en-cause

And

SAMSON BÉLAIR/DELOITTE & TOUCHE INC.

Monitor

JUDGMENT

JS 1319

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FACTS

[1] The Debtors/Petitioners ("Debtors") were subject to an initial stay order issued on September 9, 2011 pursuant to the *Companies' Creditors Arrangement Act* [1] ("CCAA") by the Honourable Justice Louis Gouin. The latter has been charged with the management of the case but due to a conflict of interest with the attorneys the four (4) Taberna entities mises-en-cause in the instant proceedings ("Taberna"), the undersigned presided over the present matter.

[2] After a number of extensions of the CCAA stay order, the Debtors filed an arrangement which was accepted by the statutory majority of creditors under the

[1] R.S.C., 1985, c. C-36.

CCAA and subsequently sanctioned by the Court on June 5, 2013. Implementation of this plan, including payments thereunder, has begun.

[3] The undersigned is called upon to adjudicate on the Debtor's Re-Amended Motion for Directions which was originally filed on January 25, 2013. The motion seeks resolution of issues regarding the rank *inter se* of, in essence, two series of debentures one held or administered by the mise-en-cause Stichting Homburg Bonds ("Stichting") referred to above and the other by Taberna.

[4] In May 2006, Homburg Invest Inc. ("HII"), one of the Co-Petitioners/ Debtors, entered into a trust indenture with Stichting as trustee providing, *inter alia*, for the issuance of bonds. In 2002, Homburg Shareco Inc. ("Shareco") another Co-Petitioner Debtor entered into an indenture also with Stichting providing for the issuance of additional bonds. The face-amount of the outstanding bonds as at the CCAA filing aggregated in excess of 400 Million Euros (or approximately 500 Million dollars) and constituted the largest single bloc of debt of the Debtor of approximately 1.8 Billion dollars.

[5] In July 2006, HII entered into a "junior subordinate indenture" with Wells Fargo Bank, N.A. ("Wells Fargo") providing for the issuance of 20 Million US dollar notes. A second indenture was signed at the same time providing for the issuance of 25 Million euro notes (hereinafter together, the 2006 Taberna Indentures).

[6] Both of the 2006 Taberna Indentures contained the following clauses:

> **"SECTION 12.1. Securities Subordinate to Senior Debt.**
>
> The Company covenants and agrees, and each Holder of a Security, by its acceptance thereof, likewise covenants and agrees, that, to the extent and in the manner hereinafter set forth in this Article XII, the payment of the principal of and any premium and interest (including any Additional Interest) on each and all of the Securities are hereby expressly made subordinate and subject in right of payment to the prior payment in full of all Senior Debt.
>
> **SECTION 12.2. No Payment When Senior Debt in Default; Payment Over of ProceedsUpon Dissolution, Etc.**
>
> (a) In the event and during the continuation of any default by the Company in the payment of any principal of or any premium or interest on any Senior Debt (following any grace period, if applicable) when the same becomes due and payable, whether at maturity or at a date fixed for prepayment or by declaration of acceleration or otherwise, then, upon written notice of such default to the Company by the holders of such Senior Debt or any trustee therefor, unless and until such default shall

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have been cured or waived or shall have ceased to exist, no direct or indirect payment (in cash, property, securities, by set-off or otherwise) shall be made or agreed to be made on account of the principal of or any premium or interest (including any Additional Interest) on any of the Securities, or in respect of any redemption, repayment, retirement, purchase or other acquisition of any of the Securities.

(b) In the event of a bankruptcy, insolvency or other proceeding described in clause (d) or (e) of the definition of Event of Default (each such event, if any, herein sometimes referred to as a "Proceeding"), all Senior Debt (including any interest thereon accruing after the commencement of any such proceedings) shall first be paid in full before any payment or distribution, whether in cash, securities or other property, shall be made to any Holder of any of the Securities on account thereof. Any payment or distribution, whether in cash, securities or other property (other than securities of the Company or any other entity provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in these subordination provisions with respect to the indebtedness evidenced by the Securities, to the payment of all Senior Debt at the time outstanding and to any securities issued in respect thereof under any such plan of reorganization or readjustment), which would otherwise (but for these subordination provisions) be payable or deliverable in respect of the Securities shall be paid or delivered directly to the holders of Senior Debt in accordance with the priorities then existing among such holders until all Senior Debt (including any interest thereon accruing after the commencement of any Proceeding) shall have been paid in full.

(c) In the event of any Proceeding, after payment in full of all sums owing with respect to Senior Debt, the Holders of the Securities, together with the holders of any obligations of the Company ranking on a parity with the Securities, shall be entitled to be paid from the remaining assets of the Company the amounts at the time due and owing on account of unpaid principal of and any premium and interest (including any Additional Interest) on the Securities and such other obligations before any payment or other distribution, whether in cash, property or otherwise, shall be made on account of any Equity Interests or any obligations of the Company ranking junior to the Securities and such other obligations. If, notwithstanding the foregoing, any payment or distribution of any character on any security, whether in cash, securities or other property (other than securities of the Company or any other entity provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in these subordination provisions with respect to the indebtedness evidenced by the Securities, to the payment of all Senior Debt at the time outstanding and to any securities issued in respect thereof under any such plan of reorganization or readjustment) shall be received by the Trustee or any Holder in contravention of any of the terms hereof and before all Senior Debt shall have been paid in full, such payment or distribution or security shall be

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> received in trust the benefit of, and shall be paid over or delivered and transferred to, the relevant holders of the Senior Debt at the time outstanding in accordance with the priorities then existing among such holders for application to the payment of all Senior Debt remaining unpaid, to the extent necessary to pay all such Senior Debt (including any interest thereon accruing after the commencement of any Proceeding) in full. In the event of the failure of the Trustee or any Holder to endorse or assign any such payment, distribution or security, each holder of Senior Debt is hereby irrevocably authorized to endorse or assign the same."
>
> (Underlined by the Court)

[7] Senior Debt is broadly defined in the 2006 Taberna Indentures and it is not contested that it includes the debt existing under and pursuant to the Stichting bonds.

[8] Thus, the 2006 Taberna notes were subordinate to the Stichting debt, in that once a payment of capital or interest on the Stichting debt was in default, no payment on account of the 2006 Taberna Indentures was permitted by HII.

[9] The 2006 Taberna Indentures further provided that they are governed by the laws of the State of New York.

[10] In 2011, HII was in default in virtue of certain financial covenants provided in the 2006 Taberna Indentures. Negotiations ensued between the business people followed by exchanges between the lawyers culminating in the signature of an Exchange Agreement on February 28, 2011 providing for the issuance of new indentures and new notes thereunder, to replace the 2006 Taberna Indentures and notes.

[11] Accordingly, and also on February 28, 2011, two new indentures and notes were issued to replace the Dollar and Euro 2006 Taberna Indentures (the "2011 Taberna Indentures"). These notes remain outstanding.

[12] Sections 12.1 and 12.2 referred to above were altered in that the pertinent portions of the said Sections 12.1 and 12.2 now read as follows:

> **"SECTION 12.1. Securities Subordinate to Senior Debt.**
>
> The Company covenants and agrees, and each Holder of a Security, by its acceptance thereof, likewise covenants and agrees, that, to the extent and in the manner hereinafter set forth in this Article XII, the payment of the principal of and any premium and interest (including any Additional Interest) on each and all of the Securities are hereby expressly made subordinate to the Senior Debt. Notwithstanding anything to the contrary contained herein, the securities issued pursuant to those certain Junior Subordinated Indentures, each dated as of the date hereof, between the

Company and the Trustee shall not be Senior Debt or otherwise entitled to the subordination provisions of this Article XII and the Securities shall rank pari passu in right of payment to such securities.

SECTION 12.2. No Payment When Senior Debt in Default.

(a) In the event and during the continuation of any default by the Company in the payment of any principal of or any premium or interest on any Senior Debt (following any grace period, if applicable) when the same becomes due and payable, whether at maturity or at a date fixed for prepayment or by declaration of acceleration or otherwise, then, upon written notice of such default to the Company by the holders of such Senior Debt or any trustee therefore, unless and until such default shall have been cured or waived or shall have ceased to exist, no direct or indirect payment (in cash, property, securities, by set-off or otherwise) shall be made or agreed to be made on account of the principal of or any premium or interest (including any Additional Interest) on any of the Securities, or in respect of any redemption, repayment, retirement, purchase or other acquisition of any of the Securities."

(Underlined by the Court)

[13] Of most significance and pertinent to these presents is the fact that Section 12(b) and (c) of the 2006 Taberna Indentures were deleted. Section 12.2(b) provided for full payment of the "Senior Debt" (in this case, Stichting) in priority to the Junior Debt (i.e. Taberna) in the event of a bankruptcy or insolvency of HII. Section 12.2(c) provided that in the event of payment received by Wells Fargo as trustee under the Taberna Indentures, in contravention of Section 12.2(b), then such proceeds would be remitted or turned over to Senior Debt holders. Such a clause is commonly referred to as a "turnover provision".

[14] The definition of "Senior Debt" and the New York choice of law have not been modified.

[15] The effect of the foregoing modifications in the context of the CCAA arrangement of the Debtors is the gravaman of this litigation.

[16] According to Taberna, the effect of the drafting changes taken with other factors to be discussed hereinbelow, is that the claim of Taberna notes is no longer subordinate to the Stichting claim and should be paid *pari passu* with Stichting under the plan of arrangement approved by the Court.

[17] As stated above, the Debtors' plan of arrangement was sanctioned by the Court on June 5, 2013, in other words after the Motion for Directions was filed but before the present matter was set down for hearing.

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[18] Under the plan of arrangement, all ordinary creditors including holders of Stichting bonds and Taberna notes were grouped in one and the same class. The intention of the Debtors supported by the Monitor was to pay nothing on account of the Taberna claim given the provisions of the subordination clauses referred to above and the fact that Stichting would not, under the plan, be paid in full. This was and is not acceptable to Taberna. However, in order to allow the HII plan to be confirmed and allow HII to move forward with its reorganization, the following was provided in the plan:

> "9.6 b) Notwithstanding any other provision in the Plan, HII and the Monitor shall comply with the Taberna Order in making any distributions on account of the Taberna Claim under the Plan, using the reserves created under the HII/Shareco Plan, as applicable. To the extent that the Taberna Order directs that the distribution entitlement under the Plan in respect of the Taberna Claim shall be remitted to any Person or Persons other than the holders of the Taberna Claim, any Newco Common Shares Cash-Out Election made by any holders of the Taberna claim shall be null."
>
> "**Taberna order**" means a Final Order of the Court addressing the distribution entitlement of the holders of the Taberna Claim under the Plan in respect of the Taberna Claim and authorizing and directing HII and the Monitor to rely on such Order in connection with the Plan;"

[19] The present judgment is the Taberna order.

[20] By voting for the plan, the statutory majority agreed with HII that the issue of subordination between Stichting and Taberna would be resolved after the plan was sanctioned. Even though Taberna voted against the plan, it did not oppose this manner of proceeding or insist that HII's Motion for Directions be heard prior to the Court sanction of the plan.

[21] For purposes of the proof and hearing herein, the parties relied on the affidavit in support of the Motion for Directions as well as the exhibits filed by consent and admissions filed in the Court record. Only the expert witnesses testifying on the content and effect of New York law were heard *viva voce*.

SUMMARY OF THE PARTIES' POSITION

Position of Taberna

[22] Taberna submits that it should receive the same treatment as the Stichting bondholders under the plan of arrangement, or in other words be paid on a *pari passu* basis.

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[23] Taberna contends that the subordination contained in Section 12 of the 2011 Taberna Indentures no longer has effect because the bankruptcy language and the turnover provisions found in the 2006 Taberna Indentures were deleted so that in a bankruptcy or insolvency, Taberna debt is no longer subordinate and Taberna no longer has the obligation to turnover any entitlements to Stichting.

[24] Taberna continues that the deletion of the language was a result of a negotiation between the business people followed by exchanges between the attorneys after HII's covenant default which led to the Exchange Agreement and the 2011 Taberna Indentures. It was part of the consideration for forbearing the covenant defaults. According to Taberna, the parties involved in the negotiation intended the result that Taberna no longer be subordinate in the event of a bankruptcy or insolvency.

[25] Moreover, the fact that Taberna was placed in the same class for purposes of the plan of arrangement as Stichting (and indeed the same class as all of the unsecured creditors) dictates that Taberna should receive the same treatment as the other unsecured creditors, or in other words not be treated in a subordinate fashion.

Position of the Debtor, Stichting and the Monitor

[26] The other parties contend that the drafting changes left the basic subordination language intact, so that the fundamental legal position of the Taberna debt remains unchanged – i.e. it is subordinate to Stichting and other HII creditors.

[27] The wording of the 2011 Taberna Indentures is clear that Taberna is subordinate and the Court should not and indeed is not permitted by New York law, to look beyond the clear terms of the agreement between the parties. Under the parole evidence rule of New York law, evidence extrinsic to the document should not be considered unless there is an ambiguity on the face of the document. In such regard, no comparison should be made between the 2011 Taberna Indentures and the wording of the 2006 Taberna Indentures, to draw any inference (or ambiguity) from the deletion of the portions of Section 12.2. Equally the Exchange Agreement should not be considered in reading or interpreting the 2011 Taberna Indentures.

[28] The parties other than Taberna add that there is no legal impediment under the CCAA to placing two (2) creditors in the same class for voting purposes though they may not under the plan of arrangement receive equal treatment on distribution or payment of dividends.

[29] It is underlined that Stichting was a third-party beneficiary of the 2006 Taberna Indentures (as well as the 2011 Taberna Indentures), such that its rights

could not be altered without its consent. Thus, the subordination from which it benefited under the 2006 Taberna Indentures could not be modified without its consent. Stichting was not a party to the Exchange Agreement nor to any of the negotiations leading up to the Exchange Agreement. Its consent was not obtained, nor even sought.

[30] Moreover, Section 12.6 of the 2011 Taberna Indentures (section 12.7 in the 2006 Taberna Indentures) provides that a waiver of the subordination may not be presumed so that the fact that the Debtor may have placed Stichting in the same class as Taberna under the plan of arrangement (and Stichting not protesting) cannot be interpreted against Stichting as a waiver of the subordination from which it benefits under the 2011 Taberna Indentures.

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DISCUSSION

[31] In virtue of the choice of law clause in both the 2011 Taberna Indentures and the 2006 Taberna Indentures, the law of the State of New York applies. Though New York law applies to the interpretation and the validity of the contract, it is local law that applies to the insolvency estate established pursuant to the CCAA [2] so that issues of distribution in the insolvency or questions of priority of payment are decided by application of the *lex fori* [3]. In Québec private international law, insolvency laws are characterized as procedural, so that the conflict rule indicates that the law of the forum applies [4].

[32] Since New York law is taken as a fact to be proved by expert testimony, each of Taberna, Stichting and the Monitor called expert witnesses who also, in accordance with Article 402.1 C.C.P., had filed reports.

[33] Mr. Howard E. Levine, a practicing attorney and a former New York Court of Appeal Judge opined for Stichting that under New York law a clear and unambiguous contract is deemed "the definitive expression of the contracting parties' intent and must be enforced according to its terms, without reference to extrinsic evidence" (i.e. evidence other than the language used in the contract itself). Such extrinsic evidence may only be invoked where the language of the contract is ambiguous. Extrinsic evidence cannot be relied upon to create an ambiguity in the text of the contract. Since the subordination language used in the 2011 Taberna Indentures is clear and unambiguous, then, under New York law, extrinsic evidence would not be admitted. The lack of a turnover provision does not change the subordinated status of the Taberna notes. Mr. Levine was

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2 DICEY AND MORRIS, The Conflict of Laws, 2000, par. 31-040).

3 *Todd Shipyards Corporation vs Ioannis Daskalelis, The*, [1974] S.C.R. 1248; DICEY, op.cit., par. 7-032.

4 C. EMANUELLI, Droit International Privé Québecois, 3e ed., 2011 para. 582; J. WALKER, CASTEL & WALKER, Canadian Conflict of Laws, 6th ed., pp. 6-7 and 29-7.

adamant that the New York courts strictly apply this parole evidence rule but he conceded that interrelated contracts executed contemporaneously may be read together.

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[34] Mr. Jeffrey D. Saferstein, a New York insolvency attorney, was called as an expert by the Monitor and echoed Mr. Levine's opinion on contract law and added an insolvency dimension.

[35] Mr. Saferstein agreed that the subordination language in the 2011 Taberna Indentures was clear and unambiguous so that given the default, "Senior Debt" (i.e. the Stichting claims) must be paid in full before any monies can be received by Taberna noteholders. Turnover provisions are usually found in New York subordination agreements, but the absence of such a clause does not dilute the effect of the remaining subordination language. The turnover language reinforces the subordination, but its absence does not fundamentally alter the subordinated rights. In a New York insolvency, the US Bankruptcy Court would look at New York state law as the law of the contract and based on the parole evidence rule would exclude extrinsic evidence and give effect to the clear terms of the subordination of the 2011 Taberna Indentures, according to Mr. Saferstein.

[36] Mr. Peter S. Partee, Taberna's expert, is also a New York insolvency lawyer. His quality as an expert was challenged since he is a partner in the law firm representing Taberna and it was argued that he did not have sufficient independence to be qualified as an expert. The undersigned dismissed the objection at the hearing, considering that the issue would go to probative value of the testimony rather than the qualification of Mr. Partee as an expert. This is particularly so because the principal concept of foreign law dealt with by the experts (i.e. the exclusion of extrinsic evidence when the terms of the parties' contract are clear and unambiguous) is not really that "foreign" at all. Québec law shares similar rules of evidence and interpretation.

[37] Mr. Partee finds in the fact of the deletion of the turnover provisions from the 2006 Tarberna Indentures and in the extrinsic evidence, proof of the parties' intent that the subordination of the Taberna debt cease to have effect in an insolvency filing. The presence of a turnover provision is common and the fact of its deletion is significant and does not constitute parole evidence, so that the deletion would be considered by a New York court in the opinion of Mr. Partee. Absent the turnover, a court would not impose such an obligation on Tarberna – i.e. to turnover any entitlement to or funds received in an insolvency. Mr. Partee analyzed the turnover clause in the context of US bankruptcy proceedings where turnover provisions allow senior and subordinated debts to be classified together in a plan (for voting purposes) but not to receive the same financial treatment since the subordinated creditor will be obliged to turnover what it receives pursuant to its contractual obligations.

[38] Mr. Partee also underlined in his testimony that the recitals of the 2011 Taberna Indentures refer explicitly to the concurrent Exchange Agreement which in turn refers to the 2006 Taberna Indentures. Thus, he argues, those documents are not extrinsic to the 2011 Taberna Indentures and may be considered in the interpretation exercise.

[39] Counsel for Taberna went further, arguing that certain drafting inconsistencies brought about ambiguity so that the negotiations and email exchanges between the business people and counsel of the Debtors and Taberna leading up to the signing of the 2011 Taberna Indentures should be considered by this Court.

[40] The undersigned does not believe that this Court must choose one expert's opinion over the other. The resolution of the differing expert's opinions does not change the outcome. The subordination clause clearly establishes the principal. The extrinsic evidence adduced by Taberna is not convincing of any intention to change the principal of subordination that existed under the 2006 Taberna Indentures. Canadian insolvency law (with Québec civil law as suppletive) provides that the effect of that subordination in the insolvency of the Debtor is that the Taberna debt is to be treated as subordinate and not paid unless and until full payment has been made to the Senior Debt (including Stichting) .

[41] The undersigned has considered the Exchange Agreement as a concurrent document and thus has considered it not to be extrinsic evidence. Since the Exchange Agreement specifically refers to the 2006 Taberna Indentures, the undersigned has considered the previous subordination drafting.

[42] It is accepted in Canadian insolvency law that in proposals under the *Bankruptcy and Insolvency Act* [5] ("BIA"") to which CCAA arrangements are fundamentally similar, the rights of the debtor vis-à-vis its creditors is altered under the proposal but not the rights of the creditors *inter se* [6].

[43] Subordination clauses are fully enforceable in a bankruptcy or insolvency context [7]. Giving effect to a subordination clause as HII proposed does not make a plan unfair or unreasonable [8] as the fair and reasonable criterion for court sanction of a CCAA plan of arrangement does not require equal treatment of all creditors [9].

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5 R.S.C., c. B-3.

6 *Merisel Canada Inc. vs 2862565 Canada Inc.*, 2002 R.J.Q. 671 (QCCA)..

7 Re *Maxwell Communications Corp*, [1994] 1 All.E.R. 737 (Ch.D.) pp. 13-14, 21; *Bank of Montréal vs Dynex*; (1997) 145 D.L.R. (4th) 499 (Alta Q.B.) confirmed on other grounds 182 D.L.R. 4th 640 (Alta C.A.) and [2002] 1 S.C.R. 146.

8 *Bank of Montréal vs. Dynex*, ibid.

9 *Air Canada*, (2004) 2 C.B.R. (5th) 4 at para 2. and 11 (Farley, J.).

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[44] Subordination clauses not containing express language addressing the effect of the subordination in a bankruptcy are given effect in a bankruptcy, nonetheless [10].

[45] Subordinate creditors have been ordered to turnover to senior creditors monies received in an insolvency based on general subordination language – i.e. absent a turnover clause [11].

[46] Significantly, in *Stelco* [12], the Ontario Court of Appeal confirmed Farley, J. that a debtor may group subordinate with senior debt in classification. The creditors are classified according to their rights vis-à-vis the debtor [13]. Both Stichting and Taberna are unsecured note or debenture debt. It is their rights *inter se* which differ.

[47] It is noteworthy that on the facts of the *Stelco* case, there was a turnover clause which was characterized as reinforcing the subordination [14], which in turn reinforces Mr. Safestein's testimony before the undersigned that the general language is sufficient.

[48] The Ontario Court of Appeal has stated that classification that would jeopardize plans of arrangement should not be favoured [15]. In *Stelco* as here, junior debt was grouped with senior debt since the junior debt was "out of the money" and accordingly would vote against the plan, as did Taberna in the present case. If placed in their own class, the Taberna noteholders could either defeat the plan, or not be bound by the plan so that the Debtor would be unable to arrange all of its debts. The debt of all the other creditors, senior to Taberna would be arranged but that of Taberna would not be arranged since they would not be bound by the plan.

[49] Mr. Partee and Mr. Saferstein explained that in US bankruptcy law, the cram down provisions of the US Bankruptcy Code could allow the Court to sanction a plan and bind a creditor in a separate class who had voted against the plan. However, this possibility does not exist under the CCAA so that the "cram down" must exist at the voting level by grouping subordinate debt with senior debt. Otherwise, junior debt would have a veto or an option of not being bound which is what Farley, J. characterized as the "tyranny of the minority" [16].

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10. *Air Canada*, ibid.
11. *Merisel Canada Inc. vs. 2862565 Canada Inc.*, op.cit.
12. *Re Stelco*, (2005) 15 C.B.R. (5th) 297 (Ont S.C.); affirmed (2005) 15 C.B.R. (5th) 307 (Ont. C.A.).
13. See s. 22 CCAA concerning criteria for classification.
14. Re *Stelco*, 2007 ONCA 483; , para.483; para. 41-45.
15. Re *Stelco*, (2005), C.A.,op.cit. para. 36.
16. Re *Stelco*, (2005), op.cit., para. 15.

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[50] In the second round of *Stelco* litigation, the Ontario Court of Appeal again confirmed the trial judge (this time, Wilton-Siegel, J.) in giving effect to the subordination (*albeit* containing a turnover) but emphasizing the principle applicable here that a plan vote and implementation do not alter the rights of creditors *inter se*.

[51] Accordingly, applying principles of Canadian insolvency law to the subordination in the present cause, Taberna remains subordinate in the insolvency and this absent the specific bankruptcy language and a turnover clause.

[52] Unfortunately for Taberna, the extrinsic evidence adduced is not helpful to its case.

[53] The testimony of Mr. Miles, the officer of HII involved in the business negotiation of the 2011 Taberna Indentures, at best, might support an argument that the new language was intended to eliminate subordination in the event that HII went into a bankruptcy liquidation [17]. However, the present regime is that of a plan of arrangement under the CCAA. There is no proof that there was a meeting of the minds that subordination ended within an insolvency filing.

[54] The email exchanges of draft wording between the attorneys charged with preparing the 2011 Taberna Indentures are not proof of any meeting of the minds either. Initially, a draft was sent by Taberna's lawyer eliminating the whole subordination section from the 2006 Taberna Indentures. HII counsel replied with a request that the omitted subordination language be reinserted into the document. The end-result was the present wording. After HII consulted Dutch and Canadian counsel, the present wording was accepted. Taberna's counsel at trial invokes this exchange as part of its argument that it was agreed that there would be no turnover obligation in the event of an insolvency. However, the position of Canadian and Dutch counsel is equally consistent with the position of the Canadian case law summarized above that the general subordination language was sufficient to continue the status of Taberna debt as fully subordinated notwithstanding an insolvency filing and notwithstanding the absence of specific turnover language. Taberna counsel may have sought an advantage for Taberna in the drafting but no meeting of the minds to change the basic subordination concept has been demonstrated.

[55] Taberna counsel's argument that the modification to the subordination was the consideration for Taberna forbearing the HII covenant default is not supported by the evidence. It is axiomatic that unsecured creditors generally benefit from their debtor continuing in business and avoiding forced liquidation. Particularly in this case, Taberna received letters of credit aggregating

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[17] Deposition of James Miles, February 21, 2013, pp. 29 to 30, and page 34.

approximately $2 Million. Payment under the letters of credit was not subordinated. Taberna also received fee compensation in the six figures as additional consideration for entering into the Exchange Agreement and the 2011 Taberna Indentures. Payment to Taberna under the letters of credit is explicitly stated in the 2011 Taberna Indentures not to be subject to the subordination. Clearly, if the bargain had been that subordination would cease on bankruptcy or insolvency filing, then the parties could have easily so stated as they did for the payment under the letters of credit.

[56] Most significantly, and in itself fatal to Taberna's position is the fact that Stichting was not a party to the negotiations leading up to the 2011 Taberna Indentures nor to the documents themselves.

[57] Section 1.10 of both the 2006 and 2011 Taberna Indentures provides as follows:

> **"SECTION 1.10** ***Benefits of Indenture***
>
> Nothing in this Indenture or in the Securities, express or implied, shall give to any Person, other than the parties hereto and their successors and assigns, the holders of Senior Debt and the Holders of the Securities any benefit or any legal or equitable right, remedy or claim under this Indenture."

[58] Accordingly, and in virtue of Section 1.10, Stichting can rely on the terms of the Taberna Indentures and claim the benefit thereof.

[59] Moreover, Section 12.7 of the 2006 Indentures (equivalent to Section 12.6 in the 2011 Taberna Indentures) provides as follows:

> **"SECTION 12.7** ***No Waiver of Subordination Provisions***
>
> *(a).* No right of any present or future holder of any Senior Debt to enforce subordination as herein provided shall at any time in any way be prejudiced or impaired by any act or failure to act on the part of the Company or by any act or failure to act, in good faith, by any such holder, or by any noncompliance by the Company with the terms, provisions and covenants of this Indenture, regardless of any knowledge thereof that any such holder may have or be otherwise charged with.
>
> *(b)* Without in any way limiting the generality of paragraph (a) of this Section 12.7, the holders of Senior Debt may, at any time and from to time, without the consent of or notice to the Trustee or the Holders of the Securities, without incurring responsibility to such Holders of the Securities and without impairing or releasing the subordination provided in this Article XII or the obligations

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> hereunder of such Holders of the Securities to the holders of Senior Debt, do any one or more of the following: (i) change the manner, place or terms of payment or extend the time of payment of, or renew or alter, Senior Debt, or otherwise amend or supplement in any manner Senior Debt or any instrument evidencing the same or any agreement under which Senior Debt is outstanding, (ii) sell, exchange, release or otherwise deal with any property pledged, mortgaged or otherwise securing Senior Debt, (iii) release any Person liable in any manner for the payment of Senior Debt and (iv) exercise or refrain from exercising any rights against the Company and any other Person."

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[60] Accordingly, Stichting senior rights existing at the time of the 2011 Taberna Indentures could not be waived or altered by HII dealing with Taberna alone, the whole in virute of the 2006 Taberna Indentures. Stichting's agreement was necessary.

[61] This is clear on the basis of the afore-mentioned provisions and is underscored by the application of the principles of the Québec Civil Code dealing with the stipulation in favour of a third-party beneficiary to a contract (see Article 1444 and following of the Québec Civil Code).

[62] There is no evidence of any revocation of the stipulation in favour of Senior Debt agreed to by Stichting. Indeed, the stipulations in their favour (Article 1.10) are reiterated in the 2011 Taberna Indentures.

[63] In view of all of the foregoing, any debt under the 2011 Taberna Indentures is subordinate to the Stichting debt and based on the clear terms of the 2011 Taberna Indentures cannot receive payment unless and until Senior Debt including Stichting debt is paid in full.

[64] Taberna's argument that the plan implementation changed the foregoing, is simply not correct. As stated above, the plan of arrangement does not alter the rights of creditors *inter se* [18]. Moreover, the process undertaken of seeking a judgment on the matter and writing into the plan that Taberna's claim would be dealt with on the basis of the Court order to be issued pursuant to such legal proceedings was not only a valid manner of dealing with the issue, but was a commercially practical manner of allowing the plan to move forward for the benefit of HII and all of the creditors and other stakeholders. Such an approach attains the policy objectives of the CCAA and was lauded by the Ontario Court of Appeal in *Stelco* [19], in similar circumstance to this case.

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[18] Re *Stelco*, 2007, op.cit, para. 41-45.
[19] Re *Stelco*, op.cit. no 2, para. 43

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[65] Equally, neither Stichting nor the Monitor can validly argue that Taberna renounced its position or waived any right by not contesting the classification. The Motion for Directions was tabled prior to the plan. Everyone involved knew what the issue was. Taberna voted against the plan and awaited its day in court on the Motion to learn how its claim would ultimately be treated. It bought into the same commercially reasonable approach as the other parties in resolving the issue while allowing the plan to move forward. There was no waiver or renunciation by Taberna of its rights.

[66] The Monitor aggressively supported Stichting's position. Mr. Saferstein, the expert produced by the Monitor, provided useful evidence since he brought a bankruptcy perspective into the evidence of US or New York law. There was however an inevitable overlap with Stichting's expert evidence made through Mr. Levine who did not deal with the the bankruptcy law effects of the subordination but solely the effect as between the parties. Accordingly, Stichting will be awarded costs including those of Mr. Levine fixed at US$76,413.00 according to the evidence filed at the hearing. Since no proof was made of the applicable exchange rate, this will be subject to taxation. The Monitor will be awarded one half of its expert's costs which will be subject to taxation since invoices were not filed at the hearing. Also, the Monitor did not testify nor file a report as is customary in order to bring the Court up to date on the state of the CCAA file. In view of the foregoing, no judicial costs of the Monitor will be awarded other than half of its expert fees.

[67] Since HII's position was essentially represented by Stichting and the Monitor, no costs will be awarded to HII.

[68] HII's counsel amended the conclusions of the Motion for Directions at the request of the undersigned to avoid reference to terms defined outside of the conclusions. The other parties did not contest the wording so that the conclusions in this judgment will follow such wording.

FOR ALL OF THE FOREGOING REASONS, THE COURT:

[69] **GRANTS** the Petitioners' *Re-amended Motion for Directions* (the "Motion");

[70] **DECLARES** that the payment of any and all amounts owing under and pursuant to:

70.1. Taberna Preferred Funding VI, Ltd.'s US $12 million interest pursuant to a Junior Subordinated Indenture dated as of July 26, 2006 (the "2006 USD Indenture") by and between Homburg Invest Inc. ("HII") and Wells Fargo Bank, N.A. ("Wells Fargo") for the

issuance of US $20 million junior subordinated notes due 2036 (the "Original Taberna VI Note");

70.2. The note issued to Taberna Preferred Funding VIII, Ltd. ("Taberna VIII") pursuant to a Junior Subordinated Indenture dated as of February 28, 2011 (the "2011 Taberna VIII Indenture") by and between HII and Wells Fargo (the "2011 Taberna VIII Note"); and

70.3. The notes issued to Taberna Europe CDO I P.L.C. and Taberna Europe CDO II P.L.C. on February 28, 2011 witnessing their respective interest of €20 million and €5 million pursuant to a Junior Subordinated Indenture dated as of February 28, 2011 (collectively with the 2006 USD Indenture and the 2011 Taberna VIII Indenture, the "Taberna Indentures") by and between HII and Wells Fargo for the issuance of €25 million junior subordinated notes due 2036 (the "2011 Taberna Europe Notes");

(the Original Taberna VI Note, the 2011 Taberna VIII Note and the 2011 Taberna Europe Notes are collectively referred to as the "Current Taberna Notes") is subordinated to the full and complete payment of any and all amounts owing in respect of the principal of and any premium and interest on all debt of HII (excluding trade accounts payable or liabilities arising in the ordinary course of business), whether incurred on or prior to the date of the Indentures or thereafter incurred, unless it is expressly provided in the instrument creating or evidencing the same that such obligations are not superior in right of payment to the Current Taberna Notes (the "Senior Debt"), including without limitation Stichting Homburg Bonds' claims against HII pursuant to a Trust Indenture dated as of December 15, 2002, and any related supplemental indentures thereto, and a Trust Indenture dated as of May 31, 2006 as guaranteed by HII pursuant to a Guarantee Agreement dated as of December 15, 2002 (the "Bonds"), unless and until the Senior Debt is fully satisfied;

[71] **ORDERS** that for the purpose of any distribution to occur under the Fourth Joint Amended and Restated Plan of Compromise and Reorganization of HII and Homburg Shareco Inc. dated as of March 27, 2014 (the "Plan"), any distribution to the holders of the Current Taberna Notes by virtue of their status as unsecured creditors and holders of the Current Taberna Notes shall be remitted to the holders of the Senior Debt on a pro-rata basis, including without limitation the Bonds, unless and until the Senior Debt is fully satisfied;

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[72] **CONDEMNS** the mis-en-cause Taberna entities to judicial costs in favour of the mis-en-cause Stichting Homburg Bonds including experts' fees of US$76,413.00 subject to taxation but only for conversion to Canadian dollars, and to one half the expert costs of the Monitor regarding the report and testimony of Mr. Jeffrey Saferstein subject to taxation.

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Dates of Hearing: June 10, 11 and 12, 2014

COURT OF APPEAL

CANADA
PROVINCE OF QUEBEC
REGISTRY OF MONTREAL

No: 500-09-024589-145
(500-11-041305-117)

2015 QCCA 62 (CanLII)

MINUTES OF THE HEARING

DATE: January 16, 2015

CORAM: THE HONOURABLES YVES-MARIE MORISSETTE, J.A.
JULIE DUTIL, J.A.
NICHOLAS KASIRER, J.A.

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1810040 ALBERTA LTD. (FORMERLY KNOWN AS HOMBURG INVEST INC. AND HOMBURG SHARECO INC.) ET AL.	Mtre MARTIN DESROSIERS (*OSLER, HOSKIN & HARCOURT, S.E.N.C.R.L./S.R.L.*)
IMPLEADED PARTY	ATTORNEY / COUNSEL
HOMCO REALTY FUND (52) LIMITED PARTNERSHIP ET AL.	

In appeal from a judgment rendered on June 30, 2014 by the Honourable Justice Mark Schrager, of the Superior Court, (Commercial Division), district of Montreal

NATURE OF THE APPEAL: **Interlocutory judgment - Companies' Creditors Arrangement Act.**

Clerk: Marcelle Desmarais	Courtroom: Antonio-Lamer

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HEARING

9 h 30	Submissions by Mtre Sylvain Rigaud.
11 h 00	Suspension.
11 h 17	Resumption.
11 h 17	Continuation of submissions by Mtre Rigaud.
11 h 21	Submissions by Mtre Martin Desrosiers.
11 h 32	Submissions by Mtre Guy Paul Martel.
11 h 56	Submissions by Mtre Mason Poplaw.
12 h 31	Reply by Mtre Sylvain Rigaud.
12 h 42	Comments by Mtre Mason Poplaw.
12 h 43	Comments by Mtre Rigaud.
12 h 44	End of arguments.
12 h 44	Suspension.
13 h 04	Resumption.
	BY THE COURT:
	Unanimous judgment see page 3.

Clerk

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BY THE COURT

JUDGMENT

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[1] With leave of a judge of this Court, the appellants have appealed a judgment of the Superior Court, District of Montreal (the Honourable Mark Schrager), rendered on June 30, 2014, which granted the respondents' re-amended motion for directions pursuant to the *Companies' Creditors Arrangement Act*.[1] The judge declared, *inter alia*, that the payment of amounts due to the appellants under certain indentures and notes collectively referred to by the judge as the 2011 Taberna Indentures be subordinated to the full and complete payment of the Senior Debt of Homburg Invest Inc. (HII), including claims by the respondent Stichting Homburg Bonds (Stichting).[2]

***

[2] For the most part, the facts are not in dispute. All parties refer to the account given by the motion judge, in particular in paragraphs [1] to [20] of his reasons.

[3] The key issue before the Superior Court was the meaning to be given to the 2011 Taberna Indentures, specifically to the sections of those agreements that provided that payment of the Taberna notes held by the appellants be subordinate to Senior Debt holders, including Stichting.

[4] As the judge noted at para. [13] of his reasons, the 2011 Taberna Indentures replaced the 2006 Taberna Indentures following a period of negotiation. Significantly, sections 12.2(b) and 12.2(c) of the 2006 Taberna Indentures were deleted and do not appear in the 2011 Indentures. Section 12.2(b) had provided for full payment of the Senior Debt (including the Stichting bonds) in priority to the Junior Debt (including the Taberna notes) in the event of bankruptcy or insolvency of HII. Section 12.2(c) was a "turnover clause": it provided that, in the event of a payment received by the trustee under the 2006 Taberna Indentures in contravention with the terms of the Indentures, such proceeds would be remitted or turned over to the Senior bondholders.

[5] According to Taberna, the effect of these deletions on the meaning to be given to the 2011 Taberna Indentures is that the claim of the Taberna noteholders is no longer subordinate to the claim of the Stichting bondholders in connection with the HII plan. This is the case, they say, notwithstanding the terms of Article XII of the 2011 Taberna Indentures which continue to refer to the subordination of securities issued thereunder to Senior Debt. The Taberna noteholders asked the Superior Court to declare that under the 2011 Taberna Indentures, they should be paid *pari passu* with the Stichting bondholders pursuant to the CCAA plan of arrangement.

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1 R.S.C., 1985, c. C-36.

2 2014 QCCS 3135. The terms used to describe the various bonds, notes and indentures herein are defined in the reasons of the motions judge and, as the parties have done, we shall refer to those defined terms for ease of reference.

[6] The judge disagreed. He decided that, notwithstanding the deletions and other evidence adduced as to the parties' intentions, the claim of the Taberna noteholders under the 2011 Taberna Indentures remained subordinate to the Senior Debt, including the Stichting debt. He agreed with the expert evidence that, under governing New York law, the terms of a contract should be enforced as the definitive expression of the parties' intent where they are clear and unambiguous. The subordination language in the 2011 Taberna Indentures was clear and unambiguous expression of the parties' intention that the Taberna notes be subordinate to the Stichting bonds. The deletion of the turnover provisions from the 2006 Indentures did not change the subordinated status of the Taberna notes. Moreover, held the judge, the rights of the creditors *inter se* were not altered by the approval and homologation of the CCAA plan of arrangement. The subordination clause was held to be this fully enforceable even if the Taberna noteholders and the Stichting bondholders are in the same class of creditors.

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[7] The appellants argue that the judge made three errors, each of which justifies setting aside the judgment *a quo*: he purportedly misinterpreted Article XII of the 2011 Taberna Indentures; he allegedly erred in his appreciation of the impact of the CCAA proceedings on the rights of the creditors *inter se* pursuant to the subordination provisions of the Indentures; and he is said to have been mistaken in his view of the enforceability of the Indentures against the Stichting bondholders as third parties.

[8] The appellants are mistaken on the first two grounds of appeal. For the reasons that follow, we are of the view that the appellants have failed to show that the judge committed a reviewable error. It is not necessary to decide the third point. In the result, the appeal should be dismissed.

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I Alleged Error in the Interpretation of the 2011 Taberna Indentures

[9] Did the judge err in his interpretation of the subordination provisions of the 2011 Taberna Indentures leading him to conclude, mistakenly, that the claims held by the Taberna noteholders are still subordinated to the claims of the Stichting boldholders?

[10] The appellants present three sub-arguments under this heading. They are treated here in turn.

[11] First, the appellants argue that the judge wrongly resolved the subordination dispute on the basis of general insolvency law principles rather than on the contractual wording in the 2011 Taberna Indentures, including the choice of law clause designating New York law as applicable to the contract's interpretation. In support of this position, they point to language used in para. [51] of the judge's reasons where he stated the following: "[a]ccordingly, applying principles of Canadian insolvency law to the subordination in the present [case], Taberna remains subordinate in the insolvency and this absent the specific bankruptcy language and a turnover clause".

[12] The appellants are mistaken on this point.

[13] The motion judge correctly identified New York law as providing the rules of interpretation applicable to the 2011 Taberna Indentures and determined the content of these rules based on expert evidence presented before him: see paras. [14], [32] and [40] of his reasons. Once he decided that the determination of the substantive rights of the parties under the contract was governed by New York law, the judge also correctly held that the procedural treatment of such rights, for affected creditors under the plan of arrangement, was subject to Canadian insolvency law: paras [31], [32] and [40]. The judge's comment in para. [51], when read in the context of his analysis as a whole, is not inconsistent with this approach and evinces no reviewable error.

[14] Second, the appellants submit that the judge erred "in law" when he concluded that the deletion of the existing turnover provision in the 2011 Taberna Indentures by HII and the Taberna noteholders did not constitute evidence that the parties no longer intended the Taberna notes to be subordinated to the Stichting bonds.

[15] Writing on the terms of the 2011 Taberna Indentures at paragraph [40] of his reasons, the judge observed that "[t]he subordination clause clearly establishes the princip[le]. The extrinsic evidence adduced by Taberna is not convincing of any intention to change the princip[le] of subordination that existed under the 2006 Taberna Indentures". After reviewing expert evidence on the rules for the interpretation of contracts in New York law, the judge decided that there was "no meeting of the minds" regarding the legal consequences of not reproducing the turnover provisions in the 2011 Taberna Indentures (para. [54]). On his view of the evidence, while the parties did delete the turnover provisions, they did not agree to change the basic subordination concept expressed in the 2006 agreements and carried forward by the clear and unambiguous wording of the 2011 Taberna Indentures. Even without the turnover clause, the subordination provisions are fully enforceable in a bankruptcy or insolvency context. The judge considered that the subordination language in Article XII of the 2011 Taberna Indentures was "sufficient" notwithstanding the deletion of the turnover provisions (para. [47]).

[16] The interpretation of the intention of the parties as expressed in the 2011 Taberna Indentures is a finding of fact. Courts have been emphatic in deciding that whether or not a judge correctly interpreted a contract is a question of fact or, at best, a mixed question of fact and law.[3] The appellants bear the burden of showing that the judge committed a palpable and overriding error in order to have the judgment reversed.[4]

[17] They have failed to meet that burden.

[18] The judge found that, according to the clear meaning of the 2011 Taberna Indentures, the Taberna notes are subordinated to the Stichting bonds. In so doing, he applied the rule of interpretation in New York law that a clear and unambiguous wording is considered to be the definitive expression of the parties' intention.

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3 *Sattva Capital Corp.* v. *Creston Moly Corp.*, 2014 SCC 53, paras. 42 to 55. See also *René Corriveau & Fils Inc.* v. *9201-0958 Québec inc.*, 2014 QCCA 1765, para. 10 and *Compagnie de chemin de fer du littoral nord de Québec et du Labrador Inc.* v. *Sodexho Québec ltée*, 2010 QCCA 2408, para. 211.

4 *Housen* v. *Nikolaisen*, [2002] 2 S.C.R. 235.

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[19] The judge added that the evidence that Taberna brought did not convince him that the parties had agreed to set aside the subordination "principle" or "concept" by deleting the turnover provisions. In paragraphs [37] to [40], he specifically considered the appellants' argument, founded upon the testimony of their expert, that the deletion of the turnover provision was not parole evidence and that, instead, it was significant as an indication of the parties' intention to end subordination. The judge rejected that view of the evidence and preferred to discern the parties' intention from the clear terms of the contract.

[20] Contrary to the appellants' submission, the judge did not decide that there was no meeting of minds on the basis of the "subjective" motivations of the parties but he relied, above all, on the clear terms of the 2011 agreements. The appellants have failed to show that this was a palpable and overriding error.

[21] Thirdly, the appellants contend that the judge wrongly imposed an obligation to turnover payment upon the Taberna noteholders notwithstanding the fact that the turnover provisions had been deleted from the 2011 Indentures.

[22] This argument is without merit.

[23] Once again, the judge simply applied the clear terms of the 2011 Indentures, in particular, section 12.2(a) which provides that no payment shall be made to the Taberna noteholders so long as a payment default of the Senior Debt exists. Sections 12.2(b) and 12.5 impose on the Taberna noteholders and the trustee an obligation to take reasonable action to ensure the effectiveness of subordination. Section 5.6 of the 2011 Indentures provides that payment of all the Senior Debt shall be made in priority to amounts due under the Taberna notes. Moreover, contrary to the argument of the appellants, the judge did not order the Taberna noteholders to "turn over" the amounts recovered under the plan of arrangement to Stichting since, pursuant in particular to section 9.6b) of the Plan, those funds have been reserved pending the outcome of the subordination dispute. In this respect, having received no distribution under the plan, the noteholders have nothing to "turn over".

II Impact of the CCAA Proceedings on the Subordination Provisions

[24] Did the motions judge err in concluding that the debtors' CCAA plan of arrangement did not alter the rights of the Stichting bondholders and the Taberna noteholders in relation to each other?

[25] The appellants contend that by voting in favour of the plan of arrangement under the CCAA, Stichting waived its right to be considered senior to the Taberna noteholders pursuant to the subordination provisions.

[26] The judge rejected this argument. He wrote, at para. [42] that "[...] the rights of the debtor vis-à-vis its creditors [are] altered under the proposal but not the rights of the creditors *inter se*". Later in his reasons, he explicitly relied on the judgment of the Court of Appeal for Ontario in *Re Stelco*[5] to reject the Taberna noteholders' submission that the implementation plan changed the substantive rights of the Stichting and Taberna creditors as between themselves.

[5] 2007 ONCA 483, confirming [2006] CanLII 27117 (Sup. Ct J.).

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[27] The appellants have not convinced us that the judge erred in this regard.

[28] The respondents have correctly noted, as the judge himself observed, that the motion for directions was filed before the plan of arrangement was adopted. All ordinary creditors, including holders of the Stichting bonds and the Taberna notes, were grouped in the same class. But the plan provided that nothing would be paid to the Taberna noteholders before the outcome of the "Taberna Order" – *i.e.* the motion for directions before Schrager, J. – dealing with the subordination provisions pursuant to section 9.6b) of the Plan, as noted above.

[29] In para. [46] of his reasons, the judge correctly relied on *Re Stelco*[6] which held that junior and senior debt may be grouped within the same class. To this end, the judge also correctly relied on the judgment of this Court in *Mérisel*[7].

[30] In the circumstances, the appellants are wrong to suggest that the HII plan has an impact on this dispute between competing creditors as to their rank *inter se*. While it is true that the approval, sanction and implementation of a CCAA plan of arrangement can extinguish indebtedness of a creditor, it has no necessary impact on the rights between the creditors themselves.

III *Ultra petita*

[31] The appellants argue that the judge ventured beyond the arguments made by the respondents in first instance by deciding that it is "in itself fatal to Taberna's position [...] that Stichting was not a party to the negotiations leading up to the 2011 Taberna Indentures nor to the documents themselves" (para. [56]). They say the judge was wrong to do so and that his finding on this point is insufficient to sustain the judgment.

[32] It is not necessary to decide this point to dispose of the appeal.

[33] As a practical matter, the reasons given by the judge concerning the fact that Stichting was not a party to the 2011 Taberna Indentures were not strictly speaking necessary to his conclusion. As the judge explained, the meaning to be given to the clear and unambiguous terms of the 2011 Taberna Indentures, despite the absence of a turnover clause, was the basis in law for his decision to rank the Taberna notes subordinate to the Stichting bonds. The judge's discussion of Stichting's rights under the law on stipulation for the benefit of a third party was not decisive for the outcome of the case in first instance.

[34] All parties before this Court agree that this was a subsidiary argument made by the respondents in first instance. Given our conclusion that the judge made no reviewable error in his interpretation of the 2011 Indentures, the Court refrains from deciding the point.

[35] In dismissing the appeal, the Court will not disturb the order for costs made by the motion judge in first instance.

[6] (2005) 15 C.B.R. (5th) 307 (Ont. C.A.), confirming 2005 CanLII 41379 (Sup. Ct J.).

[7] *2862565 Canada Inc.* v. *Mérisel Canada Inc.*, [2002] R.J.Q. 671 (QC CA).

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[36] **FOR THE AFOREMENTIONED REASONS,** the Court:

[37] **DISMISSES** the appeal, with costs.

YVES-MARIE MORISSETTE, J.A.

JULIE DUTIL, J.A.

NICHOLAS KASIRER, J.A.

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TAB 5

Alberta Court of Queen's Bench
Bank of Montreal v. Dynex Petroleum Ltd.
Date: 1997-04-04

Richard B. Jones and Gordon S. Griffiths, Q.C., for Plaintiff Bank of Montreal.

James C. Crawford, Q.C., for Defendants Enchant Resources Ltd. and D.S. Willness.

Frank R. Dearlove and Scott H.D. Bower, for Defendants Meridian Oil Inc.

& Odessa Natural Corporation.

Richard C. Dixon, for Ernst & Young Inc.

(Calgary 9301-08195, BK 039154)

April 4, 1997.

1997 CanLII 14795 (AB QB)

I. Introduction

[1] ROOKE J.: — The issue in this Decision, in its simplest form, is to determine the effect of the bankruptcy of a petroleum and natural gas company, Dynex Petroleum Ltd., then in receivership, on the competing interests of the secured real and personal property, duly registered and crystallized debenture holder, the Plaintiff, the Bank of Montreal (the "B of M"), as against certain overriding royalty and net profits interests of various Defendants (including the parties to this hearing, Enchant Resources Ltd. ("Enchant"), Meridian Oil Inc. ("Meridian"), Odessa Natural Corporation ("Odessa"), and D.S. Willness ("Willness")) (collectively the "ORRs"), granted by Dynex or its predecessors (collectively "Dynex") under petroleum and natural gas leases, when the B of M's debenture was subordinated to the interests of only partially registered ORRs.

II. Executive Summary

[2] After considering all of the issues herein, as set out in these Reasons, I have concluded that the priorities between the B of M and the ORRs relate less to the status of these parties in the bankruptcy (as a secured creditor and unsecured creditors respectively, as I have found) than to the effect of the bankruptcy on the subordination. I have found that the subordination of the B of M to the ORRs survives the bankruptcy of Dynex, and that the ORRs are entitled to recover any of their loss in bankruptcy (that is not recovered from the Trustee) from the B of M.

III. Simple Facts

[3] The simple facts necessary to have a proper appreciation of this Decision, by someone other than the parties, can be set out fairly succinctly utilizing the very helpful headnote of the Alberta Law Reports in the decision that I granted on some earlier questions between these parties: *Bank of Montreal v. Dynex Petroleum Ltd.* (1995), 39 Alta. L.R. (3d) 66 (Alta. Q.B.), flowing from oral reasons for decision granted December 19 and 20, 1995 (the "December 1995 Decision", on three separate specific issues, and a formal Order dated December 20, 1995.

[4] Those simple facts, relying on the Alberta Law Reports headnote (with necessary changes), are as follows:

> [Dynex and its predecessors] had granted overriding royalty and net profit interests to certain third parties [ORRs] in respect of its oil and gas leases. Some time later, [Dynex] went to the [B of M] for financing, employing the oil and gasleases as security. [Dynex] gave a debenture [and other security documents including "General Assignments" under what is now Section 426 of the *Bank Act*, formerly Section 82 and later Section 177], and all of the documentation supporting the transaction stated that the [ORRs] interests were permitted encumbrances ... [Dynex] eventually defaulted on the loan and the [B of M] put it into receivership under the debenture [May 14, 1993]. A short time later [Petition -May 26, 1993 and Receiving Order May 27, 1993] [Dynex] went into bankruptcy. The [B of M] sued [Dynex, in bankruptcy] and the numerous [ORRs], seeking, as against the [ORRs], a declaration that the security granted by [Dynex] to the [B of M] ranked in priority to the [ORRs] in the context of bankruptcy. [In the hearings held in December, 1995] the [B of M] applied for a preliminary determination that the interest claimed by the [ORRs] were not interests in land. [Some of the ORRs] applied for summary judgment dismissing the action. [All of the parties to the application requested the Court to determine the priorities between the B of M and the ORRs after crystallization of the debenture security on May 14, 1993 and prior to the Bankruptcy Petition of May 26, 1993].

[5] There are substantially more detailed facts than set out above within the December 1995 Decision and referred to in the legal briefs of the parties then, and in the within application, and as contained in numerous documents filed by the parties prior to the December 1995 Decision and in this application (the latter 2 volume binder set referred to as the "Document Record"). However no useful purpose would be served in these Reasons by setting out the facts in any greater detail at this point. Accordingly, I will not do so, except as may later be necessary to make the within Decision and provide these Reasons. Anyone wanting a more detailed analysis of the facts will have to look at the background material.

IV. December 1995 Decision

[6] In the December 1995 Decision, I basically came to three conclusions, namely:

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(1) the ORRs interests, being granted "downstream" of leases, could not, as a matter of law, become interests in land, and, in the alternative, if that decision was incorrect in law, a trial of an issue would be necessary to determine whether, as a matter of fact, the documentation pertaining to the ORRs did create such an interest in land;

(2) the priorities in bankruptcy could not be determined on the summary application, and therefore, summary judgment was denied; and

(3) after crystallization of the debenture (and other related security), but before the bankruptcy, the B of M's interests were subordinated to the interests of the ORRs.

[7] While the aforementioned three points constituted the substance of the December 1995 Decision of the Court, it is, once again, set out fairly succinctly, but in somewhat more detail, in the headnote of the Alberta Law Reports, which I adopt, with the necessary changes, for this purpose. The decision as therein stated is as follows (at 67):

> As a matter of law, a lessee of an oil and gas lease, which, as a *profit à prendre,* is itself an interest in land, obtained from a lessor, cannot pass on an interest in land. If it was permissible in law to have an interest in land downstream of a profit à prendre, then the language of the instrument creating the interest would have to reflect an intention to create an interest in land. Examination of such instrument[s] could not be made in a summary proceeding.
>
> The Statement of Claim referred to the parties' interest in the context of bankruptcy, while it was apparent that the defendants' motion referred to the parties' interest at a point in time after the appointment of a receiver, but prior to the bankruptcy. Clearly, therefore, there were triable issues in respect of the parties' interest after the bankruptcy, and summary judgment would not be available to determine the parties' interest in that context.
>
> The defendants' main application concerned the rights and priorities between the [B of M] and [ORRs] at the point after the Receiver had been appointed, but before the bankruptcy ...
>
> The subordination clauses within the debenture and loan agreements, by their terms, contemplated a subordination of the [B of M's] interest under the debenture to the previously granted interests of the [ORRs]. Explicitly, they allowed those [ORRs] to rank ahead of the debenture holder in regards to their interests ... The commercial reality in the oil and gas industry, in conjunction with the financial industry, required that documents of that nature be given that effect.

[8] The December 1995 Decision has been appealed to the Court of Appeal and is expected to be heard in the fall of 1997. Notwithstanding the Court's ruling with respect to the application for summary judgment therein (and a similar ruling I understand was made on a similar application by the B of M before another member of the Court), the parties have now requested (by consent) that the Court determine the priorities between the parties in bankruptcy on a summary basis, relying on the material before the Court. It is

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further contemplated that, because of the substantial issues to be determined and the dollar effect of those issues, the within Decision will be added by the unsuccessful party(ies) to the matters to be heard before the Court of Appeal in the fall. Accordingly, the application resulting in this Decision comes forward by way of an agreement between the parties, concurred in by the Case Management Justice, Forsyth, J., that the matter be heard by myself.

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V: Issue - Question to be Decided and its Relevance

[9] The precise question to be decided was intentionally not articulated by the Court in the formal Order setting the hearing of the application, so as to permit further arguments on, and refinement of, the question during the hearing of the application. However, in substance the issue it is to ask the same question as in the December 1995 Decision, but at a later time, namely, the priorities between the B of M and the ORRs, after the point of bankruptcy.

[10] While not substantially different in substance, the parties describe the question in various ways. Counsel for B of M stated it thus in their legal brief:

> ... the effect or effects, if any, of the bankruptcy of Dynex upon the finding of the Court in its Order of December 20, 1995.

Counsel for Meridian Oil Inc. and Odessa Natural Corporation ("Meridian and Odessa") stated it thus in their legal brief (opening and para. 14[1]):

> ... the effects, if any, of the intervening bankruptcy of Dynex ... on the subordination of the [B of M's] security interest to Odessa's and Meridian's overriding royalty.
>
> Has the intervening bankruptcy of Dynex ... affected the subordination of the [B of M's] security interests to Odessa's and Meridian's overriding royalty?

Counsel for Enchant Resources Ltd. and D.S. Willness ("Enchant and Will-ness") was slightly more elaborate (para. 51):

> At the moment in time after the Bankruptcy of [Dynex] and after debentures issued by [Dynex] to [B of M] had crystallized, is the security granted by [Dynex] to [B of M] in those debentures and securities under the *Bank Act* subordinated to or do they rank in priority to, or extinguish, the interests of [Meridian and Odessa, and Enchant and Willness] in the said Overriding Royalty Agreements and Net Profit Agreements?

Finally, Ernst & Young Inc., in its capacity as Trustee in Bankruptcy for the Estate of Dynex, a bankrupt, and, as Court appointed Receiver Manager, pursuant to the B of M

[1] References to paragraph numbers in relation to arguments, unless otherwise stated, or the context requires, are to the paragraphs of the party's written legal brief (or reply brief) filed prior to the hearing.

security (by Orders of June 25 and August 20, 1993), of Dynex ("Ernst & Young[2]") stated the question this way:

> What effect, if any, does the bankruptcy of May 26,1993 of [Dynex] have with respect to the Court's findings, as reflected by its December 20, 1995 Order?

All of these expressions, in my view, create the same question, as identified at the beginning of these Reasons, but, in hindsight, the articulation by Counsel for Meridian and Odessa most precisely defines the point in issue.

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[11] I intend to build on the facts found in the December 1995 Decision, which, in large part, set out the nature of the interests of the parties, and the nature of the subordination, just prior to bankruptcy. With those interests properly understood as a background, I then propose to look at what the interests of the parties were at the point of bankruptcy (ignoring the subordination for the moment), and finally to analyze the effect of the bankruptcy (if any) on the subordination. This order of determining rights in not an inappropriate way in which to determine matters, as pointed out by *Goode, Principles of Corporate Insolvency Law* (London: Sweet & Maxwell, 1990) ("*Goode* - Principles"), at 17:

> ... corporate insolvency law for the most part recognizes and adopts rights conferred by the general law and by contract.
>
> . . . . .
>
> The general rule is that the commencement of an insolvency proceeding does not of itself terminate contracts or extinguish rights, though it does inhibit the pursuit of remedies. The starting position of insolvency law is that rights accrued prior to the insolvency proceeding will be respected. To this principle there are important exceptions ...

[12] I said in the December 1995 Decision that the question of the priorities between the parties after receivership and prior to bankruptcy was not moot. Answers to further enquiries in the within application elaborated upon that. As I understand it, without intending to be too technical about the matter, there have been ongoing revenues in the form of the proceeds from the sale of petroleum and natural gas production resulting from the leases, notwithstanding the financial troubles of Dynex. To a certain point in time, the share due to the ORRs flowed to them in regular monthly cash payments. While the bankruptcy was relatively quick on the heels of the receivership, there were some funds generated during the period of (and perhaps even before) the receivership and prior to bankruptcy, for which the ORRs claim an interest, but which are held by the Trustee. Moreover, there are the regular proceeds of the production that have been held by the

[2] The fact that the same firm fulfils both the role of Receiver-Manager and Trustee makes it more difficult to keep separate the function being performed - while I will try to keep these separate, the reader should permit some inadvertent and unintentional confusion.

Trustee subsequent to bankruptcy, which, since the sale of Dynex's assets by the Receiver to Channel Lake Petroleum Ltd. ("Channel Lake"), approved, with reservations, by Court Order dated September 1, 1993 (on which more later in these Reasons), constitute in excess of $1.1 million (Meridian & Odessa legal brief, para. 9). Finally, there are the proceeds of the sale of the assets of Dynex by the Trustee to Channel Lake (including the interest of Dynex in the subject leases), from which have been reserved and held in the hands of the Trustee some $5 million purporting to represent the value of the acquisition of the ORRs interests. This latter matter deserves some further recognition of the facts.

[13] To be stated relatively simply, as I understand it from the material, after the bankruptcy, the Receiver Manager effected a Court approved sale of the oil and gas properties of Dynex to Channel Lake, reserving out certain issues with respect to whether or not the Receiver Manager had the right to sell the ORRs interest and the effect of the bankruptcy on the revenues from the production. For the purposes of these Reasons that circumstance is set out relatively succinctly, but in more detail, among other places, at paragraph 24 of the legal brief of Counsel for Enchant and Willness, referring back to the legal brief of Counsel for the B of M filed November 9,1994 in the within action. That statement, appropriately edited, is as follows:

> Shortly after this action was commenced, a receiving order was made against [Dynex] under the *Bankruptcy and Insolvency Act* and Ernst & Young was appointed as Trustee in Bankruptcy. Pursuant to orders of this Court made on June 25, 1993 and August 20, 1993, [Ernst & Young] was also appointed by this Court as a Receiver under the *Judicature Act* of all the petroleum and natural gas properties of Dynex and of all the claimed interests of the [ORRs] therein under the contracts specified in the Order. By order made August 20, 1993, the Receiver was authorised to sell the properties to [Channel Lake]. Channel Lake was ordered to pay and to continue to pay to the Receiver all payments attributable to the [ORRs] pursuant to the Royalty Agreements which were designated as the "Disputed Interests". These payments now aggregate approximately $5,000,000 with respect to all the [ORRs] in this Action and are being held pending determination of the relative priorities of the parties to this action.

[14] Therefore I understand that proceeds not only from the sale of the "Disputed Interests", but also the proceeds from production from the properties since bankruptcy, for which the ORRs claim an interest, are being held by the Trustee to the extent of the purported interest of the ORRs.

VI. Categorization of the Interest of the ORRs

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[15] Without retreading on the December 1995 Decision that the interests of the ORRs were not interests in land.(on which I will have more to say later), because, on the material before me, they could not, in law, be interests in land, the question then remains as to what were the interests of the ORRs. If the interest of the ORRs were not interests in land (upon which the Court of Appeal will undoubtedly have further to say), it is clear that the interests are, in that context, *choses in action*.

[16] While this is not the decision in which to provide a treatise on the meaning of a *chose in action,* a brief understanding may be helpful to considermore clearly the true nature of the interests of the ORRs. A right to benefit under a contract is a *chose in action:* Waters, *Law of Trusts in Canada* (Second Edition) (Toronto: Carswell, 1984), at 141. *Black's Law Dictionary* defines a *chose in action* as "a right to personal things which the owner has not the possession, but merely a right of action for their possession", including "all property in action which depends entirely on contracts express or implied". While there are undoubtedly further and even more detailed definitions of a *chose in action* in law, this case is more easily resolved if one looks first at a *chose in action* in a simple, common, lay form of understanding (as I tried to do throughout my December 1995 Decision and will attempt to do so in these Reasons).

[17] In lay language, pertinent to this case, the interests of the ORRs, are rights, to the extent of the percentage of their interests in accordance with the documents creating the same, to receive a portion of the proceeds of the sale of petroleum and natural gas substances from the leases held by Dynex. Keeping with lay terminology, they are not rights to any specific tangible chattel or thing. Moreover, to the extent that the December 1995 Decision is correct, they are not interests in real property. That is, they are not rights to a *piece* of property (personal or real). What are these rights? They are intangible personal property rights - contractual rights - in this case, as I have said, the rights to receive a portion of a revenue stream from production. Using a hypothetical example, they are as if, for consideration, but without providing a capital fund, the ORRs were given rights to a monthly annuity equal to some percentages of production, or shares of profits, etc.

[18] What is the effect of a bankruptcy of the holder of these contractual rights? Normally, in a bankruptcy, such rights would (absent other facts) constitute simple debts for past (and damages for future) revenues, the rights to which would be changed by the bankruptcy to a right to register an unsecured claim with the trustee in bankruptcy. However, the issue in the case at hand, is whether the documentation under which the

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ORRs received these interests, the registration (or lack thereof) of the documentation, and the subordination by the B of M of its interest to those interests, give them more? Let us look at the possibilities and consequences, and then determine whether the ORRs interests are merely unsecured claims in debt/damages in bankruptcy, in comparison to the claim of the B of M, or some higher state.

VII. Classification of the Interest of the ORRs and The Bankruptcy Consequences of the Classification

[19] From the legal briefs and the submissions of Counsel to the Court, it appears that the interests of the ORRs in bankruptcy consists of one of four possibilities. These four possibilities are the following:

(1) trust interests;

(2) secured creditor status as to real property, by virtue of real property interests;

(3) secured creditor status as to personal property, by virtue of personal property interests; and

(4) unsecured creditors.

[20] For the purposes of these Reasons, it is recognized that, in comparison, the interest of B of M is that of a secured creditor, with fully registered real and personal property interests, a status effectively recognized by the Court on August 20, 1993, when it was declared that the Bank had a valid and subsisting charge on all of the assets of Dynex, subject to the determination of the issues relating to the interests of the ORRs.

[21] Simply put, without considering the considerable issue of subordination (to which I will turn shortly), the bankruptcy consequences of these classifications (using the same numbering) are that the interests of the ORRs in question would have priorities, *vis-à-vis* the B of M, as follows:

(1) preferred and rank in priority to the B of M;

(2) secured creditors, ranking at least equal to the B of M, as to real property interests;

(3) secured creditors, ranking equal to the B of M, as to personal property interests, but ranking after the B of M in respect of any real property interests; and

(4) unsecured creditors, subject in priority to the B of M secured creditor interest.

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Each of these possibilities deserve further detailed examination.

A. Trust Interest

[22] Insofar as the ORRs interests represent a trust interest, it would mean that Dynex held the interests in trust for the ORRs and it is generally conceded (Counsel for Ernst & Young admits) that such interests would be outside of the bankruptcy.

[23] This conclusion is consistent with the following "second principle of insolvency identified by *Goode* - Principles, at 18:

> **Second Principle: only the assets of the debtor company are available to creditors**
>
> ... It is not the function of corporate insolvency to confiscate for the benefit of creditors assets in the company's possession or control which belong to others. Only that which is the property of the company at the time of liquidation or comes into its hands thereafter is available for its creditors. So assets held by the company on trust do not form part of its estate ...

It is also consistent with s.67 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("BIA"), which provides as follows:

> (1) The property of a bankrupt divisible among his creditors shall not comprise
>
> (a) property held by the bankrupt in trust for any other person,

[24] The onus is on the party claiming a trust relationship to establish it, by showing, *inter alia,* that it capable of being identified and that there was a clear intention to create a trust: *Bennett on Bankruptcy* (Third Edition) (North York: CCH Canadian, 1993), at 97.

[25] Again, in lay language, property that is held in trust for a third party by an entity that/who becomes bankrupt, is, on bankruptcy, delivered to that third party by the trustee in bankruptcy, and no other creditor has a claim on it, because it never was the property of the bankrupt, and the trustee only takes what the bankrupt owned. Again, a hypothetical example, in simple lay language, could be considered. If a third party takes furniture to a furniture repair establishment for repair and, prior to its redelivery to the customer, the repair company goes into bankruptcy without title to the furniture passing to the repair company, that would be, in simplistic terms, a trust relationship where the property would remain owned by the third party and be delivered to the third party by the trustee in bankruptcy. This is to be distinguished from a situation where, if the furniture were sold to the furniture repair company, but the payment proceeds were not delivered to the third party prior to bankruptcy. In such a case, the funds held by the trustee would not be trust funds but would be held subject only to an unsecured claim by the third party who had sold

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the furniture. At the risk of oversimplifying the matter, that is the difference between them, and applicable to this case.

[26] It is clear from the hypothetical example, and in law, that there need not be a specific document or specific types of wording to constitute a trust: *Bank of Nova Scotia v. Société Générale (Canada)*, [1988] 4 W.W.R. 232 (Alta. C.A.) (the *"Sorrel"* case). Indeed, the whole relationship of trust is being continually expanded into resulting trust, constructive trusts and other fiduciary relationships.

[27] Counsel for Enchant and Willness argued that a trust existed because the assignment of the interests to the ORRs were absolute, for consideration, and without the need for any conversion or "back in" by the ORRs. Again, however, while no specific words are necessary, the intention that Dynex held the interests in trust for the ORRs as against all the world must both be clear, and they must be interests capable of being so held. Here the interests are not interests in real property, or lease payments from the lease of real property (e.g. as in *Scurry-Rainbow Oil Ltd. v. Galloway Estate* (1993), 138 A.R. 321 (Alta. Q.B.) (Hunt, J.)), or a specific personal asset (e.g. an existing fund, as in the *Sorrel* case), but contractual rights to future revenues after bankruptcy - a *chose in action*[3]. They are property rights, in the sense that they relate to personalty, but they are rights to future revenues, unlike a specific existent fund held in a trust account - e.g. an RRSP, a deposit, etc.. Even if that does not prevent such a trust, there must be an intention to create a trust relationship.

[28] In *Sorrel*, the issue related to specifically ear-marked funds paid to the operator of petroleum production facilities, by non-operators, that were in excess of that required for operations. The headnote sets this out in the following way:

> The creation of a trust does not require express words, and ... a trust could be inferred from an examination of the entire agreement. The subject-matter (the excess funds and revenues [on deposit with the operator] and the object (the non-operators) of the trust were certain, and the agreement as a whole evinced an intention to create a fiduciary relationship between the parties.

Consequently, in *Sorrel*, the Court held that excess revenues and interest thereon were trust funds.

[29] It is also clear from the documentation that the ORRs owned nothing independent of, or except through, the interest of Dynex. This is evident in the

[3] I do not believe it to be disputed in this case that funds otherwise earned by the ORRs up to the point of bankruptcy of Dynex will be accounted to them.

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documentation in that Dynex (in the case of Odessa and Meridian, as can be seen in the Document Record, Tab 25) was entitled to fail to keep the subject leases in good standing, and to allow them to expire, to abandon them, to release them, or surrender them (not transfer or encumber). Therefore, in effect, Dynes was entitled to abandon any of its interest, without liability to the ORRs -I find such rights to be inconsistent with the intention to create a trust.

[30] The Trustee argued that this was not the time or method to determine if there was a trust relationship, but that it should be determined under the expedited procedure of s. 81 of the BIA, the onus of which was on the party seeking to establish the trust under s. 81(3). More substantively he argued that all the documentation was against the interpretation of a trust - if it was trust property, then there was no interest for which to make the B of M subordinate,.and, indeed, there would be no need for a subordination..

[31] Counsel for the B of M argued (this argument was not challenged) that to create a trust there must be three elements of certainty: intent, subject matter and object. His further argument (not accepted by Counsel for the ORRs) was that there was no certainty of subject matter because the interests were, at best, rights to a revenue stream which, at any future point (after bankruptcy) were not certain. Counsel for Enchant and Willness argued that there was certainty, and that production records and monthly statements confirmed this. Counsel for the B of M further argued that there was no evidence of intent, and noted that the agreements were commercial contracts between sophisticated parties and, while no words of trust was necessary, the agreements not only had not one word to suggest a trust, but did not look like a trust either.

[32] On the documentation I have examined, I can find no words that would constitute a trust relationship, any more than a promissory to pay (as in a promissory note) would constitute a trust. It is clearly not every promise to pay that constitutes a trust, and, in my view, the courts should be slow to so find, absent a very clear indication, such an intention. This so because there is a need for certainty as to whether or not a trust exists and that is particularly important so that parties (such as the B of M and the ORRs in this case) dealing with a debtor (Dynex in this case) can be aware of what their rights might be in the context of various scenarios (for example what happened in this case, a bankruptcy), and contract accordingly.

[33] In considering this matter, I am very mindful that there is a substantial desire by the ORRs that their interests be classified as trusts because that would effectively

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determine this issue in their favour and in priority to the B of M. Indeed, there may be good policy basis for declaring such interests to be trusts. However, this Court is not a policy court, but rather must rely upon the facts as known to the Court and the law applicable thereto.

[34] In the result, I have concluded that Counsel for the ORRs have not met the onus on them to establish that the interests of the ORRs are trust interests - that is, there is nothing present in the documentation to create trusts, or to show intentions to create trusts, in favour of the ORRs.

B. Secured Creditor by Virtue of an Interest in Real Property

[35] As noted, it is conceded that, to the extent that the registered security of the B of M gives it an interest in real and personal property, it is a secured creditor for both the real and personal property of Dynex in the bankruptcy. As a result of this conclusion, the issue of the nature of the interests of the ORRs (if less than real or personal property registered security interests) may be academic, unless the ORRs benefit from the subordination of the B of M's interest to theirs in any event of bankruptcy, because it would appear from the submissions before the Court, that any interest that is caught by the secured creditor status of the B of M would more than consume the assets of Dynes, leaving nothing for the Trustee to distribute to the unsecured creditors.

[36] In the December 1995 Decision, I have already ruled that the interests of the ORRs, being neither interests in a lease, nor rentals therefrom, but interests ranking below a lease, cannot, at law, be real property interests, and, in the alternative, if that decision were wrong in law, that a trial of an issue would need to be held to determine whether real property interests had in fact been created. Such latter determination might be further complicated in cases where the ORR was the lessee and remains bare leasehold title holder still (*vis-à-vis* the lessor), but had assigned the leasehold interest to Dynex, retaining a royalty or net profit interest only - see, for example para. 3 of the legal brief of Counsel for Enchant and Willness.

[37] The December 1995 Decision having been made on this point, I am *functus* on the issue and the result, pending appeal, can only be that the ORRs have no real property interests, or, alternatively, if they potentially can, that has not been determined. Therefore, I have effectively determined that the ORRs are not secured creditors by virtue of any real property interests. That being the case, the ORRs would have no priority over the B of M,

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but, indeed, in bankruptcy, and without considering the effect of the B of M's subordination agreement, would be unsecured creditors, subordinate to the B of M.

[38] While the legal brief of Counsel for Enchant and Willness takes great pains to point of their registration of caveats at the relevant land titles office ("LTO"), there is no real issue of registration of the ORRs interests at the LTO because the B of M was not only aware of their interests (see paras. 35 and 47 of the legal brief), but specifically recognized them, and subordinated its interest to the ORRs. It is equally clear, as Counsel for Enchant and Willness pointed out (paras. 29 and 38 of his legal brief, and para. 2 of his reply legal brief), that the B of M did not purport to register any claim to the interests of the ORRs or to seek any security interest in the ORRs interests - indeed, the subordination specifically excluded these interests from the B of M security.

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C. Secured Interest in Personal Property

[39] Again, consideration of this may well be academic, aside for the issue of subordination, because, it was fairly conceded that to the extent that the B of M did not consume all of the assets of Dynex as a secured creditor, based on it real property security, it had personal property security duly registered to capture any remainder, leaving nothing for unsecured creditors. Thus all that would be left by the ORRs attaining this status would be for the ORRs to rank equally (subject to the subordination issue) with the B of M for any remaining personal assets of Dynex.

[40] Counsel for the ORRs argue that the documentation under which the ORRs obtained their interests contain certain "charging language" which creates a personal property security interest. This argument does not appear to be made to support a secured position in bankruptcy, because it was acknowledged that the ORRs did not register any such interest and therefore had no priority over the Trustee under s. 20 of the *Personal Property Security Act*, S.A. 1988, c. P-4.05 ("PPSA"). However, the argument was apparently made to answer the argument of Counsel for the B of M that s. 40, which resolved the lack of privity issue, only applied to security interests (see para. 12 of Counsel for Meridian and Odessa's legal brief). I have already deal with that in the December 1995 Decision by holding that it applies to "any interest". Nevertheless, I will address the arguments based on "charging language".

[41] Such charging language is seen in the documentation conveying the overriding royalty interest in paragraph 2.(c) of the Odessa Overriding Royalty Agreement dated August 29, 1975 (later assigned to Meridian) (see Document Record, Tab 24):

> The said royalty shall be deemed hereafter to be a charge and encumbrance against the [Dynex] interest and accordingly any ... alienation of the [Dynex] interest shall be subject to the said royalty.

There was no such "charging language" appearing in the brief overriding royalty agreement of February 27, 1974, by which Mr. Willness received his interest, or the Enchant overriding royalty agreements of January 22 and 24 (3 in number), 1975. However, as set out in detail in the December 1995 Decision (and, in particular, paras. 53 - 70), the various debentures and loan agreements between Dynex and B of M refer to the lands being free of any "lien", "charge", "encumbrances", or "permitted encumbrances" (or wording of like effect), except for the ORRs interests, and were specifically "subject to" those ORRs interests. Nevertheless, I believe that the ORRs would be hard pressed to have such language interpreted as "charging language" so as to found "security interests" in a legal sense, whether personal or real, based on such language.

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[42] However, whether there are "charging" provisions to create a security interest, or not, is not necessary to decide because I agree with Counsel for Meridian and Odessa (para. 11) that their interests in the overriding royalties entitling them to a stream of revenues are sufficient, without "charging language", to constitute security interests to personal property in themselves.

[43] We see from s. 1(1)(qq) of the PPSA that a "security interest" includes "an intangible that secures payment or performance of an obligation", which would include a *chose in action*, unless otherwise excluded by another definition or provision of the PPSA. Section 4 provides that:

> Except as otherwise provided under this Act, this Act does not apply to the following:
>
> ......
>
> (g) the creation or transfer of an interest in a right to payment that arises in connection with an interest in land, including an interest in rental payments payable under a lease of land, but not including a right of payment evidenced by a security or an instrument;

A "security" and an "instrument" under s. 1(1)(oo) and(u) respectively would appear, in general lay language, to include such things as a share or other investment certificate, or a bill of exchange, or, in general, some form of negotiable instrument. Thus, we see that, as *choses in action*, the interests of the ORRs are registerable under the PPSA, by virtue of s. 1(1)(qq), unless excluded under s. 4.

[44] Counsel for Enchant and Willness argued that the interests that the ORRs received were created and arising, if not in, "in connection with", an interest in land, as

contemplated by s. 4. He argued that the ORRs interests were created at the time of the creation of the leases, as *profits à prendre.* I have rejected that status in my December 1995 Decision. Of course, it follows that if Counsel is correct, and I am wrong, and if the PPSA does not apply, s. 20(1)(b) has no effect and does not create any rights in favour of the Trustee. As this would appear to depend on my reasoning in the December 1995 Decision, and I am *functus,* I leave the matter for the further consideration of the Court of Appeal. Nevertheless, s. 40 referenced in my December 1995 Decision, would still apply, because it gets its application, not from the interests of the ORRs, but from the registration by the B of M of its security interests, in which the subordination is included. Put another way, even if the ORRs interests did not qualify as security interests under s. 1(1)(qq), such a determination is not necessary for s. 40, because it can be "any other interest". Thus, in Alberta, the ORRs can rely upon s. 40 to avoid the privity issue, fatal at common law (*Chiips,* at para. 76), whether or not their interests were security interest or registered under the PPSA -different from the Ontario PPSA, as I held in the December 1995 Decision, and Counsel for Meridian arid Odessa correctly restates in paras. 1(a), and 7 - 10 of their legal reply brief.

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[45] However, as I interpret s. 4(g), in conjunction with my December 1995 Decision that the ORRs interests are not interests in land, it is only rental payments to lessors, or the equivalent, that "arise in connection with an interest in land", that are excluded. The exclusion would not relate to overriding royalty or net profit interests of the type held by the ORRs, unless the ORRs could establish that they were akin to lessor rental "payment that arises in connection with an interests in land". Leases are interests in land, and accordingly lease payments to lessors pertinent thereto "arise in connection with an interest in land". However, in my view, as the ORRs interests are not payments to lessors arising from the leases, but interests created "downstream" of the lease, they are not interests in land, and the payments thereunder do not "arise in connection with an interest in land". The result is that the ORRs interests are registerable under the PPSA, and registration is not excluded by s. 4.

[46] However, while registerable, none of the interests of the ORRs were in fact registered under the PPSA. Accordingly, no registered personal property security interest sufficient to create a secured creditor status (as to personal property) has been established by the ORRs.

[47] Further, as the ORRs interests were never registered under the PPSA, s. 20(1)(b)(i) thereof makes it clear that any security interest is not effective as against a trustee in bankruptcy:

> A security interest
>
> .....
>
> (b) in collateral is not effective against
>
> (i) a trustee in bankruptcy if the security interest is unperfected at the date of bankruptcy, ...

The effect of this, as Counsel for the B of M argued, and Counsel for the ORRs concede (Counsel for Meridian and Odessa, para. 13), was that, as of the bankruptcy, at best, the ORRs had a unperfected security interest, and because it was unperfected it was ineffective against the Trustee (see *Bellini Manufacturing & Importing Ltd., Re* (1981), 32 O.R. (2d) 684 (Ont. C.A.), at 691). Accordingly, all property interests in Dynex that were not subject of a real or personal property interest duly secured and registered (which would, subject to the subordination, not include the interests of the ORRs), passed to the Trustee: s. 71 of the BIA.

[48] However, this may not end the matter, because Counsel for Meridian and Odessa argued that failure of the ORRs to register their personal property interests under the PPSA did not extinguish the ORRs rights in subordination at common law (authority for this is argued to be seen in *Euroclean Canada Inc. v. Forest Glade Investments Ltd.* (1985), 16 D.L.R. (4th) 289, 4 P.P.S.A.C. 271 (Ont. C.A.)), or under the BIA. I shall address this issue below.

[49] Counsel for Enchant and Willness argues that it would be ridiculous to believe that the ORRs would have to register under the PPSA to protect their interest in certain situations, and, in effect, that this was not the intention of the law. The response is that even if this was not what the PPSA had set out to do in the context of these (or other) oil and gas interests, that would appear to be the effect of the law (as discussed above), and those who did/do not take the steps to register might not be protected in certain situations - bankruptcy being the one in this case.

[50] The result of the application of the PPSA to the ORRs is that s. 20 is applicable to make any unregistered security interests of the ORRs ineffective against the Trustee, thereby denying secured creditor status as to personal property.

D. The Unsecured Creditor

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[51] As I indicated above, the interests of the ORRs, based upon the limitations from my December 1995 Decision relative to real property, are that of *choses in action,* which entitles them to their appropriate proceeds from the sale of petroleum and natural gas substances - in essence a revenue stream based thereon.

[52] The result, I find, in the context of bankruptcy, is merely the entitlement to a debt for a past, or damages for an ongoing, monetary sum against Dynex which would render the ORRs unsecured creditors.

[53] On this basis, leaving aside the issue of the subordination, it is clear that the ORRs rank much behind the B of M as to priorities in bankruptcy. The interests of the ORRs prior to bankruptcy had priority over the claim of the B of M because they were specifically permitted to be encumbrances ("permitted encumbrances") in the subordination by the B of M to the ORRs, as I found in the December 1995 Decision. If this subordination survives the bankruptcy (which I will examine below), this may not be fatal to the ORRs. However, if the subordination does not survive the bankruptcy, the priority that existed to the ORRs prior to bankruptcy would be lost. Theoretically, that such priority would be lost in a bankruptcy should not be surprising, as with so many other circumstances, bankruptcy changes the rights of parties and the relationship between parties. Again, by way of analogy, and in support of this basic conclusion, Counsel for the B of M effectively pointed to the example of the status of employees who, in a general sense (without being too legalistic), would have priority for their salaries prior to bankruptcy, but in a bankruptcy would be limited to a certain fixed amounts and thereafter would rank as unsecured creditors.

VIII. The Effect of Bankruptcy on the B of M's Subordination to the ORRs

[54] I have determined that, in the bankruptcy of Dynex, the true interests of the ORRs are those of unsecured creditors and the interest of the B of M is that of a secured creditor (over both real and personal property) of Dynex and in priority to the ORRs.

[55] In face of this the lay person then would ask: "Well, what is the effect of the B of M's specific agreement to subordinate its interest to that of the ORRs?" In short, is the effect of that subordination lost by the act of bankruptcy?

[56] Before commencing this subject, it should be noted that it appears from the authorities that Counsel have provided, and some brief Canada wide case research that I have done myself, that there are very few useful (especially case) authorities on the

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subject of subordination. This caused Goode, in a text released prior to his *Principles of Corporate Insolvency Law,* to observe at one point, in *Legal Problems of Credit and Security* (London: Sweet & Maxwell, 1988) ("*Goode* - Problems"), at 24:

> Again, I cannot quote chapter and verse. So far as out textbooks are concerned, nobody ever enters into subordination agreements, because they are nowhere mentioned!

Although Philip Wood appears to have answered this call in his later text, *The Law of Subordinated Debt* (London: Sweet & Maxwell, 1990) ("*Philip Wood*"), this remains an area of extremely limited authority. With this severe limitation, I start the discussion to attempt to determine this issue.

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[57] As noted above, It is clear that enforcement of a subordination agreement does not require that the beneficiary of the subordination register his interest: *inter alia, Chiips Inc. v. Skyview Hotels Ltd.* (1994), 21 Alta. L.R. (3d) 225 (Alta. C.A.), at 237 (para. 34), referencing *Euroclean;* and Cuming & Wood, *Alberta Personal Property Security Act Handbook* (Third Edition) (Carswell) ("*Cuming & Wood*"), at 337.

[58] While not decisive of the matters before me, it would appear that the subordination has no direct effect on the Trustee, or the results in the bankruptcy itself. This is so because, as I understand it, the Trustee does not normally recognize interests, except insofar as they, having created some form of security status in bankruptcy, must be examined further to determine priorities. If two claimants had the same security position in bankruptcy, then the Trustee would have to give effect to interparty subordinations to determine the priorities of the similar claimants. Thus, if the ORRs had registered their security interests in their *choses in action* under the PPSA, such that there was a competition between the ORRs and the B of M for Dynex's personal property interests, those interests would be binding on the Trustee, and the subordination might need to be considered to determine the priority between them. However, that is not applicable in this case by virtue of the failure of the ORRs to register their security interests, and accordingly they gained no security position that the Trustee had to recognize, by virtue of s. 20 of the PPSA. Thus, the Trustee had no need to have regard to any subordination arguments because the ORRs failure to register under the PPSA had the effect in the bankruptcy that the ORRs are unsecured, and therefore rank considerably behind the B of M. Therefore, the subordination in this case has no direct relevance to the bankruptcy itself, or to the Trustee.

[59] That the benefit of the subordination to the ORRs was lost in bankruptcy was the nature of the argument of Counsel for the B of M, when in their legal brief they stated (paras. 27, 30, 31 and 32):

> 27. *If the ... interest of the* beneficiary of the subordination *[the ORRs]* should be satisfied, *discharged*, invalid or *otherwise unenforceable* against the debtor's [Dynex] property, *the subordination ceases to have any effect. There is no interest which can have the benefit.*
>
> . . . . .
>
> 30. The bankruptcy of Dynex vested all of its property in its trustee in bankruptcy subject only to the rights of secured creditors as holders of security that would be enforceable against such property and the trustee in bankruptcy. The only holder of such security is the [B of M].
>
> 31. The charges, encumbrances or interests of [the ORRs] ... are not effective against the trustee in bankruptcy since they ... were never perfected in accordance withe the PPSA.
>
> 32. *As a result of the bankruptcy* of Dynex, *the [interests] of [the ORRs]* in ... Dynex *ceased to exist.* The only remaining rights of [the ORRs] ... are to claim as unsecured creditors ...
>
> 33. ... *Upon bankruptcy ... [t]here is no longer any interest that can receive the benefit of a subordination...* [Emphasis added.]

By this I understand the position of Counsel for the B of M to be that, on bankruptcy, as the *chose in action* rights of the ORRs give way to merely unsecured creditor claims, because the ORRs have no registered security interests to pursue those rights directly (as they would if they were secured creditors, by virtue of registration under the PPSA), any such previous rights held at the time of the subordination are "lost" and there is nothing left to be the subject of the subordination, and, thus, the effect of the subordination is equally lost.

[60] Counsel for the ORRs argue, however, in effect, that: "[b]oth before and after the bankruptcy of Dynex, the [B of M's] security is subordinated to the interests of [the ORRs]" (para. 15); the subrogation by the B of M was not in favour of any specific security interests held by the ORRs, but of all (and any) of the interests of the ORRs, whatever those interests were, including any rights as unsecured creditors; the loss of the *chose in action* interests of the ORRs by virtue of the bankruptcy did not leave the ORRs without any interests, but merely converted them into other interests, namely the interests of unsecured creditors; while collection from the Trustee might, in the circumstances, be impossible, the subordination by the B of M to the ORRs (of what ever interest they had remaining - their unsecured creditors interests) is not lost in the bankruptcy; and, by way of mechanics, the B of M, in realizing on its secured interest, holds that realization in trust for

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the ORRs to the extent of their interest as unsecured creditors, by virtue of the continuing subordination.

[61] There is however a flaw in the arguments of Counsel for Odessa and Meridian (paras. 19 - 22), as I understand them and the authorities relied upon, in support of the proposition that the bankruptcy does not affect the priorities or the subordination. The flaw is that Counsel, relying upon (at para. 19), *inter alia, Goode* - Principle (at 18) "Third Principle: security interests and other real rights created prior to the insolvency proceedings are unaffected by the winding up", presumes that the ORRs are "secured parties" and have real property or personal property security interests, or rights similar in legal effect and status to the B of M - a position that I find does not exist. A subordination agreement does not, by virtue of the subordination alone, and in the absence of specific language to that effect, create a security interest in favour of the beneficiary of the subordination: *Cuming & Wood,* at 336. However, that position is unnecessary for Counsel for the ORRs to take, because the subordination of the B of M to the ORRs may exist without the ORRs having any security status.

[62] The argument of the ORRs is based on the assertion (paras. 20 and 23 respectively and 15 of the reply legal brief) that "contractual subordinations ... remain enforceable between the parties despite the bankruptcy of the debtor" and "Odessa and Meridian have priority over the Bank by virtue of the Bank's subordination". The authority cited (at para. 20) is *Philip Wood* (at 120) that:

> Contractual subordinations of debt remain enforceable between the parties despite the bankruptcy of the debtor....

Also at 23, *Philip Wood* makes this similar observation:

> The better view is that an arrangement between junior creditor and the debtor that the junior creditor is to be contractually subordinated should not in principle conflict with English insolvency rules that liabilities of the insolvent are to be paid *par passu,* but the matter is undecided in England.

No other authority is cited in direct support of this proposition, nor is there any authority cited directly against it by Counsel for the B of M.

[63] The argument of Counsel for the B of M in my view can only succeed if the subordination by the B of M in favour of the ORRs was, by its terms, or in law, terminated by the bankruptcy.

[64] Looking at it another way, is be impossible for the ORRs to succeed to have priority over the B of M after a bankruptcy, where the B of M is a secured creditor, and the

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ORRs are merely unsecured creditors? In my view, it would not be, but there would be a couple of requirements. In the absence of finding a trust in favour of the ORRs, what would be required would be a finding that the subordination by the B of M was so broad in its terms, in the absence of any specific statutory or case law to the contrary, as to survive a bankruptcy, and be indifferent to the different security status that the ORRs had in the bankruptcy. That such a subordination is available appears to be recognized by both *Cuming and Wood,* and *Wood* himself, as seen in the former at 302 where they state:

> The subordination agreement may subordinate the debt of the junior creditor to all debt owed by the debtor to the senior creditor. The subordination may postpone the junior debt from the outset, or may provide that the postponement is effective only upon the occurrence of a specified event. The subordination agreement may also limit the subordination to certain kinds of debt (such as debt arising out of a specific credit agreement, debt incurred prior to a specified date, debt up to a specified amount or debt associated with a specific issue of debt securities).

Reference is also made to *Wood,* at 6 - 8.

[65] Accordingly, it appears that express agreements between creditors could subordinate priorities in bankruptcy in a way that survives the bankruptcy (and the court should give effect to it), even if the interests are not the same: *Ogden Enterprises Ltd., Re* (1978), 22 N.B.R. (2d) 344 (N.B. Q.B.), at 358; and *Cuming & Wood,* at 302 (section 40[1]). The subordination by the B of M in favour of the ORRs is not expressly in relation to bankruptcy. However, is it expressly, or by law, terminated by bankruptcy?

[66] From these latter mentioned authorities, we see that a subordination by agreement or law may be "effective only upon the occurrence of a specified event". Accordingly, it would seem to follow that it could be equally "ineffective upon the occurrence of a specified event". The question is whether it is, by agreement or law, ineffective on bankruptcy? If it were not ineffective, with such a broad subordination in place, a subrogation of the type envisioned by Counsel for Odessa & Meridian (relying on *Goode* - Problems, at 98, which in turn relies on *Woodroffes (Musical Instruments) Ltd., Re,* [1985] 2 All E.R. 908 (Eng. Ch. Div.), at 912) would appear to give the ORRs the right to recover through the B of M.

[67] Counsel for the B of M argued that the subordination of B of M to the ORRs was a subordination of security not a subordination of debt, and, as a result, the remaining debt of the ORRs in Dynex did not enjoy a priority position to the debt of B of M. I reject this conclusion as unsupported in law or in fact. Let us examine both.

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[68] In support of the B of M's argument, it is clear that the subordination must be clear and unequivocal: *Sun Life Assurance Co. of Canada v. Royal Bank* (1995), 37 C.B.R. (3d) 89 (Ont. Gen. Div. [Commercial List]), at 94 (para. 23). Nevertheless, "a subordination clause is given effect according to its terms" and "commercial reality requires that documents of this nature be given effect": *Chiips*, at, *inter alia*, 243 (para. 57). While there was great debate in Chiips (referring back to *Euroclean; Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 50 O.R. (2d) 267 (Ont. C.A.); *Canadian Imperial Bank of Commerce v. International Harvester Credit Corp. of Canada* (1986), 6 P.P.S.A.C. 273 (Ont. C.A.); and *Transamerica Commercial Finance Corp., Canada v. Imperial T.V. & Stereo Centre Ltd. (Receiver of)* (1993), 13 Alta. L.R. (3d) 99, 6 P.P.S.A.C. (2d) 99 (Alta. Q.B.) (Nash, J.)) as to the adequacy of the wording of any purported subordination clause, it being conceded that a vague and non-specific clause is not sufficient (see *Chiips*, at para 49), I believe that no specific "magic" words, such as "rank" or "priority"[4], or any other words are necessary (although they may be helpful) to convey subordination, any more than the word "trust" is necessary to create a trust. *Chiips* seems to confirm this when (relying upon authorities I will not repeat) Foisy, J.A. said (para. 30):

> It is interesting to note that it is possible under the [PPSA] to prove a subordination in fact without the existence of a specific subordination agreement ...

[69] Bearing these cases and principles in mind, I find, as I believe I already made apparent in the December 1995 Decision (especially paras. 97, 105, and 110), with detailed references to the clauses themselves (especially at paras. 53 - 70), not lack of clear and unambiguous wording to support a very broad subordination in this case - the B of M, to use the language of Harradence, J. A. in *Chiips* (para. 53), was "clearly acknowledging that these [ORRs interests] rank ahead in priority". Further, I find that the subordination by the B of M, on the face of the documents, and at law, was an "unhyphenated" subordination - it was the subordination of the *interest* of the B of M (what ever it was) to the *interests* of the ORRs (what ever they were). It was not a subordination by the B of M over only "part of the property of the debtor held by a junior creditor", nor does the subordination relate only to the B of M's security interest in "personal property of the debtor ... in favour of the interests in such personal property [of the ORRs]", as argued in paras. 21 and 23 of the legal brief of Counsel for the B of M (and other similar declarations in other paragraphs - e.g. 28, and in the Trustee's legal brief at para. 20). Furthermore, there is nothing to say, as Counsel for the B of M would appear to argue (in

[4] However, in the case at bar I note that "ranking" and "priority" are specifically referenced in the B of M's debenture as seen at para. 64 of the December 1995 Decision.

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paragraphs 25 and 26 of the B of M's legal brief), that the subordination was limited to assets over which the beneficiary of the subordination (the ORRs) had a "charge over", or "security interests" registered, or registerable, under the PPSA, or "any other interest". It was a subordination, pure and simple, of what ever are the B of M's interests to the interests (what ever they were or may now be as a result of the bankruptcy) of the ORRs.

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[70] To this extent, I agree entirely with the arguments of Counsel for Odessa and Meridian at paras. 1(a), 4 - 10, and 18 of their reply legal brief.

[71] Additionally, this is not a case, in my view, where there was subordination only of a floating charge security and not a fixed charge security as in the *Chlips* case (para 23), but rather it was a subordination of all of the interest of the B of M.

[72] I agree with the essence (if not the precise words) of the reply legal brief of Counsel for Odessa and Meridian (paras. 19 - 22) that the bankruptcy did not extinguish the *choses in action* of the ORRs - indeed, it is those interests that made them creditors (albeit as unsecured) of Dynex in bankruptcy. While it is clear that the nature of the enforcement of the ORRs interests changed from *choses in action* subject of suit, to unsecured creditor claims that would appear to be worthless in themselves, that does not mean that all rights of the ORRs vanished on bankruptcy. To that extent I also agree that "[t]here remains an interest that can receive the benefit of the Bank's subordination". However, to recognize this, I would restate what Counsel for Meridian and Odessa said in the third sentence of para. 21 of their legal brief to indicate that the ORRs in bankruptcy, because their interests were not secured, lose the right to continue to receive revenues under their overriding royalties (the *choses in action*), and, instead, are each left merely with an unsecured creditor's claim based on those *choses in action*. They nevertheless, in my view, continue to be entitled to the benefit of the subordination.

[73] In this case I find that the subordination, on its terms, is: for all of the interest of the ORRs in priority of all of the interest of the B of M; it is in effect from the outset, that is, prior to any advances by the B of M; and is not limited by any particular kind of interest. The question then is whether it is expressly or implied broad enough to continue through a bankruptcy? I find that the subordination is broad and that it does not, expressly, or by implication, contemplate a bankruptcy terminating its existence. It does not exclude a bankruptcy, and, with *contra proferentum* running against the B of M (see my December 1995 Decision at paras. 57 and 106), inclusion should be implied. I find that subordination continues, after bankruptcy, in favour of the ORRs against the B of M.

IX. The Inter-Relationship of S. 40 of the PPSA and S. 59 of the LPA

[74] While, in reality the following argument is in reference back to my December 1995 Decision (para. 75), it deals with an aspect that was not there argued in detail, or, alternatively the significance of it was not fully understood by the Court (para. 76). However, it was raised again in this hearing, with a significance that is clearer to the Court. Accordingly, to the extent that I did not there expressly decide the issue, I will respond to the new aspects of this argument, which may be of benefit to the parties, if only for consideration of the Court of Appeal.

[75] The issue is privity of contract. In this case the ORRs were not privy to the subordination clauses in the agreements between the B of M and Dynex, and, accordingly, at common law, could not enforce them: *Euroclean.* However, this is remedied for personal property by s. 40 of the PPSA, which, simply put, reads:

> Section ... 40 ... of the [PPSA]... appl[ies] with necessary modifications to registrations under this section.

Nevertheless, the argument was made by Counsel for the B of M that s. 40 only provides privity to the subordination of the B of M's personal property interests and not its real property interests. The answer, Counsel for Meridian and Odessa argued (most specifically at para. 23 of the reply legal brief) is that s. 59.2(3) of the *Law of Property Act;* R.S.A. 1980, c. L-8 ("LPA") makes the lack of privity "solution" in s. 40 applicable to the real property interests. However, Counsel for the B of M advanced the new argument, in oral argument in these proceedings, that s. 59.2(3) was only mechanical to allow personal property registration under the LPA, and not substantive. It has significance because if Counsel for the B of M is correct, the B of M would not be affected by subordination of any of its real property security, due to the lack of privity, leaving only the personal property assets of Dynex available for subordination (see Counsel for the B of M's argument at para. 34).

[76] I agree with the argument of Counsel for Meridian and Odessa as a matter of interpretation of the wording of s. 59.2(3). It reads clear, as it relates to s. 40:

> Section ... 40 ... of the [PPSA]... appl[ies] with necessary modifications to registrations under this section.

It can only mean that the same considerations that apply to personal property interests registered under the PPSA (a cure of the privity issue) also apply to real property interests registered under the LPA. In my view this conclusion is unaffected by whatever is the

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effect on the LPA of the other PPSA sections referenced in s. 59.2(3) - whether "mechanical", procedural or substantive.

X. Effect of the Sale by the Trustee to Channel Lake

[77] I do not find that the sale of the Dynex assets by the Receiver makes any question moot (as Counsel for the B of M asserts at para. 34) until the determination of these questions, and the Orders of Forsyth, J. of August 20, 1993 (especially para. 5) and September 1, 1993 (especially paras. 2, 5 and 8), were broad enough to make that perfectly clear both as to the validity and priority of the B of M's security and the sale respectively. Accordingly, I agree with the argument in para. 22 of Counsel for Odessa and Meridian's reply legal brief.

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[78] As to the ability of the Receiver to sell the leases from which the ORRs obtained their flow of revenues from production, the first reaction (beyond the fact that such sale was specifically authorized by the Court) is that the Receiver could only sell what Dynex had (Per Lord Herschell, L.C. in *McEntire v. Crossley Brothers Ltd.*, [1895] A.C. 457 (U.K. H.L.), at p. 461, referenced at 690 - 1 of *Bellini*), which did not include, or was subject to, the interest of the ORRs. However, the fact is that the Receiver, on behalf of the B of M, received from the Trustee, all of the assets to which the B of M had security that the Trustee received on the bankruptcy. Thus the rights of the Receiver, through the B of M's security, were as great as what the Trustee could have sold, from the assets acquired on bankruptcy, had there been no secured creditors. As the sale of the leases would be a real property interest and the ORRs had no real property interests, the Trustee, or Receiver thereunder, would have an unfettered right to sell the real property. Counsel for the B of M described it thus in their legal brief (para. 35):

> Since the [ORRs] rights ... do not constitute interests in land, there is no encumbrance upon the real property of Dynex other than the real property charges ... held by the [B of M]. Since the interests of [the ORRs] are not interests in real property, the sale by the [Trustee] was free of such claims ...

[79] Insofar as the sale was of personal property interests, including the interests held by the ORRs prior to bankruptcy, the result is the same by a different route. *Bellini*, accompanied by s. 20 of the PPSA, is authority (at 691) that failure to perfect a security interest under the PPSA means that the creditor cannot rely on the doctrine of *McEntire*, even though failure to prefect such an interest does not in itself destroy the effect of the subordination by another creditor: *Euroclean*. In that regard, because the ORRs failed to register under the PPSA, the Trustee acquired, on bankruptcy, more than Dynex had

before, because the ORRs unregistered security interests on bankruptcy were converted from specific *choses in action* into mere unsecured claims. It follows that, if the ORRs only interests in bankruptcy were as unsecured creditors, the Trustee is free to sell the assets of Dynex unencumbered by such an interest, and through the B of M security, so is the Receiver.

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[80] It would therefore follow that the aforementioned determinations also have the effect of determining this additional issue, which was specifically reserved by the Order of Forsyth, J. of September 1,1993. The effect of this determination is that Channel Lake acquired its interest in the Dynex properties (by the agreement of August 4, 1993), as to real property unaffected by the ORRs as they had no real property interest, and free of the ORRs' overriding and net profits interests in personalty because they failed to register under the PPSA. As such, the $5 million sale proceeds (apparently purporting to represent the value of those chose in action rights) should be released by the Trustee to be distributed in the bankruptcy, and any proceeds of production paid to the Trustee under the terms of the Order for the production since the sale (that pertained to what would otherwise be the entitlement of the ORRs) must be accounted by the Trustee back to Channel Lake effective the date of sale, because they owned those rights as of sale and would no longer be required to account for the revenues therefrom.

[81] It follows from the ORRs position as unsecured creditors that, as against the Trustee, any revenues generated from production after bankruptcy to the point of sale, to which the ORRs were otherwise entitled, and the proceeds of sale of the ORRs interests (to neither of which the B of M had any interest), go to the Trustee for distribution in the bankruptcy, unaffected by any claim by the ORRs, except as unsecured creditors. To the extent that those proceeds flow to the ORRs as unsecured creditors, that lessens their loss, and the liability of the B of M to them. However, on the facts before me, in the bankruptcy, I presume those revenues will flow, in the bankruptcy, to the B of M as a secured creditor under registered secured real and personal property documentation, *vis-à-vis* the Trustee.

[82] However, that does not end the matter.

[83] The revenues from production held by the Trustee for the period of production between the receivership crystallisation and the bankruptcy, are for distribution, without issue as I understand it, to the ORRs (subject to appeal of my December 1995 Decision and this Decision), based on the acknowledgement of Counsel for the Trustee (para. 14 of

the Trustee's legal brief) that the proceeds in the hands of the Trustee, as Receiver, relating to the period prior to bankruptcy are held in trust for the ORRs to the extent of their interest. They are unaffected by this Decision and accordingly should, subject to appeal, be so disbursed. However, to the extent that the revenues held by the Trustee for the period between the receivership and the bankruptcy are unable in law to be transferred to the ORRs to the extent of their interests, and flow to the B of M as secured creditor, the B of M must also account for those to the ORRs as hereinafter set forth.

[84] It follows that as between the B of M and the ORRs, the B of M, because of its subordination will have to account (see below) to the ORRs for any funds it received directly, or through the Trustee, from the sale of the ORRs interests, and the revenues from production relating to those interests after the bankruptcy until the point of sale. Allow me to elaborate.

[85] The additional proceeds paid by Channel Lake ($5 million) pending this determination, I assume, without deciding, represent the fair value of the ORRs *chose in action* interests. The B of M has no *direct* claim on those funds as its security interests specifically excluded rights to those interests. However, to the extent that those proceeds, as between the Trustee and the creditors in bankruptcy, should be paid by the Trustee to the B of M, or flow directly to the B of M, based on its secured creditor rights to priority in the bankruptcy, as between the B of M and the ORR's, the B of M must account for them to the ORRs. This brings us to the mechanics of how the ORRs can follow these funds.

XI. Mechanics of Recovery by the ORRs from the B of M

[86] The mechanics of collection what is due to the ORRs by the effect of the continued subordination, after the bankruptcy, without doing damage to the priorities within the bankruptcy (see *Kenmore Building Materials Ltd., Re* (1966), 9 C.B.R. (N.S.) 41 (Ont. C.A.), at 48; and *Philip Wood,* at 23 (*supra*)) was presented, with authority, by Counsel for Meridian and Odessa, at paras. 23 and 24 (see, similarly, para. 15 of Counsel for Meridian and Odessa's reply legal brief):

> An apparent circularity problem does arise, in that the trustee in bankruptcy has priority over the unregistered interests of Odessa and Meridian; Odessa and Meridian have priority over the [B of M] by virtue of the [B of M's] subordination; and the [B of M] has priority over the trustee in bankruptcy by virtue of it security. However, the solution to the apparent circularity has long been recognized in similar situations occurring in bankruptcy proceedings.

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R.M. Goode, *Legal Problems of Credit and Security,* at 98 (substituting the parties in this action [which I have "collected", and added my own "substitutions"] for Professor Goode's generic parties):

> At all events, the problem is readily soluble through the principle of subrogation. Since [the ORRs] ha[ve] priority over [the B of M] by virtue of their agreement [between the B of M and Dynex, but to which the ORRs have rights by virtue of s. 40 of the PPSA], so that [the B of M] would to accountable to [the ORRs] for moneys received in the liquidation to the extent of [the B of M's] subordination, all the interests are satisfied by treating [the ORRs] as subrogated to [the B of M] to the extent necessary to give effect to the subordination agreement. That is to say, [the ORRs] will collect from the liquidator *in right of [the B of M]* the amount due to [the B of M], or such part of that amount as is necessary to satisfy [the ORRs claim].... That this is the correct solution was conceded in....
>
> *Re Woodroffe's ...*
>
> *Re Bankruptcy of Rico ...*

Accordingly, ... the [B of M] is obliged to hold in trust for [the ORRs] the proceeds it realised from the oil and gas properties affected by [the ORRs'] overriding royalty interests to the extent of the value of those overriding royalty interests.

[87] In *Rico Enterprises Ltd., Re* (1994), 24 C.B.R. (3d) 309 (B.C. S.C.), at 322 (para. 38), Tysoe, J. said (I have substituted the parties in this case for his generic terms):

> If [the B of M] subordinates its claim to the claim[5] of [the ORRs] without subordination to other claims ranking in priority to the claim of the [ORRs], it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination, except to the extent that the share of the distribution to which the [B of M] would otherwise be entitled should be paid to the [ORRs] ...

[88] The concept of the subordinated creditor holding in trust and accounting to the senior creditor was also discussed by *Goode* - Problems, at 23 - 24, where he said:

> ... If the subordinated creditor enforces his security he holds what he receives on trust for the senior creditor up to the amount due to the latter or any lower sum fixed by the subordination agreement - but that in other respects each of the two [interest holders] retains exactly the same interest as he held before. No security interest is intended and none is created.

[89] After a consideration of these passages and the arguments of both Counsel for the ORRs and the B of M, I accept this solution as the mechanics by which the ORRs are to recover what is due to them by the continuation of the subordination after bankruptcy.

[90] In such circumstance the present value of the ORRs would have to be calculated and paid out to the ORRs by the B of M. The effect of this, from a simplistic lay perspective, would be that the subordination by the B of M, no matter what the status of Dynex, would ensure (I use this word in a lay, not legal, sense) that the ORRs did not rank

[5] In the case at bar it is not the "claims" that are subordinated but the "interests".

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behind the B of M in any case where Dynex, or the Trustee on its behalf, has an inability to pay the ORRs.

XII. Conclusion

[91] Based upon the above analysis I find that the interests of the ORRs in bankruptcy are those of unsecured creditors, but that the subordination of the B of M to those interests prior to bankruptcy is not lost in bankruptcy, such that the B of M must account to the ORRs for the revenues earned from production until the sale of those interests to Channel Lake, and the value of those interests on the sale to Channel Lake.

[92] Accepting the "Order Sought" provisions of Counsel for Meridian and Odessa (para. 25), I conclude and declare that:

> ... the bankruptcy of [Dynex] does not affect the subordination of the [B of M's] security interest to [the ORRs] overriding royalty and that the [B of M] continues to be obliged to hold in trust for [the ORRs] the proceeds it realized from the oil and gas properties to the extent of the value of [the ORRs] overriding royalty interests.

XIII. Other Arguments and Issues Considered - Position of Willness

[93] Counsel for the Trustee, in the Trustee's legal brief, raised certain arguments against the status of Mr. Willness as a party to the proceedings. This issue was clearly out of the scope of the issues to be decided at the subject hearing, and notice was not given to Mr. Willness's Counsel, nor did he have an opportunity to respond in his legal brief (filed prior to the counsel for the Trustee's legal brief). As such this matter is not properly before the Court, and accordingly was agreed to be adjourned *sine die.*

XIV. Order and Costs

[94] Counsel may speak to the Court to resolve any slips or lack of clarity (if any) in these Reasons (relatively hastily assembled), and, if necessary, to work out the terms of the formal Order resulting herefrom.

[95] Counsel may also speak to costs at an appropriate time before the formal Order is taken out, by agreement or on motion, but, subject to any such further determination by the Court at the request of Counsel, the ORRs are entitled to their costs, in Schedule "C", in any event of any issues remaining in the cause.

Order accordingly.

1997 CanLII 14795 (AB QB)

Bank of Montreal *Appellant*

v.

Enchant Resources Ltd. and D. S. Willness *Respondents*

INDEXED AS: BANK OF MONTREAL v. DYNEX PETROLEUM LTD.

Neutral citation: 2002 SCC 7.

File No.: 27766.

Hearing and judgment: November 9, 2001.

Reasons delivered: January 24, 2002.

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

ON APPEAL FROM THE COURT OF APPEAL FOR ALBERTA

Commercial law — Oil and gas industry — Overriding royalties — Whether overriding royalties arising from working interest capable of being interest in land.

The appellant Bank was a secured creditor of D, a corporation in liquidation. The trustee in bankruptcy wanted to sell all the oil and gas properties of D. One issue of concern was whether any such sale would be subject to overriding royalties arising out of the working interest held by D. Also, the respondents held overriding royalties and claimed priority over the Bank, as to the assets of D, because their interests, as protected by caveats filed in a land registration office, preceded the Bank's loans to D and its predecessors. The caveats claimed an interest in D's working interest as a result of services performed for D and/or its predecessors. The chambers judge granted the Bank's application for a preliminary determination finding that an overriding royalty interest cannot be an interest in land. The Court of Appeal set aside that decision, holding that overriding royalty interests can, subject to the intention of the parties, be interests in land.

Held: The appeal should be dismissed.

Banque de Montréal *Appelante*

c.

Enchant Resources Ltd. et D. S. Willness *Intimés*

RÉPERTORIÉ : BANQUE DE MONTRÉAL c. DYNEX PETROLEUM LTD.

Référence neutre : 2002 CSC 7.

N° du greffe : 27766.

Audition et jugement : 9 novembre 2001.

Motifs déposés : 24 janvier 2002.

Présents : Le juge en chef McLachlin et les juges Gonthier, Iacobucci, Major, Bastarache, Binnie et LeBel.

EN APPEL DE LA COUR D'APPEL DE L'ALBERTA

Droit commercial — Industrie pétrolière et gazière — Redevances dérogatoires — Une redevance dérogatoire issue d'une participation directe peut-elle constituer un intérêt foncier?

La Banque appelante était un créancier garanti de D, société en voie de liquidation. Le syndic de faillite voulait vendre tous les avoirs gaziers et pétroliers de D. Se posait donc notamment la question de savoir si la vente serait conclue sous réserve des redevances dérogatoires provenant de la participation directe détenue par D. Par ailleurs, les intimés étaient titulaires de redevances dérogatoires et prétendaient prendre rang avant la Banque quant aux avoirs de D, parce que leurs intérêts, protégés par des oppositions déposées à un bureau d'enregistrement foncier, étaient antérieurs aux prêts consentis par la Banque à D et à ses prédécesseurs. Les oppositions faisaient valoir un intérêt dans la participation directe détenue par D par suite de la fourniture de services à D ou à ses prédécesseurs. Le juge en chambre a accueilli la demande présentée par la Banque en vue de faire statuer de façon préliminaire qu'un droit de redevance dérogatoire ne pouvait constituer un intérêt foncier. La Cour d'appel a infirmé cette décision, statuant qu'un droit de redevance dérogatoire peut constituer un intérêt foncier, à condition que telle soit l'intention des parties.

Arrêt : Le pourvoi est rejeté.

2002 SCC 7 (CanLII)

The common law prohibition against the creation of an interest in land from an incorporeal hereditament is inapplicable to the oil and gas industry given its practices and the support found in the law. A royalty which is an interest in land may be created from an incorporeal hereditament such as a working interest or a *profit à prendre* if that is the intention of the parties.

L'interdiction reconnue en common law de créer un intérêt foncier à partir d'un héritage incorporel est inapplicable à l'industrie gazière et pétrolière, étant donné ses pratiques et l'appui fourni par la jurisprudence. Une redevance qui est un intérêt foncier peut être créée à partir d'un héritage incorporel tel qu'une participation directe ou un profit à prendre, si telle est l'intention des parties.

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POURVOI contre un arrêt de la Cour d'appel de l'Alberta (1999), 74 Alta. L.R. (3d) 219, 255 A.R. 116, 220 W.A.C. 116, 182 D.L.R. (4th) 640, 2 B.L.R. (3d) 58, 15 C.B.R. (4th) 5, 15 P.P.S.A.C. (2d) 175, [2000] 2 W.W.R. 693, [1999] A.J. No. 1463 (QL), 1999 ABCA 363, infirmant un jugement de la Cour du Banc de la Reine (1995), 39 Alta. L.R. (3d) 66, [1996] 6 W.W.R. 461, 11 P.P.S.A.C. (2d) 291, [1995] A.J. No. 1279 (QL). Pourvoi rejeté.

Richard B. Jones, for the appellant.

Richard B. Jones, pour l'appelante.

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James C. Crawford, Q.C., *Frank R. Dearlove* and *Scott H. D. Bower*, for the respondents.

The judgment of the Court was delivered by

MAJOR J. —

I. Introduction

1 This appeal arises from an application made by the appellant Bank of Montreal before the chambers judge in the Alberta Court of Queen's Bench for a determination that, as a matter of law, an overriding royalty is incapable of being an interest in land. The application was opposed by several defendants including the respondents in this Court, Enchant Resources Ltd. ("Enchant") and D. S. Willness ("Willness"), each holders of overriding royalties who claim their interests to be interests in land. The learned chambers judge allowed the Bank's application which the Alberta Court of Appeal reversed, holding that an overriding royalty is capable of being an interest in land. This appeal to the Supreme Court of Canada was dismissed with reasons to follow.

II. Facts

2 The material filed and submissions of counsel indicated that royalty arrangements are common forms of arranging exploration and production in the oil and gas industry in Alberta. Typically, the owner of minerals *in situ* will lease to a potential producer the right to extract such minerals. This right is known as a working interest. A royalty is an unencumbered share or fractional interest in the gross production of such working interest. A lessor's royalty is a royalty granted to (or reserved by) the initial lessor. An overriding royalty or a gross overriding royalty is a royalty granted normally by the owner of a working interest to a third party in exchange for consideration which could include, but is not limited to, money or services (e.g., drilling or geological surveying) (G. J. Davies, "The Legal Characterization of Overriding Royalty Interests in Oil and Gas" (1972), 10 *Alta. L. Rev.* 232, at p. 233). The rights and obligations

James C. Crawford, c.r., *Frank R. Dearlove* et *Scott H. D. Bower*, pour les intimés.

Version française du jugement de la Cour rendu par

LE JUGE MAJOR —

I. Introduction

Le présent pourvoi vise une demande que la Banque de Montréal, appelante, a présentée à un juge de la Cour du Banc de la Reine de l'Alberta siégeant en chambre afin qu'il statue, en droit, qu'une redevance dérogatoire ne peut constituer un intérêt foncier. Plusieurs défendeurs se sont opposés à la demande. Au nombre des opposants figuraient les intimés devant notre Cour, Enchant Resources Ltd. (« Enchant ») et D. S. Willness (« Willness »), titulaires de redevances dérogatoires qui prétendaient détenir un intérêt foncier. Le juge a fait droit à la demande de la Banque. La Cour d'appel de l'Alberta a infirmé cette décision, statuant qu'une redevance dérogatoire peut être un intérêt foncier. Notre Cour a rejeté le pourvoi, avec motifs à suivre.

II. Les faits

Les pièces produites et les plaidoiries des avocats révèlent que les arrangements en matière de redevances sont de pratique courante en Alberta dans le secteur de l'exploration et de la production pétrolières et gazières. D'ordinaire, le propriétaire des minéraux *in situ* donne à bail à un producteur potentiel le droit d'extraire ces minéraux. Pour désigner ce droit, on utilise l'expression « participation directe ». Une redevance est une part ou participation fractionnaire non grevée dans la production brute issue de cette participation directe. La redevance du bailleur est une redevance accordée au bailleur initial (ou qu'il se réserve). Une redevance dérogatoire ou redevance dérogatoire brute est une redevance accordée normalement par le titulaire d'une participation directe à un tiers en échange d'une contrepartie qui peut comprendre notamment une somme d'argent ou des services (par exemple, le forage ou les études géologiques) (G. J. Davies,

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of the two types of royalties are identical. The only difference is to whom the royalty was initially granted.

« The Legal Characterization of Overriding Royalty Interests in Oil and Gas » (1972), 10 *Alta. L. Rev.* 232, p. 233). Les mêmes droits et obligations se rattachent aux deux types de redevance. Seul les différencie le fait que la redevance n'est pas accordée initialement à la même personne.

3

The appellant Bank of Montreal was a secured creditor of Dynex Petroleum Ltd. ("Dynex"), a corporation in liquidation. The trustee in bankruptcy wanted to sell all the oil and gas properties of Dynex. One issue was whether any such sale would be subject to overriding royalties arising out of the working interest held by Dynex. Also, there were several competing claims against the appellant, which by the time of this appeal had narrowed to the overriding royalties of the respondents Enchant and Willness, who claimed a preference by way of a caveat filed in the South Alberta Land Registration District, claiming an interest in Dynex's working interest as a result of services performed for Dynex and/or its predecessors. The respondents claimed their royalty rights comprised interests in land and claimed priority over the appellant because their interests, as protected by caveats, preceded the appellant's loans to Dynex and its predecessors. The appellant submitted that at common law an interest in land could not arise from an incorporeal hereditament and therefore the respondents' overriding royalties (which arose from a working interest, an incorporeal hereditament) did not rank higher in priority than the appellant's security interest.

La Banque de Montréal, appelante, était un créancier garanti de Dynex Petroleum Ltd. (« Dynex »), société en voie de liquidation. Le syndic de faillite voulait vendre tous les avoirs gaziers et pétroliers de Dynex. La question se posait donc de savoir si la vente serait conclue sous réserve des redevances dérogatoires provenant de la participation directe détenue par Dynex. De plus, l'appelante se voyait opposer plusieurs réclamations concurrentes dont ne subsistaient plus, au moment du présent pourvoi, que les redevances dérogatoires des intimés Enchant et Willness, qui revendiquaient un rang prioritaire en invoquant une opposition déposée au bureau d'enregistrement foncier du district du sud de l'Alberta, faisant valoir un intérêt dans la participation directe détenue par Dynex par suite de la fourniture de services à Dynex ou à ses prédécesseurs. Les intimés soutenaient que leurs droits de redevance comportaient des intérêts fonciers et prétendaient prendre rang avant l'appelante parce que leurs intérêts protégés par les oppositions étaient antérieurs aux prêts consentis par l'appelante à Dynex et à ses prédécesseurs. L'appelante a soutenu que, en common law, un intérêt foncier ne pouvait dériver d'un héritage incorporel et que, partant, les redevances dérogatoires des intimés (dérivées d'une participation directe et, donc, d'un héritage incorporel) ne prenaient pas rang avant la sûreté qu'elle détenait.

4

This case pits this ancient common law rule against a common practice in the oil and gas industry. The Court is asked to resolve the apparent conflict.

La présente affaire oppose cette ancienne règle de common law et une pratique courante du secteur pétrolier et gazier. La Cour est appelée à trancher ce conflit apparent.

III. Judicial History

III. Historique des procédures judiciaires

5

The appellant applied to the Court of Queen's Bench of Alberta ((1995), 39 Alta. L.R. (3d) 66) for a preliminary determination that the overriding royalty interests do not constitute interests in land. The learned chambers judge, Rooke J. in allowing the application held at para. 3 that:

L'appelante a demandé à la Cour du Banc de la Reine de l'Alberta ((1995), 39 Alta. L.R. (3d) 66) de statuer, par une décision préliminaire, que les droits de redevance dérogatoire ne constituaient pas des intérêts fonciers. Le juge Rooke siégeant en chambre a fait droit à la demande en ces termes, au par. 3 :

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> . . . as a matter of law, a lessee of an oil and gas lease (which is a profit à prendre), which is in itself an interest in land, obtained from a lessor (whether the Crown or freehold), cannot in law pass on an interest in land to a third party.

He also concluded that if an interest in land could issue from a *profit à prendre*, which he held that it could not, the matter could not be determined summarily as evidence would be necessary to examine the language of the instruments and the intentions of the parties.

6 After a review of policy considerations, industry practice and Canadian and United States case law, the Alberta Court of Appeal ((1999), 74 Alta. L.R. (3d) 219) concluded that overriding royalty interests can constitute interests in land if intended by the parties. For substantially the same reasons as the Court of Appeal, I conclude that overriding royalty interests can be interests in land.

IV. Issue

7 Can an overriding royalty issued from a working interest (an incorporeal hereditament) be an interest in land?

V. Analysis

8 At common law, an interest in land could issue from a corporeal hereditament but not from an incorporeal hereditament. "Corporeal hereditament" is defined by *The Dictionary of Canadian Law* (2nd ed. 1995) as:

> 1. A material object in contrast to a right. It may include land, buildings, minerals, trees or fixtures. . . .
>
> 2. Land. . . .

"Incorporeal hereditament" is defined as:

> 1. "(A right) . . . in land, which (includes) such things as rent charges, annuities, easements, profits à prendre, and so on.". . .

> [TRADUCTION] . . . en droit, le preneur à bail d'une concession pétrolière et gazière (qui est un profit à prendre), qui est en soi un intérêt foncier, obtenue d'un bailleur (location de la Couronne ou location à bail franche), ne peut, en common law, transmettre un intérêt foncier à un tiers.

Il a également conclu que, si un intérêt foncier pouvait dériver d'un profit à prendre — solution qu'il a écartée —, la question ne pourrait être tranchée sommairement, car une preuve serait nécessaire aux fins de l'examen des termes des instruments et de l'intention des parties.

Après avoir examiné les considérations de principe, la pratique du secteur d'activité en cause et la jurisprudence canadienne et américaine, la Cour d'appel de l'Alberta ((1999), 74 Alta. L.R. (3d) 219) a conclu que les droits de redevance dérogatoire pouvaient constituer des intérêts fonciers si telle était l'intention des parties. M'appuyant essentiellement sur les mêmes motifs que la Cour d'appel, je suis d'avis que les droits de redevance dérogatoire peuvent constituer des intérêts fonciers.

IV. La question en litige

Une redevance dérogatoire issue d'une participation directe (un héritage incorporel) peut-elle constituer un intérêt foncier?

V. Analyse

En common law, un intérêt foncier pouvait être issu d'un héritage corporel, mais non d'un héritage incorporel. Dans le *Dictionary of Canadian Law* (2e éd. 1995), la notion de « *corporeal hereditament* » (héritage corporel) est définie comme suit :

> [TRADUCTION]
>
> 1. Chose matérielle par contraste avec un droit. Peut s'entendre de fonds de terre, bâtiments, minéraux, arbres ou accessoires fixes. . .
>
> 2. Fonds de terre. . .

L'expression « *incorporeal hereditament* » (héritage incorporel) est définie comme suit :

> [TRADUCTION]
>
> 1. « (Droit) . . . sur un fonds de terre, qui (inclut) des choses telles que les rentes-charges, annuités, servitudes, profits à prendre, etc. » . . .

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2. Property which is not tangible but can be inherited. . . .

In *Berkheiser v. Berkheiser*, [1957] S.C.R. 387, at p. 392, Rand J. held that an oil and gas lease, the interest from which an overriding royalty is created, can be a *profit à prendre*, an interest in land. A *profit à prendre* is an incorporeal hereditament. The appellant has submitted that at common law, an interest in land could not issue from an incorporeal hereditament and therefore overriding royalties cannot be interests in land.

Canadian case law suggests otherwise. In *Saskatchewan Minerals v. Keyes*, [1972] S.C.R. 703, the majority declined to decide whether an overriding royalty could be an interest in land. However, Laskin J. in dissent specifically addressed that issue. He did not find the distinction between corporeal and incorporeal hereditaments to be useful in this context and discussed the difficulty of conforming new commercial concepts to anachronistic categories at p. 722:

> The language of "corporeal" and "incorporeal" does not point up the distinction between the legal interest and its subject-matter. On this distinction, all legal interests are "incorporeal", and it is only the unconfronted force of a long history that makes it necessary in this case to examine certain institutions of property in the common law provinces through an antiquated system of classification and an antiquated terminology. The association of rents and royalties has run through the cases (as in *Re Dawson and Bell*, *supra*, the *Berkheiser* case, *supra*, and cf. *Attorney-General of Ontario v. Mercer*, at p. 777) but without the necessity hitherto in this Court to test them against the common law classifications of interests in land or to determine whether those classifications are broad enough to embrace a royalty in gross.

Laskin J. referred to *Berkheiser*, *supra*, where Rand J. held that a royalty was analogous to rent. While that case involved a lessor's royalty, Laskin J. found that although theoretically the holder of a lessor's royalty holds an interest in reversion, whereas the holder of an overriding royalty does not, since in essence the two interests are identical,

2. Bien qui n'est pas matériel, mais qui peut être transmis par voie héréditaire . . .

9 Dans *Berkheiser c. Berkheiser*, [1957] R.C.S. 387, p. 392, le juge Rand a décidé qu'une concession pétrolière et gazière, l'intérêt dont est issue une redevance dérogatoire, peut être un profit à prendre, un intérêt foncier. Un profit à prendre est un héritage incorporel. L'appelante a prétendu que, en common law, un intérêt foncier ne pouvait être issu d'un héritage incorporel et que, par conséquent, les redevances dérogatoires ne pouvaient pas constituer des intérêts fonciers.

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10 La jurisprudence canadienne semble indiquer le contraire. Dans *Saskatchewan Minerals c. Keyes*, [1972] R.C.S. 703, la Cour suprême à la majorité s'est abstenue de décider si une redevance dérogatoire pouvait constituer un intérêt foncier. Toutefois, le juge Laskin, dissident, s'est intéressé précisément à cette question. Il n'a pas jugé la distinction entre les héritages corporels et incorporels utile dans ce contexte et il a traité de la difficulté de concilier les concepts modernes du commerce et les catégories anachroniques à la p. 722 :

> Les expressions « corporel » et « incorporel » ne font pas ressortir la distinction entre l'intérêt en droit et l'objet auquel il se rattache. D'après cette distinction tous les intérêts en droit sont « incorporels », et c'est l'autorité jamais attaquée d'une longue évolution historique qui nous oblige ici à étudier certaines institutions de la propriété dans les provinces régies par la *common law* au moyen d'un système de classification suranné et d'une terminologie surannée. Les rentes et les redevances ont été associées dans la jurisprudence (par exemple, dans les cause *Re Dawson and Bell* et *Berkheiser*, précitées; voir aussi *Attorney General of Ontario v. Mercer*, p. 777), mais jusqu'à maintenant, cette Cour n'a jamais eu à les analyser en regard de la classification des intérêts dans un bien-fonds en *common law*, ni à déterminer si cette classification est assez générale pour englober une redevance existant par elle-même.

11 Le juge Laskin s'est reporté à la décision *Berkheiser*, précitée, où le juge Rand a décidé qu'une redevance était assimilable à une rente. Bien que cette affaire ait porté sur une redevance de bailleur, le juge Laskin a estimé que, même si en théorie le titulaire d'une redevance de bailleur détient un intérêt de réversion, ce qui n'est pas le

there should be no distinction between the two royalty interests in their treatment as interests in land. The effect of Laskin J.'s reasons was to render inapplicable, at least insofar as overriding royalties, the common law rule against creating interests in land out of incorporeal interests.

cas du titulaire d'une redevance dérogatoire, il n'y avait pas lieu de faire de distinction entre ces deux redevances dans l'effet qui leur est attribué à titre d'intérêts fonciers, puisque les deux intérêts sont essentiellement identiques. Les motifs du juge Laskin ont eu pour effet de rendre inapplicable, du moins quant aux redevances dérogatoires, la règle de common law interdisant la création d'intérêts fonciers à partir d'intérêts incorporels.

12 Laskin J. concluded that the overriding royalty was an interest in land, analogous to a rent-charge. It is significant that he did not find all overriding royalty interests to be interests in land. He held that the intentions of the parties judged by the language creating the royalty would determine whether the parties intended to create an interest in land or to create contractual rights only.

Le juge Laskin a conclu que la redevance dérogatoire était un intérêt foncier, analogue à une rente-charge. Il est significatif qu'il n'ait pas jugé que toutes les redevances dérogatoires étaient des intérêts fonciers. Il a estimé que les intentions des parties révélées par les termes du contrat de redevance permettraient de décider si les parties avaient l'intention de créer un intérêt foncier ou uniquement des droits contractuels.

13 In *Scurry-Rainbow Oil Ltd. v. Galloway Estate* (1993), 138 A.R. 321 (Q.B.), aff'd (1994), 157 A.R. 65 (C.A.), and in *Canco Oil and Gas Ltd. v. Saskatchewan* (1991), 89 Sask. R. 37 (Q.B.), Hunt J. and Matheson J. respectively relied upon the dissent in *Keyes, supra*, to find that lessor royalties can be interests in land depending on the intentions of the parties and the language used to create the interest. The Court of Appeal in *Scurry-Rainbow* did not base its decision on this issue.

Dans *Scurry-Rainbow Oil Ltd. c. Galloway Estate* (1993), 138 A.R. 321 (B.R.), conf. par (1994), 157 A.R. 65 (C.A.), et dans *Canco Oil and Gas Ltd. c. Saskatchewan* (1991), 89 Sask. R. 37 (B.R.), les juges Hunt et Matheson, respectivement, se sont fondés sur l'opinion dissidente exprimée dans *Keyes*, précité, pour conclure que les redevances de bailleur pouvaient être des intérêts fonciers selon les intentions des parties et les termes employés pour créer l'intérêt. La Cour d'appel dans *Scurry-Rainbow* n'a pas fondé sa décision sur cette question.

14 The appellant referred to cases that held royalty interests not to be interests in land. (See *St. Lawrence Petroleum Ltd. v. Bailey Selburn Oil & Gas Ltd.*, [1963] S.C.R. 482; *Vanguard Petroleums Ltd. v. Vermont Oil & Gas Ltd.*, [1977] 2 W.W.R. 66 (Alta. S.C.T.D.); *Isaac v. Cook* (1982), 44 C.B.R. 39 (N.W.T.S.C.); *Guaranty Trust Co. v. Hetherington* (1987), 50 Alta. L.R. (2d) 193 (Q.B.), aff'd in part [1989] 5 W.W.R. 340 (Alta. C.A.); *Vandergrift v. Coseka Resources Ltd.* (1989), 67 Alta. L.R. (2d) 17 (Q.B.); *Nova Scotia Business Capital Corp. v. Coxheath Gold Holdings Ltd.* (1993), 128 N.S.R. (2d) 118 (S.C.).) Although each of these cases held that the royalty therein is not an interest in land, they do not support the proposition that a royalty cannot be an interest in land. In each case the court found

L'appelante a cité des décisions où il a été jugé que des droits de redevance n'étaient pas des intérêts fonciers. (Voir *St. Lawrence Petroleum Ltd. c. Bailey Selburn Oil & Gas Ltd.*, [1963] R.C.S. 482; *Vanguard Petroleums Ltd. c. Vermont Oil & Gas Ltd.*, [1977] 2 W.W.R. 66 (C.S. 1re inst. Alb.); *Isaac c. Cook* (1982), 44 C.B.R. 39 (C.S.T.N.-O.); *Guaranty Trust Co. c. Hetherington* (1987), 50 Alta. L.R. (2d) 193 (B.R.), conf. en partie par [1989] 5 W.W.R. 340 (C.A. Alb.); *Vandergrift c. Coseka Resources Ltd.* (1989), 67 Alta. L.R. (2d) 17 (B.R.); *Nova Scotia Business Capital Corp. c. Coxheath Gold Holdings Ltd.* (1993), 128 N.S.R. (2d) 118 (C.S.).) Bien que dans toutes ces décisions, il ait été statué que la redevance en cause n'était pas un intérêt foncier, elles ne permettent pas d'affirmer qu'une redevance ne peut

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that the language used by the parties in creating the interest did not evidence the intention to create an interest in land.

That royalties can be interests in land finds support in W. H. Ellis's "Property Status of Royalties in Canadian Oil and Gas Law" (1984), 22 *Alta. L. Rev.* 1, at p. 10:

> Royalties, as used in the oil and gas industry, make sense only if they are property interests in unproduced minerals. Owners of mineral rights should be able to create them as such if they make clear their intent to do so.

In *Oil & Gas Agreements Update* (1989), J. F. Newman in his article "Can a Gross Overriding Royalty Be an Interest in Land?" concludes that most parties to an overriding royalty interest intend for such interest to be an interest in land. Evidence of this is the common practice of registering caveats in the Land Titles Office of Alberta seeking to protect that interest.

The oil and gas industry, which developed largely in the second half of the 20th century and continues to evolve, is governed by a combination of statute and common law. The application of common law concepts to a new or developing industry is useful as it provides the participants in the industry and the courts some framework for the legal structure of the industry. It should come as no surprise that some common law concepts, developed in different social, industrial and legal contexts, are inapplicable in the unique context of the industry and its practices.

The appellant could not offer any convincing policy reasons for maintaining the common law prohibition on the creation of an interest in land from an incorporeal hereditament other than fidelity to common law principles. Given the custom in the oil and gas industry and the support found in case

jamais être un intérêt foncier. Dans chacune, la cour a conclu que les termes employés par les parties pour créer l'intérêt ne révélaient pas l'intention de créer un intérêt foncier.

15 La thèse selon laquelle les redevances peuvent constituer des intérêts fonciers est étayée par l'article de W. H. Ellis, « Property Status of Royalties in Canadian Oil and Gas Law » (1984), 22 *Alta. L. Rev.* 1, p. 10 :

> [TRADUCTION] Les redevances, telles qu'utilisées dans le secteur des hydrocarbures, n'ont de sens que si elles constituent des intérêts de propriété dans les minéraux non encore produits. Les titulaires des droits miniers doivent pouvoir créer de tels intérêts, s'ils précisent clairement que telle est leur intention.

16 Dans l'article intitulé « Can a Gross Overriding Royalty Be an Interest in Land? », publié dans *Oil & Gas Agreements Update* (1989), J. F. Newman conclut que, la plupart du temps, il est de l'intention des parties à un contrat de redevance dérogatoire que le droit de redevance constitue un intérêt foncier. En fait foi la pratique courante qui consiste à enregistrer des oppositions au bureau d'enregistrement des titres fonciers de l'Alberta afin de protéger ces intérêts.

17 Le secteur des hydrocarbures, qui s'est développé en grande partie dans la seconde moitié du XXe siècle et continue d'évoluer, est régi par un ensemble de lois et de règles de common law. L'application des notions de common law à une industrie nouvelle ou en évolution est utile, car elle fournit aux intervenants de l'industrie et aux tribunaux un cadre juridique à l'intérieur duquel structurer les activités de ce secteur. Il n'est guère étonnant que certaines notions de common law élaborées dans des contextes sociaux, industriels et juridiques différents soient inapplicables dans le contexte particulier de ce secteur d'activité et de ses pratiques.

18 L'appelante n'a pu invoquer aucune raison de principe convaincante justifiant le maintien de la règle de common law qui interdit la création d'un intérêt foncier à partir d'un héritage incorporel, si ce n'est la fidélité aux principes de common law. Étant donné, d'une part, la coutume dans le secteur des

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law, it is proper and reasonable that the law should acknowledge that an overriding royalty interest can, subject to the intention of the parties, be an interest in land.

19 The Alberta Court of Appeal offered compelling insight into the evolution of the law at para. 52:

> The principles inherent in the above argument need not be applied to prevent an overriding royalty from being an interest in land for a number of reasons. First, royalties and ORRs need not be classified into a traditional common law property category unsuited to the realities of the oil and gas industry and need not be subject to the arcane strictures of traditional categories. Second, some authorities suggest it is possible to have an incorporeal interest (an overriding royalty) created from an incorporeal interest. Third, even if it is not possible, the rule need not be blindly adhered to because, as stated by Mr. Justice Holmes in "The Path of the Law" (1897) 10 Harv. L. Rev. 457 at p. 469, it is "revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV," and "still more revolting if the grounds upon which it was laid down have vanished long since, and the rule persists from blind imitation of the past."

20 In *Friedmann Equity Developments Inc. v. Final Note Ltd.*, [2000] 1 S.C.R. 842, 2000 SCC 34, at para. 42, Bastarache J. outlined when changes to the rules of common law are necessary:

> (1) to keep the common law in step with the evolution of society,
>
> (2) to clarify a legal principle, or
>
> (3) to resolve an inconsistency.
>
> In addition, the change should be incremental, and its consequences must be capable of assessment.

21 In this appeal, to clarify the status of overriding royalties, the prohibition of the creation of an interest in land from an incorporeal hereditament is inapplicable. A royalty which is an interest in land may be created from an incorporeal hereditament such as

hydrocarbures et, d'autre part, l'appui fourni par la jurisprudence, il est opportun et raisonnable que la loi reconnaisse qu'un droit de redevance dérogatoire peut constituer un intérêt foncier, à condition que telle soit l'intention des parties.

La Cour d'appel de l'Alberta nous offre des réflexions convaincantes sur l'évolution du droit, au par. 52 :

> [TRADUCTION] Il n'est pas nécessaire d'appliquer les principes qui se dégagent de l'argument précité pour empêcher qu'une redevance dérogatoire ne constitue un intérêt foncier, et ce pour plusieurs raisons. D'abord, il n'est pas nécessaire de classer les redevances et les redevances dérogatoires dans les catégories classiques du droit des biens en common law qui ne s'accordent pas avec les réalités du secteur pétrolier et gazier, ni de les assujettir aux définitions ésotériques des catégories classiques. Ensuite, certaines sources semblent indiquer qu'il est possible qu'un intérêt incorporel (une redevance dérogatoire) soit créé à partir d'un intérêt incorporel. Enfin, même si cela n'était pas possible, nous ne serions pas tenus de suivre la règle aveuglément, puisque, pour reprendre les propos du juge Holmes dans « The Path of the Law » (1897) 10 Harv. L. Rev. 457, p. 469, il est « choquant que la valeur d'une règle de droit ne tienne qu'à son ancienneté, dût-elle remonter à Henri IV », et « encore plus choquant que son fondement ait disparu depuis longtemps, mais qu'elle subsiste en raison d'un passéisme aveugle. »

Dans *Friedmann Equity Developments Inc. c. Final Note Ltd.*, [2000] 1 R.C.S. 842, 2000 CSC 34, par. 42, le juge Bastarache a mis en lumière les cas où une modification de la common law sera nécessaire :

> (1) pour permettre à la common law de suivre l'évolution de la société;
>
> (2) pour préciser un principe de droit;
>
> (3) pour éliminer une contradiction.
>
> De plus, la modification doit être graduelle et ses conséquences doivent pouvoir être évaluées.

Dans le présent pourvoi, pour préciser le droit en matière de redevances dérogatoires, l'interdiction de créer un intérêt foncier à partir d'un héritage incorporel est inapplicable. Une redevance qui est un intérêt foncier peut être créée à partir d'un héritage

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a working interest or a *profit à prendre*, if that is the intention of the parties.

incorporel tel qu'une participation directe ou un profit à prendre, si telle est l'intention des parties.

22 Virtue J. in *Vandergrift*, *supra*, at p. 26, succinctly stated:

Dans *Vandergrift*, précité, p. 26, le juge Virtue dit succinctement :

. . . it appears reasonably clear that under Canadian law a "royalty interest" or an "overriding royalty interest" can be an interest in land if:

1) the language used in describing the interest is sufficiently precise to show that the parties intended the royalty to be a grant of an interest in land, rather than a contractual right to a portion of the oil and gas substances recovered from the land; and

2) the interest, out of which the royalty is carved, is itself an interest in land.

[TRADUCTION] . . . il semble assez clair que, selon le droit canadien, un droit de redevance ou un droit de redevance dérogatoire peut être un intérêt foncier si les conditions suivantes sont réunies :

(1) les termes employés pour décrire l'intérêt sont suffisamment précis pour démontrer l'intention des parties que la redevance constitue un intérêt foncier, plutôt qu'un droit contractuel sur une fraction des hydrocarbures extraits du sol;

(2) l'intérêt dont est issue la redevance est lui-même un intérêt foncier.

VI. Conclusion

23 The appeal is dismissed with costs to the respondents.

VI. Conclusion

Le pourvoi est rejeté avec dépens en faveur des intimés.

Appeal dismissed.

Solicitors for the appellant: Jones, Rogers, Toronto.

Solicitors for the respondents: McDonald Crawford; Bennett Jones, Calgary.

Pourvoi rejeté.

Procureurs de l'appelante : Jones, Rogers, Toronto.

Procureurs des intimés : McDonald Crawford; Bennett Jones, Calgary.

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Bank of Montreal v. Enchant Resources Ltd., 1999 ABCA 363

Date: 19991217
Docket: 96-16526, 96-16536 & 97-17211

IN THE COURT OF APPEAL OF ALBERTA

THE COURT:

THE HONOURABLE MR. JUSTICE FOISY
THE HONOURABLE MR. JUSTICE BERGER
THE HONOURABLE MR. JUSTICE SULATYCKY

BETWEEN:
Appeal #16526

BANK OF MONTREAL

Respondent
(Plaintiff)

- and -

ENCHANT RESOURCES LTD., AND D.S. WILLNESS

Appellants
(Defendants)

- and -

DYNEX PETROLEUM LTD., ALBERTA ENERGY COMPANY LTD., ARDMORE INVESTMENTS LTD., TRANSCANADA PIPELINES LTD., AMOCO CANADA PETROLEUM LTD., ATCOR LTD., CRESTAR ENERGY INC., DANA DISTRIBUTORS LTD., VIMYVIEW LTD., COL-SYB HOLDINGS LTD., HEXAM HOLDINGS LTD., DAVIDS INVESTMENTS LTD., EDWARD W. HADWAY, ESTATE OF HARRY VEINER, VICTOR SOPKIW, NANCY OIL & GAS LTD., STANILOFF OIL & GAS LTD., CORY OILS LTD., DORAN INVESTMENTS LTD., ENCOR ENERGY CORPORATION INC., EPIC RESOURCES LTD., KIRRIEMUIR RESOURCES LTD., MERIDIAN OIL INC., NORTH CANADIAN OILS LIMITED, ODESSA NATURAL CORPORATION, PRECAMBRIAN SHIELD RESOURCES LIMITED, STAR OIL AND GAS LTD., SUNCOR INC., EARL GORDON, ANTELOPE LAND SERVES LTD., BRANNIGAN RESOURCES CANADA (1992) LTD., JIM BRUCE CONSULTANTS, SASKATCHEWAN OIL AND GAS CORPORATION, SASK OIL RESOURCES INC., LANDSEA OIL & GAS LTD., INTENSITY RESOURCES LTD., DEANE ENTERPRISES LTD., SHELL CANADA RESOURCES LTD., CHANNEL LAKE PETROLEUM LTD., AND ENRON OIL CANADA LTD.

Defendants not
party to the Appeal

1999 ABCA 363 (CanLII)

AND BETWEEN:
Appeal #16536

BANK OF MONTREAL

Appellant
(Plaintiff)

- and -

MERIDIAN OIL INC., ODESSA NATURAL CORPORATION, ENCHANT RESOURCES LTD., and D.S. WILLNESS

(Respondents)
Defendants

- and -

DYNEX PETROLEUM LTD., ALBERTA ENERGY COMPANY LTD., ARDMORE INVESTMENTS LTD., TRANSCANADA PIPELINES LTD., AMOCO CANADA PETROLEUM LTD., ATCOR LTD., CRESTAR ENERGY INC., DANA DISTRIBUTORS LTD., VIMYVIEW LTD., COL-SYB HOLDINGS LTD., HEXAM HOLDINGS LTD., DAVIDS INVESTMENTS LTD., EDWARD W. HADWAY, ESTATE OF HARRY VEINER, VICTOR SOPKIW, NANCY OIL & GAS LTD., STANILOFF OIL & GAS LTD., CORY OILS LTD., DORAN INVESTMENTS LTD., ENCOR ENERGY CORPORATION INC., EPIC RESOURCES LTD., KIRRIEMUIR RESOURCES LTD., NORTH CANADIAN OILS LIMITED, PRECAMBRIAN SHIELD RESOURCES LIMITED, STAR OIL AND GAS LTD., SUNCOR INC., EARL GORDON, ANTELOPE LAND SERVICES LTD., BRANNIGAN RESOURCES CANADA (1992) LTD., JIM BRUCE CONSULTANTS, SASKATCHEWAN OIL AND GAS CORPORATION, SASK OIL RESOURCES INC., LANDSEA OIL & GAS LTD., INTENSITY RESOURCES LTD., DEANE ENTERPRISES LTD., SHELL CANADA RESOURCES LTD., ENRON OIL CANADA LTD. and CHANNEL LAKE PETROLEUM LTD.

Defendants

AND BETWEEN:
Appeal #17211

BANK OF MONTREAL

Appellant
(Plaintiff)

- and -

MERIDIAN OIL INC., ODESSA NATURAL CORPORATION, ENCHANT RESOURCES LTD., and D.S. WILLNESS

(Respondents)
Defendants

- and -

1999 ABCA 363 (CanLII)

DYNEX PETROLEUM LTD., ALBERTA ENERGY COMPANY LTD., ARDMORE INVESTMENTS LTD., TRANSCANADA PIPELINES LTD., AMOCO CANADA PETROLEUM LTD., ATCOR LTD., CRESTAR ENERGY INC., DANA DISTRIBUTORS LTD., VIMYVIEW LTD., COL-SYB HOLDINGS LTD., HEXAM HOLDINGS LTD., DAVIDS INVESTMENTS LTD., EDWARD W. HADWAY, ESTATE OF HARRY VEINER, VICTOR SOPKIW, NANCY OIL & GAS LTD., STANILOFF OIL & GAS LTD., CORY OILS LTD., DORAN INVESTMENTS LTD., ENCOR ENERGY CORPORATION INC., EPIC RESOURCES LTD., KIRRIEMUIR RESOURCES LTD., NORTH CANADIAN OILS LIMITED, PRECAMBRIAN SHIELD RESOURCES LIMITED, STAR OIL AND GAS LTD., SUNCOR INC., EARL GORDON, ANTELOPE LAND SERVICES LTD., BRANNIGAN RESOURCES CANADA (1992) LTD., JIM BRUCE CONSULTANTS, SASKATCHEWAN OIL AND GAS CORPORATION, SASK OIL RESOURCES INC., LANDSEA OIL & GAS LTD., INTENSITY RESOURCES LTD., DEANE ENTERPRISES LTD., SHELL CANADA RESOURCES LTD., ENRON OIL CANADA LTD. and CHANNEL LAKE PETROLEUM LTD.

1999 ABCA 363 (CanLII)

Defendants
(Not Parties to this Appeal)

APPEAL FROM ORDERS OF
THE HONOURABLE MR. JUSTICE ROOKE
DATED DECEMBER 21, 1995 AND APRIL 4, 1997

REASONS FOR JUDGMENT

COUNSEL:

G. S. Griffiths, Q.C.
R. B. Jones
For the Bank of Montreal

J. C. Crawford, Q.C.
For the Enchant Resources Ltd. and D. S. Willness

R. C. Dixon
For Ernst & Young Inc, Trustee in Bankruptcy of Dynex Petroleum Ltd.

REASONS FOR JUDGMENT

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THE COURT:

INTRODUCTION

[1] This appeal involves the competing interests of a bank as a debenture holder and parties holding overriding royalties and net profits interests from a petroleum and natural gas company now in bankruptcy.

[2] These matters initially came before the chambers judge pursuant to two notices of motion seeking summary judgment on the issue of priorities between the bank and the overriding royalty holders, and a preliminary determination of a point of law prior to trial that the overriding royalties do not constitute interests in land binding upon any successor in title to the petroleum and natural gas properties. After those motions were determined, leave was granted to determine the effect of the bankruptcy upon the earlier order.

[3] Appeals from each of the three applications before the chambers judge were heard.

ISSUES

[4] The issues argued in this appeal were:

1. Can net profits and overriding royalty interests constitute interests in land.
2. If they are not interests in land, are the debenture security interests and similar interests granted to the bank subordinated to the overriding royalty interests.
3. If the bank's interests are subordinated to the overriding royalty interests, does the bankruptcy affect the subordination of the bank's security interest to the overriding royalty interests and does the bank continue to be obliged to hold in trust proceeds received prior to the sale of the oil and gas properties.

SUMMARY OF CONCLUSIONS

[5] We conclude that overriding royalties or net profits interests can constitute an interest in land. Whether the interests in this appeal are interests in land depends upon the intentions of the parties. We do not make a determination on the second and third issues since their outcome depends upon the determination of the first.

FACTS

[6] On May 27, 1993, Ernst & Young Inc. ("the Trustee") was appointed trustee in bankruptcy of Dynex Petroleum Ltd., previously M-P Petroleum Ltd. ("Dynex") pursuant to the petition of the Bank of Montreal ("the Bank"). The Trustee wanted to sell all the petroleum and natural gas properties of Dynex. One issue was whether those properties must be sold subject to the rights of persons with overriding royalties and net profits agreements. Those persons included Enchant Resources Ltd. ("Enchant") and D. S. Willness ("Willness").

[7] In August 1993, all the oil and gas properties of Dynex were sold to Channel Lake Petroleum Ltd. minus the proceeds held by the Trustee for payments due to overriding royalty interest holders.

The Overriding Royalty Interests

[8] The overriding royalty interests of Enchant and Willness (collectively referred to as "ORRs") result from various agreements. Enchant held petroleum and natural gas leases of freehold land in southeastern Alberta. It also acquired other leases, including Crown leases.

[9] Without going into all the details, these interests were acquired in various ways.

[10] One agreement, from 1974, between Enchant and Willness provides that Willness or his successors and assigns be paid a 2½% gross overriding royalty from and out of the net petroleum substances produced, saved and sold from freehold leases referred to within the agreement. The royalty was payment in consideration for Willness' services in introducing Enchant to the holders of the lease.

[11] Some other royalties were obtained by Enchant through farm out agreements. Various companies successfully drilled wells and parties' rights under the farm out were earned. Dynex later assumed the obligation to pay the overriding royalties.

[12] As an example, by a 1972 agreement, Enchant purchased petroleum and natural gas leases on freehold land. Enchant filed caveats at the South Alberta Land Registration District registering a "good and valid claim upon the said land".

[13] That acreage was part of a farmout by the Hadway Fund Group, which became Dana Distributors Ltd. A 15% gross overriding royalty was reserved to Enchant plus a 2½% gross overriding royalty to Willness.

[14] The agreement provided among other things:

> (6) Should additional acreage, other than that mentioned previously, become available either by purchase or farm in, Hadway will supply the necessary funds to acquire and drill the acreage, reserving a 15% gross override to Enchant.
>
> . . .

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> (13) Enchant's override shall be calculated at 15% of the gross value of the gas sold subject only to the deduction of the actual processing and compressing costs.

[15] A successful gas well validated the farmout agreement. These and other lands were sold subject to the ORRs, to M-P Petroleum Ltd., which later became Dynex. In an agreement entitled Assignment and Net Profits Agreement, M-P Petroleum Ltd., as assignee of various lands and leases, "did sell, assign, transfer, convey and set over unto the assignee" and did accept the transfer of such lands and did undertake to hold same:

> subject to the assumption by the assignee of the overriding royalties burdening the leases and the lands as described and set forth in Part I, II and III of Schedule "A" hereto (hereinafter call the "overriding royalties")

[16] Enchant was named signatory and assignor under this agreement which set forth both the Enchant and the Willness royalties. That agreement also provided that the assignors, including Enchant, also reserved to themselves 40% of the net profits realized by the assignee from the oil and gas produced from the properties assigned and conveyed to the assignee. The agreement further provided that "40% of the net profits" meant "an interest in land entitling the assignors to receive monthly an amount equal to" a percentage as computed by an accounting procedure set out in Schedule "B".

[17] Additionally, Enchant's rights to be paid overriding royalties by Dynex was documented in four overriding royalty agreements. The agreement dated January 22, 1975 provided:

> The Grantor hereby agrees to pay or cause to be paid to the Grantee, an overriding royalty of three percent (3%) of the proceeds (subject to the deductions hereinafter referred to) received by the Grantor on the sale of all petroleum substances produced, saved and marketed from the said lands.

The Security Interests of the Bank of Montreal

[18] From 1979, and at various times after, the Bank lent money to M-P Petroleum Ltd., then later, Dynex. Securities for the loans included petroleum and natural gas leases, which were assigned pursuant to the *Bank Act*, R.S.C. 1985, c. B-1, and fixed and floating charge debentures.

[19] At the time of making the loans and executing the various security agreements, the Bank knew of Dynex's obligations to pay the ORRs. These are noted, for example, in the general assignment between the Bank and M-P Petroleum Ltd. M-P Petroleum covenanted that the property was free of any encumbrances save those set forth in the schedule that included the gross overriding royalties.

[20] Similarly, for example, in the debenture, Dynex mortgaged and charged, as a first, floating charge in favour of the Bank, all of its undertaking, property and assets subject to the conditions which included any interests of a third party under any pooling, unitization,

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development, farm out, operating royalty or overriding royalty agreements as "permitted encumbrances". A similar exception for permitted encumbrances existed in the loan agreement of the same date.

[21] On May 26, 1993, the Bank issued a petition pursuant to the BIA seeking a receiving order and gave rise to the further issues of the priority of the ORRs to the Bank's interest and the effect of the bankruptcy on the priorities between the ORRs and the Bank.

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JUDGMENTS BELOW

[22] The chambers judge issued two orders. In his reasons dated December 19, 1995, he held that overriding royalties do not constitute interests in land. As a matter of law, he found that a lessee of an oil and gas lease (which is a *profit à prendre*), which is in itself an interest in land, obtained from a lessor (whether the Crown or freehold), cannot pass an interest in land to a third party. He did not name any particular authorities but stated he was guided by binding authorities in reaching this conclusion. He went on further to say that if it were possible to have an interest in land, it required an examination of the language of the instrument to see if the intention of the parties was to create such an interest. Because this requires a fact finding in each case, it could not be decided on a motion under Rule 220, but had to be determined at trial.

[23] On the issue of the priorities of the interests between the Bank and the ORRs prior to the bankruptcy of Dynex, the chambers judge held that by the terms of the clauses in the debenture and loan agreements, the Bank subordinated its interest to the previously granted interests of the ORRs. He reasoned that commercial reality of the oil and gas industry required that such effect be given to the documents.

[24] In his reasons dated April 4, 1997, the chambers judge held that the Bank's subordination to the ORRs survives the bankruptcy of Dynex and that the ORRs are entitled to recover any of their losses in bankruptcy (that are not recovered from the Trustee) from the Bank.

[25] He held that the interests of the ORRs constituted a chose in action, basically, an unsecured claim which could only be a secured interest in personalty if the ORRs had registered pursuant to the PPSA. That did not occur in this case. In bankruptcy, therefore, without the subordination agreement, the ORRs, as unsecured creditors, would have no priority over the Bank.

[26] The chambers judge went on to hold that the subordination of the Bank to the ORRs exists and continues despite the bankruptcy because the subordination agreement did not expressly, or by implication, terminate upon bankruptcy.

[27] However, Dynex's assets sold by the Trustee to Channel Lake were unencumbered by the interests of the ORRs as they were mere unsecured claims and therefore, Channel Lake Petroleum Ltd. acquired the Dynex properties free of the ORRs.

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ANALYSIS

Issue 1. Can net profits and overriding royalty interests, as a matter of law, constitute interests in land?

[28] We are of the view that overriding royalties can be interests in land. There are practical reasons why ORRs should be treated as interests in land and where an agreement expresses the appropriate intentions, parties can grant or reserve interests in land.

General Observations

[29] By way of general observation, we adopt those set out by Hunt J. (as she then was) in *Scurry-Rainbow Oil Limited et al.* v. *Galloway Estate et al.*, [1993] 4 W.W.R. 454 (Alta. Q.B.); appeal dismissed, [1995] 1 W.W.R. 316 (C.A.); leave to appeal denied, [1994] S.C.C.A. No. 475 (Q.L.), at pp. 464-5. Her first observation was a caution regarding reliance on American authorities:

> First, since the development of the oil and gas industry in Alberta and other parts of western Canada, Canadian courts have been called upon to make many decisions relating to the industry's activities. Due to the early dearth of jurisprudence and the fact that many industry practices in Canada were modelled upon those in the United States, Canadian courts have at times relied upon American decisions. Although such decisions can be of assistance, in my view they must be used cautiously because of the fact that different American jurisdictions have adopted varied approaches to basic concepts of oil and gas law, approaches that at times are in distinct contrast to those of Canadian courts. . . .

Her second observation was a caution regarding rigid reliance on English common law:

> Second, in trying to come to grips with some of the novel legal problems created by the industry's presence in our country, Canadian courts have often drawn upon English common law concepts, especially those of real property law. That this should be the case is hardly surprising, given our legal traditions. Moreover, these traditional concepts have often proven helpful in sorting out complex problems. On the other hand, too rigid a reliance on common law principles that have developed in vastly different circumstances can lead to results that are out of touch with the realities of the industry and that deviate from the sorts of solutions needed by the affected parties. . . .

Her third observation was the need to interpret documents within their context:

> A third and related point is that judicial resolutions of industry-related problems have typically occurred long after the fact, for example, long after a contract was entered into. Thus, the courts may have interpreted the language of a document

> two or three decades after it was drafted. These judicial views are often argued to be binding in the interpretation of other agreements entered into long before the jurisprudence was in existence, and of course, long before the parties could possible have known how the courts might construe the language they have chosen. . . . While these authorities should not be disregarded simply because they were later in time and thus could not have been in the contemplation of the drafters of the Agreements before me, the discrepancy in time is a factor to be weighed in considering the persuasiveness of such authorities in the context of the issues raised here.

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Royalties and Overriding Royalties

[30] A lessor's royalty is a share of the product or the proceeds reserved to the owner for permitting another to use the property and also a right to receive, either in kind or its equivalent in money, a stipulated fraction of the oil and gas produced and saved from the property covered by the lease, free of all costs of development and production: E. Kuntz, *A Treatise on the Law of Oil and Gas* (Cincinnati, Ohio: Anderson, 1991) Vol. 1, s. 15.1.

[31] An overriding royalty or a gross overriding royalty is an unencumbered share or fractional interest in the gross production granted to a third party in exchange for performing duties (*e.g.* drilling). Commonly, it is reserved in an assignment, part assignment or sublease of an oil and gas lease, often carved out or reserved by lessees who have a working interest created by a lease: G. J. Davies, in "The Legal Characterization of Overriding Royalties in Canadian Oil and Gas Law" (1972) 10 Alta. L. Rev. 232 at p. 233.

Net Profit Agreements

[32] A net profits interest includes, at least, the right to receive a portion of the proceeds from the sale of petroleum and natural gas. Whether it is an interest in land was determined by Martland J. in *St. Lawrence Petroleum Limited et al.* v. *Bailey Selburn Oil & Gas Ltd. et al.*, [1963] S.C.R. 482, by ascertaining the intention of the parties pursuant to two farmout agreements. He looked at both the wording and the context of the agreements in issues. They assigned "such an undivided interest in the petroleum and natural gas and related hydrocarbons . . . as well" after production was obtained and sold. In the opinion of Martland J. opinion, the interest was only an equitable interest because the interest was held in trust for the purposes of the agreement and the beneficiaries would receive the money equivalent of their share of the proceeds of production. He could not find that the parties contemplated or agreed to convey an interest in the lands capable of assignment or registration. He agreed with the trial judge at p. 490, "Had it been intended to convey such an interest it would have been a very simple thing to do in plain and unmistakable words."

[33] Martland J. left open the possibility that a net profits agreement can convey an interest in land where the parties intended to convey such an interest. Here, unlike *St. Lawrence Petroleum Limited* v. *Bailey Selburn Oil & Gas Ltd.*, the agreement stated that the interest was an interest in

land. But in each particular case, the interest conveyed is to be found by interpreting the agreement as a whole and within its context. A net profits interest, in many cases, can function in much the same manner as a royalty or other non-working interests where the interest is a right to a share of production as opposed to a right to a certain amount of money out of a certain described portion of production. The analysis which follows discusses royalties and overriding royalties, but where the intention of the parties to the net profits agreement was to create an interest analogous to that of a royalty or overriding royalty, we are of the opinion that the result should be the same.

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The Function of Royalties

[34] A partial list of the ways in which royalties are used was set out by W. H. Ellis, "Property Status of Royalties in Canadian Oil and Gas Law" (1984) 22 Alta. L. Rev. 1 at pp. 2-3. They include financing the costs of drilling and spreading the risks of exploration. For the buyer, it is a chance to invest in areas where he or she may not own enough interest to consider drilling. For the seller, it is a way to realize immediately on part of the investment against the chance the hole will be dry and keep part of the investment on the chance that an oil or gas well will be drilled. This results in further economic benefits by stabilizing the volatile industry and raising money for exploration. Additionally, overriding royalties are used to compensate employees whose efforts determine the success of a project.

[35] Ellis described two further characteristics important to understanding the function of royalties in the oil and gas industry. Oil and gas ventures require huge amounts of capital but only a small fraction are successful. The oil and gas investor is betting that the many losses will be made up by the small fraction of successes. Therefore, the industry needs first, the incentive to induce such high risk investments by offering the hope of a share of production from successful ventures. Second, good investment decisions in the oil and gas industry depend on good geological information. Geological information is information about specific land.

[36] Royalties fit these characteristic needs because they are investments in a particular piece of property, not in a particular operator or company. There are other means for investing in the owner or operator. The investment return on a royalty results from the success of the property regardless of who owns or is working the property. These unique functions and characteristics apply equally to overriding royalties as well as royalties. The fact that overriding royalties are not granted from the whole of the mineral interest but from the working interest does not change their role in oil and gas production.

Assumptions that Royalties are Interests in Land

[37] American authorities, Williams and Meyers, *Oil and Gas Law* (New York: Matthew Bender, looseleaf) assert that royalties are interests in land and that almost all courts in the United States treat them as such. As noted also by this Court in *Scurry-Rainbow, supra* at pp. 321-2, while it would be erroneous to rely too heavily on U. S. decisions, the American cases are persuasive when not in conflict with authoritative Canadian decisions.

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[38] In oral argument, counsel for the appellants asserted that despite the uncertainty in the common law and the absence of any statutory authority, overriding royalty holders are treated as having an interest in land when they are pursued for the costs of abandoned wells. (The abandonment costs procedure was described in *Panamericana De Bienes Y Servicos, S.A. (Receiver of)* v. *Northern Badger Oil and Gas Ltd.* (1989), 75 Alta. L.R. (2d) 185 (Q.B.); (1991), 81 D.L.R. (4th) 280 (C.A.); leave to appeal refused (1992), 86 D.L.R. (4th) 567n (S.C.C.).)

[39] Edward Evans, Forbes Newman and Keith Smith, in an article titled, "Overriding Royalties and Subleases as Interests in Land" *Papers Presented at the Mid-Winter Meeting of the Alberta Branch, Canadian Bar Association* (Calgary, 1988) pp. 406-457, analysed the overriding royalty provisions in the proposed model farm-out agreement prepared by a joint committee of the Canadian Bar Association Natural Resources Section and the Canadian Association of Petroleum Landmen. The authors, after reviewing case law, concluded at p. 424 that "an overriding royalty, properly drafted, can be an interest in land." They also made it clear that the oil and gas industry has traditionally assumed that overriding royalties were interests in land. As was done for some of the overriding royalties in this case, they have been registered as caveats with land titles offices on the assumption that they were interests in land.

[40] Indeed, many transactions over many years have been predicated on this assumption. This is not a fact which should be taken lightly. This conclusion echoes the remarks of Ellis, in "Property Status of Royalties in Canadian Oil and Gas Law," *supra* at p. 10:

> Royalties, as used in the oil and gas industry, make sense only if they are property interests in unproduced minerals. Owners of mineral rights should be able to create them as such if they make clear their intent to do so.

[41] Davies, *supra* at pp. 235-6, stated that the usual overriding royalty interest is limited to endure as long as the lease upon which it is raised and that in turn, is usually for a fixed term and thereafter for the producing life of the land. The overriding royalty is treated as analogous to a determinable fee interest, assuming that the overriding royalty is an interest in land.

[42] Academic and professional literature, such as that cited above, support the view that overriding royalties should be classified as an interest in land primarily on the basis of expediency.

[43] Eugene Kuntz, in a discussion paper entitled "Classifying Non-Operating Interests in Oil and Gas," (Calgary: Canadian Institute of Resources Law, 1988), argued that the law should provide a framework within which unnecessary risks for those who invest or participate in oil and gas operations are removed. The oil and gas industry has created new devices to meet the high risks of the enterprise. Included among the new devices are non-operating interests which are used to make the sharing of the benefits of mineral ownership definite and certain, minimize taxes, make clear delegation of operating rights and make proper allocation of the risks and rewards of an operation without invoking many objectionable features associated with creating a

conventional business association. Non-operating interests include royalty interests, overriding royalty interests, production payments, net profit interests and carried interests.

[44] He pointed out that it is of great importance to the party acquiring a non-operating interest that such an interest be classified as a property interest and not a mere contractual right in order to guard against the consequences of possible financial difficulties of the granting party and to protect the interests against the rights of third persons generally.

[45] There are other practical arguments that can be marshalled to support overriding royalties as interests in land. First, certainty and stability are desirable qualities and the industry expects or assumes that overriding royalties can be interests in land. It should be noted, however, that for some time this assumption has been known to be somewhat tenuous – the body of literature on royalties as interests in land attests to this fact. Second, one consequence of the ruling below, that overriding royalties are not interests in land, is that some oil and gas companies with leases encumbered by overriding royalties may be worth more to a bank holding those leases as security if the company is petitioned into bankruptcy and the leases sold free of the ORRs, than if allowed to continue operating and paying the ORRs. This could create problems if it leads to otherwise unnecessary bankruptcies. Third, as Ellis argued, *supra,* at p. 4, royalties and overriding royalties as real property interests protect owners and purchasers against double conveyancing, innocent or otherwise.

Lessor Royalties as Interests in Land

[46] Given the proper construction, lessor's royalties can constitute an interest in land.

[47] *Scurry-Rainbow, supra* is the most recent important case concerning lessor's royalties. It dealt with royalty owners, who banded together and assigned their royalties to a trust in order to pool income and guarantee returns. *Scurry-Rainbow* makes several important points about the nature of lessor's royalties. Hunt J. found that the lessor's royalty can be an interest in land in the form of a "species of rent" or akin to rent or a *profit à prendre.* Alternatively, even if a royalty was not an interest in land, a lessor could retain the capacity to transfer an interest in land in the future based upon reversionary rights under the lease.

[48] In *Scurry-Rainbow*, Hunt J. held that a lessor's royalty could constitute an interest in land and further, that the lessor's interest could be assigned to a third party and retain its character as an interest in land.

[49] The appeal to this Court was dismissed noting that the status of a royalty interest need not be decided. Nevertheless, this Court went on to consider American authorities which have held that a royalty reserved to a lessor is an interest in land and noted that concept is consistent with the decision of the Supreme Court of Canada in *Berkheiser* v. *Berkheiser,* [1957] S.C.R. 387 and an earlier decision of this Court, *Re Publix Oil & Gas Ltd,* [1963] 3 W.W.R. 634.

No Practical Difference Between Royalties and Overriding Royalties

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[50] For all intents and purposes, an overriding royalty is the same as a royalty; both are an unencumbered share of production. To distinguish between these two forms of royalty is to place form before substance. Royalties, whatever their origin, should be subject to the same set of rules.

[51] In this case, however, the chambers judge held that he was bound by authorities which state that an interest in land cannot be passed to a third party from a lessee of an oil and gas lease. The argument can be summarized as follows: A lessee only possesses a *profit à prendre*. A *profit à prendre* is an incorporeal hereditament. An interest in land can only be created from the corporeal estate.

[52] The principles inherent in the above argument need not be applied to prevent an overriding royalty from being an interest in land for a number of reasons. First, royalties and ORRs need not be classified into a traditional common law property category unsuited to the realities of the oil and gas industry and need not be subject to the arcane strictures of traditional categories. Second, some authorities suggest it is possible to have an incorporeal interest (an overriding royalty) created from an incorporeal interest. Third, even if it is not possible, the rule need not be blindly adhered to because, as stated by Mr. Justice Holmes in "The Path of the Law" (1897) 10 Harv. L. Rev. 457 at p. 469, it is "revolting to have no better reason for a rule of law than that so it was laid down in the time of Henry IV," and "still more revolting if the grounds upon which it was laid down have vanished long since, and the rule persists from blind imitation of the past."

Royalty Interests As Akin to Rent or Profit

[53] *Berkheiser, supra* at p. 391 held that an oil and gas lease is not a lease in the normal sense of the term; rather, it is a *profit à prendre*: A *profit à prendre* is essentially a right to come onto an estate to capture or take a resource. *Berkheiser* further held at pp. 391-4 that if a lease was a *profit à prendre*, then as a mere right over land rather than being an estate proper, it was only an incorporeal interest in land.

[54] However, Hunt J. in *Scurry-Rainbow, supra,* suggested *Berkheiser* also could be interpreted to say that royalties are a species of profit. Further, she rejected the argument that a royalty must fall into some pre-existing category and not be considered as analogous to an existing interest such as rent. She rejected the argument for three reasons.

[55] First, other courts which recognized a royalty as an interest in land did not specify the nature of the interest. She concluded that the notion that categories of interest in land were closed did not figure in at least two of those decisions, *Canco Oil & Gas Ltd.* v. *Saskatchewan, infra* and *Re Publix Oil & Gas Ltd., supra.*

[56] Second, the notion of closed categories of interests in land was an overly restrictive view of the law. Hunt J. held that courts must be prepared to respond to the challenges presented in categorizing and classifying legal relationships and devices created by human ingenuity. She

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noted, as an example, that the category of easements is not closed.

[57] Third, the unique physical properties of oil and gas have always required that the courts be creative and at times to analogize. This was the situation in the case before her and also was the view of Laskin J. (as he then was) in *Saskatchewan Minerals* v. *Keyes*, [1972] S.C.R. 703 at p. 728 when he found a lessee's royalty to be analogous to a rent-charge. Hunt J. found additional support that the oil and gas industry posed challenges for the law in the observations of the Supreme Court of California in *Callahan v. Martin*, 43P. 2d 788 (1935) at p. 791:

> The difficulty . . . is due in part to the fact that the oil industry is of very recent development, while in the country . . . our classification of property as realty or personalty is based on common-law definitions which crystallized in a time when oil interests were not the subject of judicial cognizance.

[58] Other courts have regarded royalties as analogous to rent. In *Re Dawson and Bell*, [1945] O.R. 825, for example, the Ontario Court of Appeal held that royalty payments under a lease of a tract of land were in essence rent. The majority held *per* McRuer J.A. at p. 835 that the right granted under the lease was "a *profit à prendre* in gross, an incorporeal hereditament, which is an estate in the whole land and which will continue to exist, unless otherwise terminated, as long as oil or gas is produced under the provisions of the lease." Relying on the English decision, *R. v. Westbrook; R. v. Everist* (1847), 10 Q.B. 178 and finding nothing in the reasoning of the American courts that took a contrary view, the majority concluded at p. 842 that "a royalty is compensation for the right to occupy land, and that in its essence it is rent."

The Corporeal/Incorporeal Problem

[59] When it comes to overriding royalties, the objection has been raised that there can be "no rent on a rent". As stated by R.E. Megarry and H.W.R. Wade, *The Law of Real Property*, 4th ed. (London: Stevens & Sons, 1975) at p. 794:

> At common law a rentcharge could be charged only upon a corporeal hereditament. There could be no rentcharge charged upon another rentcharge or other incorporeal hereditament, since obviously there could then be no right of distress.

[60] This longstanding rule of real property law that rent cannot issue out of an incorporeal hereditament was observed by Laskin J., in *Saskatchewan Minerals* v. *Keyes, supra* at pp. 721-22:

> At common law, whether a royalty could be classified as rent, and hence enjoy in its unaccrued state the character of an interest in land, depended on whether it issued out of a "corporeal" interest, as, for example, out of an estate in fee of minerals in place, or whether it was incident to a reversion upon a true lease which also gave a right to extract minerals. In the former case it would be in

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> effect a rent-charge; in the latter, a rent service. Rent at common law could not issue out of an "incorporeal" interest, as for example, a *profit à prendre* in gross; and whatever it might be called, it would not be an interest in land.

Hunt J. reiterated Laskin J.'s point in *Scurry-Rainbow, supra* at p. 472.

[61] Laskin J. also noted at p. 722 that "it is only the unconfronted force of a long history that makes it necessary in this case to examine certain institutions of property in the common law provinces through an antiquated system of classification and an antiquated terminology."

[62] The reason for the requirement that rent issue out of a corporeal interest is, as set out in Megarry and Wade quoted above, that a rentcharge upon another rentcharge, or other incorporeal hereditament, results in the absence of a right to distrain. The remedy of distress can only exist where the underlying interest is a corporeal hereditament.

[63] Royalty owners do not have the remedy of distress. And therefore, the argument goes, a royalty cannot be treated as rent nor can an overriding royalty.

[64] The right to distrain need not be available in order for a royalty to be an interest analogous to rent. Indeed, as Ellis, *supra*, stated at p. 10, "The idea that royalty owners could summarily seize drilling and producing equipment worth millions of dollars, especially in fields where drainage might be going on, is unthinkable."

[65] Additionally, it may be that rent can issue out of an incorporeal hereditament. No Canadian case has held that overriding royalties cannot be created as a property interest on the basis that a rent cannot be created out of rent.

[66] Rather, the contrary conclusion can be implied in *Saskatchewan Minerals* v. *Keyes*. Laskin J. appeared to find that rent could issue out of an incorporeal hereditament. Though he did not explicitly say so, he may have had in mind a different sort of rent. Some authors have argued that royalties are analogous to an ancient form of rent: rent seck. See, A. W. Walker, "The Nature of the Property Interests Created by an Oil and Gas Lease in Texas" (1928) 7 Texas L. Rev. 1; Davies, *supra*; and Ellis, *supra*. A rent seck is a rent unsupported by the remedy of distress: Megarry and Wade, *supra* at p. 793. In practice, rents seck have all but disappeared because of statutory prescriptions. Nevertheless, the existence of rents seck suggests that an interest in land analogous to rent may exist without being tied to the remedy of distress. While Justice Laskin's decision is inconclusive on the issue of whether an overriding royalty can be an interest in land, he suggested that the ancient rule that a rent could not be created out of an incorporeal interest need not be an impediment to the application of the rent analogy to overriding royalties in Canada.

[67] The longstanding dichotomy between corporeal and incorporeal rights, described by A. H. Oosterhoff and W. B. Rayner, *Anger and Honsberger Law of Real Property* (Toronto: Canada Law Book, 1985) at pp. 10-11 as "meaningless and confusing," and which underlies the old rule

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that rent cannot issue out of an incorporeal hereditament, should not be an obstacle to a reasonable result in the case of overriding royalties.

The Parties' Intentions

[68] Whether a particular interest is an interest is land requires determination of the parties' intentions. This was the approach of Laskin J. in *Saskatchewan Minerals* v. *Keyes*, when he proceeded to consider the royalty before him and concluded that the formulation of the royalty accords with language that has been held sufficient for the creation of an interest in land. He rejected an overly literal approach to interpreting whether a royalty agreement indicated an interest in land or only a contractual right. He stated at p. 725:

> The words in which [a royalty] is couched may show that only a contractual right to money or other benefit is prescribed. However, if the analogy is to rent, then the fact that the royalty is fixed and calculable as a money payment based on production or as a share of production, or of production and sale, cannot alone be enough to establish it as merely a contractual interest.

[69] Similarly, as observed earlier, in *Scurry-Rainbow*, Hunt J. concluded at p. 474 "that the lessor's royalty under the Rio Bravo lease *can* be considered an interest in land. . . Whether that was the intention of the parties . . . remains to be determined." [Emphasis in original] She held at p. 488 that in the context of the agreements, "a literal approach should not be followed if it would bring about an unrealistic result not contemplated in the commercial context of the times." In contemplating the essential nature of the oil and gas lease transaction, she held that regard should be given to what the parties are actually doing.

[70] *Canco Oil & Gas Ltd.* v. *Saskatchewan* (1991), 89 Sask. R. 37 (Q.B.) also supports the proposition that royalties generally can be interests in land if the parties intend to create an interest in land. In that case, the parties' intentions were determined from the words of the grant.

[71] The registered owner of the mines and mineral interests assigned a gross royalty on substances produced, saved and sold from certain lands. The royalty agreement in *Canco* contained three important clauses. Clause 1 provided that the grantor "hereby grant, assign, transfer and convey to the grantee a gross royalty of 3% of all petroleum, natural gas and related hydrocarbons (except coal) . . . produced, saved and sold from those certain parcels of land." Clause 3 explicitly stated that the parties intended to create an interest in land. Clause 7 reserved operating rights to the grantor. (This can be read to imply that such rights may have normally passed under the royalty agreement.)

[72] N. Bankes and Bennett Jones, *Canadian Oil and Gas*, 2d ed. (Toronto: Butterworths, looseleaf) at Dig-877, suggest that the following factors in *Canco* led to the characterization of the royalty as an interest in land:

(1) the royalty was carved out of what was clearly an interest in land (fee simple

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interest);

(2) clause 3 and the language of grant in clause 1 indicated that it was the intention of the parties that the royalty be an interest in land;

(3) if it was a necessary condition of an interest in land that it also grant operating rights, clause 7 indicated that these rights might have been an incident of the grant and had been relinquished.

[73] The approach of both Matheson J. in *Canco* and Hunt J. in *Scurry-Rainbow* was to examine the parties' intentions from the agreement as a whole, along with the surrounding circumstances, as opposed to searching for some magic words. Matheson J. stated at p. 47:

> . . . the principal questions are whether Farmers Mutual was capable of granting an interest in the lands and whether it intended to do so and whether it accomplished that intention. As owner of a designated interest in mines and minerals in fee simple, Farmers Mutual clearly possessed an interest in the lands, and the wording of the Royalty Agreement permits of no other conclusion but that Farmers Mutual intended that the grant of the 3% gross royalty should constitute an interest in the lands. The fact that Farmers Mutual did not utilize all of the wording, or type of wording considered by some persons as perhaps essential, can surely not detract from an otherwise clearly manifested intention to create an interest in the lands.

And according to Hunt J. in *Scurry-Rainbow, supra*, at p. 474:

> There is in my view an unreality about placing too heavy an emphasis upon fine distinctions as the selection of words such as "in" rather than "on". Notwithstanding the significance that the courts have sometimes attached to these word choices, I doubt that parties who signed leases . . . should be taken to have intended to create an interest in land as opposed to a contractual right, as a result of such minuscule differences in language. . . . Rather, it is more appropriate to consider the substance of the transaction (namely, what were the parties actually trying to achieve?) and to regard the words they have used from that perspective.

United States Authorities

[74] No U. S. authorities on overriding royalties were provided by the parties. American case law, however, can be useful when considering issues not previously decided in Canada, particularly, in the context of oil and gas. However, as noted by Fruman J. (as she then was) in *Anderson* v. *Amoco, supra* at p. 41:

> American case law must be read with care. Unlike Canada, many U. S. states have adopted theories of ownership. Cases decided in one state may not apply in others because they differ in their classification of the interests landowners hold

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> in oil and gas. . . . Because of the differing theories of ownership among various states, it is often inappropriate to extrapolate decisions from a specific state as representing American oil and gas law generally.

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[75] This Court stated in *Scurry-Rainbow, supra* at pp. 321-2, while it would be erroneous to rely too heavily on U. S. decisions, the American cases are persuasive when not in conflict with authoritative Canadian decisions. The decision of the Supreme Court of Canada in *Berkheiser, supra*, was entirely consistent with the American authorities in recognizing that in a mineral lease of the nature under consideration, the owner retained an interest in land and that the interest in the royalties to be received under the lease formed part of that interest and was also an interest in land.

[76] An overwhelming majority of American jurisdictions hold that an overriding royalty can be an interest in land.

[77] Williams and Meyers, *supra*, leading authorities on U. S. oil and gas law, conclude at para. 554 that overriding royalties are usually held to be interests in land or real property because they are conveyances or reservations of a part of the lessee's interest which (in most United States jurisdictions and in Canada) is itself real property.

[78] They also note at para. 418.1 that the classification of overriding royalties "as realty or personalty in any particular jurisdiction corresponds to that jurisdiction's classification of an ordinary royalty". The status of royalties varies from jurisdiction to jurisdiction, but the dominant trend is that found in Texas: when a royalty or leasehold interest can last for the duration of the freehold estate, it is to be treated as real property (at para. 214). The learned authors do not offer any principled justification for grouping lessors' royalties and overriding royalties together – practical concerns seem to dictate the approach.

[79] Kuntz, "Classifying Non-Operating Oil and Gas Interests" *supra* at p. 14 summarizes that "where the lease is treated as an interest in land, as it is in an overwhelming majority of the states with a decision on the subject, the overriding royalty is also treated as an interest in land."

[80] According to Davies, *supra* at pp. 241ff, there are three ways in which American courts have found that lessor's royalties and overriding royalties are interests in land:

1. The royalty is a reservation or exception of title to a fraction of the oil and gas in place.
2. The royalty is a *profit à prendre* or as a co-tenancy in a *profit à prendre*.
3. The royalty is rent or an interest analogous to rent.

[81] Finally, Williams and Meyers, *supra*, comment at para. 215:

> We are of the opinion that in states in which the [realty/personalty] classification question has not been decided as to a particular interest, classification as realty

[i.e. an interest in land] rather than as personalty is preferable if the particular interest has the duration of a freehold.

CONCLUSION

[82] For all the above reasons, we conclude that parties may create overriding royalties that are interests in land if they manifest their intention to do so.

[83] In order to determine the parties' intentions, findings of fact must be made.

[84] As gleaned from the authorities, various indicia could be used to identify whether or not an interest in land was intended. The set of indicia, which is not exhaustive but may be relevant, is:

1. The underlying interest is an interest in land (corporeal or incorporeal);
2. The intentions of the parties, as evidenced by the language of the grant and any admissible evidence of the surrounding circumstances or behaviour, indicate that it was understood that an interest in land was created/conveyed;
3. The interest is capable of lasting for the duration of the underlying estate.

[85] Other possible indicia were set out by Evans, Newman and Smith, *supra*, at pp. 447-456 in their proposed model form overriding royalty. They include wording in the overriding royalty clause which create:

1. A reservation of interest in the petroleum substances by the farmor in the working interest to be earned by the farmee.
2. The farmee as agent of the farmor for the farmor's share of petroleum production.
3. Remedies against the interest of the farmee through a lien.

[86] This matter initially came before the chambers judge on applications under R. 220 and 221, for a preliminary determination before trial. Having found that the overriding royalties may be interests in land, depending upon the agreements between the parties, the final determination of this matter requires findings of fact. It cannot be determined under R. 220 or 221.

[87] The chambers judge stated, and both Enchant and the Bank agreed, in such a case, this matter must go back for trial. During oral argument, the parties also agreed that should this matter go back for trial on the issue of whether there was an interest in land, then any equitable remedies that Enchant and Willness may have against the Bank may be raised and Willness and Enchant should be allowed to adduce evidence and argue any and all equitable remedies which they might have against the Bank.

[88] Since the first issue must be determined by a trial, which may render the second and third issues wholly or partially moot, it is preferable that those two issues be determined in the context of the trial evidence, and in conjunction with any other issues, equitable or otherwise which

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might impact on the result relating to those issues.

[89] For that reason, the second and third issues are directed to be tried together with the first. In the result, the appeal is allowed on the first issue but the second and third issues are to be determined at trial in accordance with the preceding paragraph. The success on this appeal has been divided. Costs, therefore, are not awarded to either party.

APPEAL HEARD on November 30 to December 2, 1998,

REASONS FILED at Calgary, Alberta,
this 17th day of December, 1999

FOISY, J.A.

BERGER, J.A.

SULATYCKY, J.A.

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TAB 6

Date of Release: February 25, 1994

No. 144151 VA/92
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

IN BANKRUPTCY

IN THE MATTER OF THE BANKRUPTCY OF RICO ENTERPRISES LTD.	REASONS FOR JUDGMENT OF THE HONOURABLE MR. JUSTICE TYSOE (IN CHAMBERS)

1994 CanLII 996 (BC SC)

Counsel for the Trustee in Bankruptcy, Deloitte & Touche Inc.:	Peter A. Spencer
Counsel for Johann Schupp and four other holders of promissory notes:	Arthur L. Edgson
Counsel for Wenzel Enterprises Ltd. and Helmut Wenzel:	John F. Grieve
Counsel for Rico Enterprises (Vancouver) Ltd. and Hans Rieder:	William D. Riley
Date and place of hearing:	February 16, 1994 Vancouver, B.C.

The Trustee in Bankruptcy has applied for directions relating to the distribution of dividends to the creditors of Rico Enterprises Ltd. (the "Bankrupt"). The issues to be resolved relate to the priorities between various creditors and the existence of an outstanding action which could affect the categorization and priority of moneys owed to a group of creditors who are the plaintiffs in that action.

FACTS

The Bankrupt was an investment vehicle for the construction and operation of two restaurants at Expo '92 in Seville, Spain. The persons who invested in the enterprise purchased units in numbered companies which, in turn, purchased units in the Bankrupt. Each unit consisted of shares and debt, with a nominal amount of the purchase price being allocated to the shares and the balance being allocated to the debt. Thus, an investor would receive shares in the numbered company plus a promissory note from the numbered company, and the numbered company would receive shares in and a promissory note from the Bankrupt. The investment was apparently structured in this manner for income tax reasons. Letters of credit were also involved but they were all drawn upon and, for the purpose of this application, they can be treated the same as cash advances made in exchange for promissory notes.

The numbered companies through which the initial group of individuals invested, which became known as the First Round Investors, contributed approximately $4 million to the project in the form of cash and letters of credit. Expo '92 was to open on April 20, 1992 and it became apparent by late 1991 or early 1992 that there were significant cost overruns and that a further capital injection of at least $2 million was required to complete construction of the restaurants. If additional financing could not be obtained, the restaurants would not open and, instead of the generous profits that were anticipated as a result of the success

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of similar restaurants at Expo '86 in Vancouver, the project would be a financial disaster with all the First Round Investors and creditors (except the banks holding the letters of credit) losing all of their monies. The situation was desperate, although the outlook for the project was still optimistic if the construction of the restaurants could be finished prior to the opening of the fair.

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On February 17, 1992 the Bankrupt received an investment proposal (the "Proposal") from 419776 British Columbia Ltd. ("Newco"). It proposed that Newco would provide financing of up to $2,160,000 for 18 units in the projects. There were numerous terms and conditions of the financing, including the payment of a $432,000 bonus to Newco, the right of Newco to appoint two members of the Bankrupt's board of directors and the substitution of two key officers with persons selected by Newco. The proposal also contained the following three paragraphs:

> 6. All profits (the definition of which shall be approved by Newco) of the Company shall be dispersed to those parties and in the order set out below:
>
> (a) Newco shall receive the Bonus;
>
> (b) Newco shall be repaid of all (sic) of its initial investment;
>
> (c) loans shall be paid as approved by the new Board of Directors of Rico;
>
> (d) accrued wages and salaries of related parties and invoices of Spanish Ventures and its principals all as approved and accepted by the new Board of Directors of Rico;
>
> (e) all remaining loans of the Existing Investors shall be repaid together with interest of 12% per annum for cash loans and 1% per annum for letter of

credit loans; and

(f) the remaining profits shall be shared by all investors equally.

. . . . .

10. The terms and conditions of this proposal must be approved by a majority of the Existing Investors at a meeting of the Existing Investors called for this purpose.

11. This is a proposal only and shall be subject to preparation of formal documentation.

A meeting of the individuals who invested through the First Round Investors (who presumably were the group referred to in the proposal as the Existing Investors) was held on February 17, 1992 to consider the Proposal. The meeting approved the Proposal. Some of the individual investors did not attend the meeting and at least one of the individual investors who did attend voted against the approval of the Proposal.

The new investment did not go forward on the basis contemplated by the Proposal. Further investments in the form of cash advances and the posting of letters of credit in the aggregate of approximately $2.6 million were made but the investments were not made through the company that made the Proposal, 419776 British Columbia Ltd., and there was not the type of formal documentation one would have expected from paragraph 11 of the Proposal. The investments were made through six numbered companies, which have become known as the Second Round Investors. Four of the Second Round Investors were also numbered companies within the group of the First Round Investors. In terms of the individual investors,

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five of the 18 units were purchased by previous investors and the other 13 units were acquired by persons who were new to the project.

The only documentation relating to the new investment were the shares, promissory note and letters of credit which comprised each unit, an offering memorandum that had a copy of the Proposal included within it and two agreements which I will describe shortly.

At the time of the investment made by the Second Round Investors, the Bankrupt had several types of creditors. I have already referred to the First Round Investors and the bankers which held letters of credit issued by the bankers of the First Round Investors. The Bankrupt also had normal trade creditors, some of which were related to the Bankrupt in the sense that the trade creditor or its principal had invested in the project through the First Round Investors. Approximately $500,000 was owed to the Bankrupt's directors or their associated companies on account of loan advances made by them. The Bankrupt also owed in excess of $100,000 in respect of loans made to it by persons who had not invested in the project as shareholders.

One of the individuals who invested in the project throught the First Round Investors was Mr. Hans Rieder who was the principal of a company called Rico Enterprises (Vancouver) Ltd. That company was owed $63,000 for consulting services and $240,000 for loans made to the Bankrupt. Rico Enterprises (Vancouver) Ltd.

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and Mr. Reider (who I shall collectively refer to as "Reider") signed an agreement with the Bankrupt around the time of the second round of investments. The agreement was dated February 21, 1992 but it was signed in the first part of March 1992. In the agreement Reider agreed that it would not pursue its claims against Rico by way of court proceedings prior to October 12, 1992, which was the end of Expo '92. The agreement then contained the following two paragraphs:

> 2. It is further agreed that in consideration of the foregoing agreement to postpone any claims, such claims shall be settled as provided herein prior to distribution of profits in respect of the remaining loans of the Existing Investors (as prescribed in paragraph 6(e) of the proposal dated February 17, 1992).
>
> 3. It is further agreed that the terms of the letter of Clark, Wilson to Edwards, Kenny & Bray dated March 2, 1992 attached hereto as Schedule "A" shall form part of this Agreement, provided that the sum of $63,000.00 plus accrued interest referred to therein shall be deemed to be accrued wages for the purposes of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992).

The attached letter from Clark, Wilson stated that Mr. Rieder would release the Bankrupt from all claims related to his employment and termination of employment in exchange for payment of $63,000 plus interest and that Mr. Rieder would make himself available as a consultant for the project for up to a maximum of 20 days at a rate of $250 a day.

Another one of the investors who had invested in the project through the First Round Investors was Mr. Helmut Wenzel who

was the principal of a company called Wenzel Enterprises Ltd. That company was owed $120,000 for construction services and $203,000 for loans made to the Bankrupt. Mr. Wenzel and Wenzel Enterprises Ltd. (who I will collectively refer to as "Wenzel") also signed an agreement dated March 3, 1992 with the Bankrupt. Similar to the Rieder agreement, it provided that Wenzel would not pursue its claims against the Bankrupt by way of court proceedings prior to October 12, 1992. The agreement incorporated a Memorandum of Understanding that had been prepared by a solicitor acting for Wenzel. Paragraph C of the Memorandum of Understanding recited the $120,000 amount owing to Wenzel for construction services plus the interest owing on that amount and continued as follows:

> No payments have been made whatsoever in respect of those amounts and the same will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum.

Paragraph H(a) of the Memorandum of Understanding recited the loans made by Wenzel to the Bankrupt and continued as follows:

> The loans referred to in this paragraph (a) shall be paid not later than the loans referred to in the paragraph 6(c) of the letter dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum together with all accrued interest.

No other documentation regarding the priorities contemplated in paragraph 6 of the Proposal was signed around the time of the investment made through the Second Round Investors, but

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two parties have sent letters to the Trustee in Bankruptcy in relation to the priorities of their claims. The first letter was sent by Mr. Doug Schafer, the principal of a company called T.K. Holdings Ltd. which was owed $57,500 for "wages" and approximately $10,000 on account of loans made by it to the Bankrupt. In his letter dated March 29, 1993 Mr. Schafer stated the following with respect to the priorities of the wages and loan advances:

> On February 25, 1992 I met with Harry and Greg and agreed that I would defer my accrued wages up to February 15th totalling ($57,500.00) plus accrued interest until the new investors received their investment plus bonus.
>
> .....
>
> With respect to the promissory note holders, these funds were advanced to assist with cash-shortfalls and were not part of any investment. All note holders were advised they would be paid before any disbursements to investors.

Mr. Schafer also stated in his letter that "it was always understood that trade creditors would be paid before investors".

The other relevant letter, which was sent to the Trustee's counsel, was a letter from Davis & Company dated April 8, 1993. Davis & Company provided legal services to the Bankrupt and one of its partners was an investor and a director of the Bankrupt. Davis & Company had previously filed a proof of claim in the amount of $123,476.20 without differentiating between the legal costs incurred prior to the second round of investments and the legal costs incurred after the final investments. Davis & Company had apparently also sent a letter to counsel for the Trustee

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maintaining that its claim should be treated as a normal claim of a trade creditor. The letter dated April 8, 1993 indicated that the earlier letter had been in error and it contained the following statements:

> All the time and charges prior to February 17, 1992 were subordinated whereas the time incurred after that date was not ... The amount owing as at February 17, 1992 is $57,675.39 and we agree that this amount is subordinated to the claims of the Second Round Investors.
>
> ......
>
> As I indicated to you, the agreement that was reached between Davis & Company and Rico Enterprises Ltd. was to subordinate their previous fees and disbursements providing future fees and disbursements were paid in priority to the claims of all Investors.

As is obvious from its bankruptcy, the Bankrupt was not successful in the operation of the two restaurants at Expo '92. The construction of the restaurants was completed prior to the opening of Expo '92 but the businesses did not generate any profits. The Bankrupt filed a proposal under the ***Bankruptcy & Insolvency Act*** at the conclusion of the fair in October 1992. The proposal was rejected by the creditors in April 1993 and the bankruptcy ensued. The Trustee has received funds in excess of $800,000 with the recovery being mainly from the return of deposits that had been lodged by the Bankrupt.

After it was apparent that the project had not been successful, certain of the investors who invested through the First

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Round Investors (the "Robson Group") commenced an action against the Bankrupt and others claiming rescission of their transactions. Statements of Defence and Third Party Notices were filed in the action. No further steps have been taken since June 1993.

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DISCUSSION

None of the First Round Investors or the Second Round Investors attended at the hearing of the application. Counsel for the Trustee advised me that these Investors do not dispute that they fall under s. 139 of the ***Bankruptcy & Insolvency Act*** according to the criteria discussed in ***Laronge Realty Ltd. v. Golconda Investments Ltd.***[1]. I agree with the submission of the Trustee's counsel in this regard and I need not elaborate on the facts relating to this aspect. Hence, by virtue of s. 139, the two groups of investors are not entitled to be paid the amounts owing to them under the promissory notes until the claims of all other creditors of the Bankrupt have been satisfied.

In their action the Robson Group is claiming entitlement to rescind their investment transactions. The Trustee is concerned that if the Robson Group is successful in its rescission claim after the Trustee has made a distribution on the basis that all of the loans made by the First Round Investors fall within s. 139, the Robson Group could make a claim against the Trustee and say that

[1] ***Laronge Realty Ltd. v. Golconda Investments Ltd.*** (1986), 63 C.B.R. 74 (B.C.C.A.)

the monies owed to the First Round Investors through which they invested no longer fall within s. 139. I authorize and direct the Trustee to make distributions to the creditors of the Bankrupt on the basis that the monies owing to all of the First Round Investors do fall within s. 139 unless, prior to any such distributions, the Robson Group obtains an Order of this Court preventing any such distributions or is successful in its rescission claim and had notified the Trustee. The Trustee may apply for further directions if the Robson Group is successful in its rescission claim before the monies available for the Bankrupt's creditors have been fully distributed. I also direct the Trustee to advise the Robson Group of my ruling in this regard at least 15 days prior to making the first distribution to the creditors.

On its application for directions the Trustee proposes to the Court that the priorities contemplated in paragraph 6 of the Proposal be recognized and that, after payment of expenses and preferred claims, the available monies be distributed as follows:

(a) firstly, in payment in full of (i) the claims of the trade creditors who were not investors in the project, (ii) the claims of the trade creditors who were investors to the extent that they arose after February 17, 1992 and (iii) the claims of the lenders who were not investors;

(b) secondly, the balance to be paid to or at the direction of the Second Round Investors.

This proposed method of distribution would see

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approximately $225,000 paid to the trade creditors, $142,000 paid to the non-investor lenders and the balance in the neighbourhood of $400,000 paid to or at the direction of the Second Round Investors. The following groups would receive nothing under the Trustee's proposed distribution:

(a) trade creditors who were investors to the extent that their claims arose before February 17, 1992 (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Davis & Company who are owed an aggregate of approximately $350,000 under this category);

(b) directors who made loans to the Bankrupt (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Hans Speck who are owed approximately $540,000 under this category).

Counsel for the Trustee urged me to find that there was an agreement between all affected parties along the lines of the order of priority set forth in paragraph 6 of the Proposal. Although I respect the views of the Trustee, I am unable to accede to its proposed method of distribution.

The persons who made their investments through the Second Round Investors appear to have held the view that a majority vote at a meeting of the individuals who invested through the First Round Investors would be sufficient to bind all affected creditors to the provisions of paragraph 6 of the Proposal. This view was misconceived and it is unfortunate that these persons made their investments while under such a misconception.

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It is uncertain whether the vote at the meeting of the individuals who invested through the First Round Investors was binding on all of the First Round Investors irrespective of whether the individuals attended at the meeting or voted against the Proposal. It can be argued that the shareholders of each of the First Round Investors indicated their majority wishes at the meeting and that the majority votes at the meetings constituted agreement on behalf of each of the First Round Investors to the priorities set out in paragraph 6 of the Proposal. There was some evidence that at least one shareholder at the meeting believed that they were agreeing to the proposed transaction in principle only.

However that may be, it is clear that the vote of the meeting was not binding on the creditors of the Bankrupt who happened to be represented at the meeting. A vote at a meeting of shareholders of a company cannot be automatically binding on creditors of the company on the basis of commonality between some shareholders and some creditors. A person voting at a shareholders' meeting cannot be taken as agreeing to the subject matter of the vote in their capacity as a representative of a creditor of the company unless it is expressly stipulated to be the case. Indeed, this was recognized in the present case as a result of the agreement with Wenzel who attended the February 17 meeting. If he was to be bound in all capacities as a result of the February 17 meeting, it would not have been necessary to have Wenzel enter into the March 3, 1992 agreement with the Bankrupt.

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The Proposal itself is not an enforceable agreement for several reasons. First, it is stated on its face to be a proposal only and subject to formal documentation. Second, the party who made the proposal, 419776 British Columbia Ltd., did not invest monies in the Bankrupt. Third, there are at least two uncertainties that are not capable of clarification by the Court. The term "profits" was never defined. In view of the fact that paragraph 6 of the Proposal mixes the ranking of debt and equity, the Court is not in a position to say that any particular definition of "profits" was intended by the parties because a traditional definition of "profits" is based on the payment of expenses in priority to the payment of equity. Also, the definition of the term was subject to the approval of Newco and there is no evidence as to what definition may have been acceptable to it. Further, clause (c) of paragraph 6 refers to loans generally but the evidence indicates that there was an intention to give different treatment to loans made by directors and loans made by non-investors. The formal documentation contemplated by paragraph 11 would presumably have dealt with these points and, while the Court will generally fill out the terms of an agreement to make it enforceable, the Court should not endeavour to write the agreement on behalf of the parties when critical aspects are not known with any certainty.

Counsel for the Trustee submitted that although the Proposal itself may not be enforceable, I should find that the parties agreed to the priorities contained in paragraph 6 of the

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Proposal. I am unable to make such a finding because there is no evidence of such an agreement being reached. The only evidence before me in relation to priorities are the fact that a meeting of the individual investors approved the Proposal and the existence of the two agreements and the concessions in the two letters that I have described. It appears that the Second Round Investors proceeded on the erroneous assumption that all necessary parties had agreed to the priority contained in the Proposal.

In addition, the wording of s. 139 of the ***Bankruptcy & Insolvency Act*** should be considered. The relevant portion of the section is as follows:

> Where a lender advances money to a borrower ... under a contract with the borrower that the lender ... shall receive a share of the profits ... and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

This section must have been intended to apply notwithstanding a contrary agreement between the lender and the bankrupt. The agreement by the bankrupt to repay the monies as a loan carries with it the implication that the monies will rank in priority equally with the unsecured debt of the bankrupt. That is itself a contrary agreement which Parliament clearly intended to override. This means that in the present situation, an agreement between the Second Round Investors and the Bankrupt along the lines of paragraph 6 of the Proposal is subject to the provisions of s. 139. In other words, if there was an agreement between the Second Round

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Investors and the Bankrupt to the effect of paragraph 6, s. 139 would render unenforceable the priority given to the Second Round Investors over the Bankrupt's unsecured creditors.

It may be that the Second Round Investors have priority agreements with creditors of the Bankrupt and the First Round Investors, and they may be able to enforce such agreements in separate proceedings. It is my view, however, that the distribution by the Trustee should only be affected by agreements between the Bankrupt and its creditors, and by agreements between creditors that are conceded. There would be no point in having the Trustee distribute monies to one creditor when it is admitted by that creditor that the monies should be paid to another creditor. In support of my view, I refer to the decision of the First Appellate Division of the Ontario Supreme Court in ***Re Orzy (Canadian Garment Company)***[2] where Ferguson J.A. said the following:

> ... the practice in bankruptcy does not permit of the adjustment of the rights and privileges of creditors *inter se* but only the rights, privileges and preferences of creditors as against the insolvent and his estate ..... the reason or principle governing being that bankruptcy proceedings are designed to administer the rights of creditors of the estate as against the debtor and his estate, and therefore the Court may not in that administration be delayed or hindered by being called upon to determine questions between creditors or between a creditor and another person such as assignee of a creditor, or as here a question as to whether or not one creditor is estopped from taking a dividend from the insolvent estate to the prejudice of

[2] ***Re Orzy (Canadian Garment Company)*** (1923), 3 C.B.R. 737

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another. (p. 741)

I turn now to the interpretation and effect of the two agreements that were entered into with the Bankrupt and the effect of the concessions contained in the letters from Mr. Schafer and Davis & Company.

Each of the Rieder and Wenzel agreements have separate paragraphs dealing with the monies owing on account of loans and the monies owing in respect of consulting/construction services. I will address the corresponding paragraphs in the two agreements at the same time.

The language in the Rieder and Wenzel agreements in relation to the loans owing to them is not sufficient to postpone the loans in priority to the monies owing to the Second Round Investors or any of the Bankrupt's creditors. Indeed, paragraph 2 of the Rieder agreement was contemplated to be in favour of Rieder because it was stated to be in consideration of Rieder agreeing in the previous paragraph that it would not pursue its claims against the Bankrupt prior to October 12, 1992. Paragraph 2 was an assurance to Rieder that although it had agreed not to pursue its claims for a specified period of time, it would be paid prior to the distribution of any monies to the First Round Investors. The paragraph does not say, either expressly or by necessary implication, that Rieder has postponed its claims to the rights of the Second Round Investors, the trade creditors or other parties who made loans to the Bankrupt.

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If it was the intention of the draftsperson of the Rieder agreement to bind Rieder to the priority provisions of the proposal, they did not accomplish this intention. But it is doubtful that this was the intention of the draftsperson. Paragraph 2 of the Rieder agreement states the claims will be settled prior to distribution of profits in payment of the loans owing to the First Round Investors (as opposed to being paid at the same time as the loans referred to in clause 6(c) of the Proposal). There is no statement that the loans owing to Rieder would not be paid prior to the repayment of the new investment and bonus or any other amount. It would have been easy for the draftsperson of the Rieder agreement to state that Rieder agreed to be bound by the order of priority contained in paragraph 6 of the Proposal and that Rieder postponed its claims accordingly. There is no equivalent language in the Rieder agreement and one must conclude that the draftsperson had a different intention in drafting the language as they did.

Similarly, paragraph H(a) of the Memorandum of Understanding attached to the Wenzel agreement states that the loans owing to Wenzel will be paid not later than the loans referred to in clause 6(c) of the Proposal. There is no statement that the loans are not to be repaid prior to the new investment and bonus or any other amount. The language in paragraph H(a) of the Memorandum of Understanding is not sufficient to create a postponement or subordination of the loans owed to Wenzel.

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The draftspersons of the Rieder agreement and the Memorandum of Understanding attached to the Wenzel agreement appreciated that monies owing to the two companies for consulting and construction services were not wages or salaries. The draftsperson of the Rieder agreement therefore used the words: "[the monies owing for the consulting services] shall be deemed to be accrued wages for the purpose of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992)". The draftsperson of the Wenzel Memorandum of Understanding used the words: "[the monies owing for the construction services] will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B.C. Ltd.". The issue is whether this language is enforceable to subordinate the claims for consulting/construction services to the claims of the Second Round Investors or any other creditor.

I have found that paragraph 6 of the Proposal is not enforceable because, among other reasons, there are at least two uncertainties that are incapable of clarification by the Court. The Court cannot realistically determine what the parties meant by the term "profits" and the approval of 419776 British Columbia Ltd. to any definition is absent. Also, the evidence indicates that there is uncertainty regarding the loans referred to in clause 6(c). If paragraph 6 of the Proposal itself is unenforceable for these reasons, it follows that paragraph 3 of the Rieder agreement and paragraph C of the Wenzel Memorandum of Understanding, which

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appear to be attempts to incorporate the order of payment set out in paragraph 6 for the purposes of the payment of the consulting/construction services, are unenforceable for the same reasons.

Also, there is an argument that can be made to the effect that in addition to overriding agreements between a bankrupt and its equity type lenders, s. 139 overrides agreements between a bankrupt and its other creditors that would give equity type lenders a priority higher than the priority stipulated by s. 139 (such as the Rieder and Wenzel agreements). I will not address the argument at this time for reasons that will become apparent.

Even if the Court was in a position to formulate a definition for the term "profits", it would presumably bear a resemblance to the statement that the profits are the difference between the revenues and the expenses of the Bankrupt over a certain period of time. However, the Bankrupt's revenues never exceeded its expenses with the result that there is no profit to distribute. The language in paragraph 6 of the Proposal only deals with the distribution of profits and it does not address the present situation of a financial failure. If the new investors had directed their minds to the point, they may have insisted that the order of priorities apply to any distribution of the Bankrupt's assets but I cannot infer that Rieder or Wenzel would definitely have agreed.

The final two matters requiring consideration are the

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concessions made by T.K. Holdings Ltd. and Davis & Company in the letters to the Trustee and its counsel. Neither T.K. Holdings Ltd. nor Davis & Company attended at the hearing of the application and it may not have occurred to them that there is an argument that their agreements with the Bankrupt may be overridden by the provisions of s. 139 of the Bankruptcy Act. Their agreements regarding subordination would not be overridden by s. 139 if they made the agreements directly with the Second Round Investors because the agreements could be enforced between the parties after the making of a distribution that did not violate s. 139. From a purist's point of view, it could be said that the trustee should make the distribution in compliance with s. 139 and leave it to the parties to the subordination agreement to deal with the priorities between them. But if the subordinating creditor concedes that it has subordinated its claim to the claim of a lender which falls within s. 139, I see no reason why the trustee could not pay the share of the subordinating creditor directly to the s. 139 lender as if the subordinating creditor had assigned its claim to the lender.

However, in the present case, the two letters from Mr. Schafer and Davis & Company appear to state that the agreements were made with the Bankrupt. Accordingly, I give them leave to make an application for the purpose of advancing an argument that s. 139 overrides their agreements. I do not expect they will definitely make such an application because I appreciate that they may also have made their agreements with the Second Round

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Investors. In addition, even if there is a potential argument that their agreements with the Bankrupt are not binding in view of s. 139, they may feel a moral commitment to the Second Round Investors that they should not take the portion of the distribution allocable to their pre-February 17, 1992 services in priority to the Second Round Investors.

In the event that the agreements conceded to have been made by T.K. Holdings Ltd. and Davis & Company are not overridden by s. 139, their claims are subordinated to the claims of the Second Round Investors. There is no evidence that they subordinated their claims to all other claims ranking in priority to the claims of the Second Round Investors and that result does not automatically flow from a subordination to the Second Round Investors. If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.

It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the

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same class as the subordinating creditor should not receive the benefit of an subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination was granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

CONCLUSION

In addition to the directions that I have already given, I direct the Trustee as follows:

1. To calculate the amounts for the distribution to the unsecured creditors on the basis that all of the parties who filed proofs of claim except the preferred creditors, the First Round Investors and the Second Round Investors are unsecured creditors of equal ranking;
2. To make the distribution to the unsecured creditors of their respective amounts except the sums that would be

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payable to T.K. Holdings Ltd. and Davis & Company in respect of the indebtedness for services rendered up to February 17, 1992 ($70,666.00 and $61,476.20);

3. To pay these excepted sums to or at the direction of the Second Round Investors if so directed by T.K. Holdings Ltd. or Davis & Company, as the case may be, and, if not so directed by either of T.K. Holdings Ltd. or Davis & Company, to retain the funds in interest bearing accounts pending further Order of this Court on application of T.K. Holdings Ltd., Davis & Company, the Trustee or any other interested party.

This direction is without prejudice to the rights of the Second Round Investors to pursue any of the creditors receiving a portion of the distribution on the basis that such creditor agreed with the Second Round Investors that its claim would be subordinated to their claims.

The Trustee was acting reasonably in bringing this application. Although I did not agree with the Trustee's proposed manner of distribution, I order that the parties shall bear their own costs and that, subject to normal taxation, the Trustee's costs may be paid from the bankruptcy estate.

"D. Tysoe, J."

February 25, 1994
Vancouver, B.C.

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TAB 7

THE LAW OF CONTRACT IN CANADA

by

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to spend production costs of a film in British Columbia if the defendant guaranteed an agreement between the plaintiff and others did not constitute a collateral contract; in *Wind Power Inc. v. Saskatchewan Power Corp.*,[33] where oral representations and agreements could not constitute a collateral contract because a request for proposals issued by the defendant required any such collateral agreements to be in writing and signed by a contact person.[34]

(b) Consideration

Since a collateral contract is a contract, the promise contained therein must be supported by consideration.[35] Where a collateral contract is collateral to a main contract between the same two parties, this has not caused any problems. The consideration for the promise contained in the collateral contract is the promise by the party to whom the statement is made that he will enter into a contract with the maker of the statement, or the eventual entering into such a contract. Where the collateral contract is alleged to exist between a stranger to the main contract and one of the parties to the eventual main contract, consideration for the promise said to be contained in such collateral contract is harder to find. How can it be said to be consideration for a promise by A that B enters into a contract with C? Yet courts in England and Canada have consistently held that consideration for such a collateral contract can be found. In the words of Reid J. in *Murray v. Sperry Rand Corporation*,[36] "a person may be liable for breach of a warranty notwithstanding that he has no contractual relationship with the person to whom the warranty is given."

The cases in which this has been held concern statements by manufacturers about their products, the purpose and effect of which was to induce a person to whom they were made to enter into a contract with a third party to purchase the product in question. In this way the manufacturer is "benefited" by the act of the party to whom the statement was made. That there has to be some benefit to the promisor, to constitute consideration, is axiomatic. In *Shanklin Pier Ltd. v. Detel Products Ltd.*,[37] a paint manufacturer made representations concerning the qualities of its paint to pier owners. In consequence, as the manufacturer intended, the owners caused the paint to be specified in a contract made with another party for painting the pier. The

33 (1999), 179 Sask. R. 95 at 120-121 (Sask. Q.B.) *per* Gunn J.; affirmed 2002 [2002] 7 W.W.R. 73 (Sask. C.A.); leave to appeal refused (2002), 238 Sask. R. 159 (note) (S.C.C.).

34 See also *Northern Petroleum v. Sydney Steel Corp.* (1999), 180 N.S.R. (2d) 141 (N.S.S.C.); affirmed (2000), 202 N.S.R. (2d) 144 (N.S.C.A.); *Comfort v. Saulteaux Band* (2000), 193 Sask. R. 103 (Sask. Q.B.); *Albionex (Overseas) Ltd. v. Conagra Ltd.* (2009), 242 Man. R. (2d) 258 (Man. Q.B.).

35 *Crowe v. Saskatchewan Indian Gaming Authority Inc.* (2006), 276 Sask. R. 218 at 227 (Sask. Q.B.), in which there was no evidence of consideration for an alleged collateral contract restricting the application of a termination clause in a written contract; *Morin v. Board of Education of Regional Administrative Unit No. 3* (1995), 125 Nfld. & P.E.I.R. 211 (P.E.I.C.A.); leave to appeal to S.C.C. refused (1995), 194 N.R. 80n (S.C.C.), where a letter purporting to state that every effort would be made to place the plaintiff in a position in the next year following the year for which he was contractually employed did not constitute a collateral contract, as there was no consideration for such undertaking: *Albionex (Overseas) Ltd. v. Conagra Ltd.* (2009), 242 Man. R. (2d) 258 (Man. Q.B.).

36 (1979), 23 O.R. (2d) 456 at 466 (Ont. H.C.).

37 [1951] 2 K.B. 854.

painting contractor purchased the paint and applied it to the pier. The paint failed to perform as it had been specified it would do. Consequently, the owners of the pier sued the manufacturer. McNair J. held that the manufacturer was liable. As regards the question of consideration, he said[38]

> [i]f, as is elementary, the consideration for the warranty in the usual case is the entering into of the main contract in relation to which the warranty is given, I see no reason why there may not be an enforceable warranty between A and B supported by the consideration that B should cause C to enter into a contract with A or that B should do some other act for the benefit of A.

It would seem clearly established by a long list of cases[39] that in a three party situation a collateral contract can be found to have been entered into for consideration as long as the effect of the collateral contract is that one party thereto makes a contract with a third party, to the ultimate financial benefit of the party making the promise in the collateral contract. Manufacturers, for example, will indirectly benefit through the purchase of their products from dealers. In situations of this kind, there is no necessity for the benefit to the promisor to come directly and immediately from the promisee, as long as there is some eventual economic or similar benefit, and it can be traced back to the actions of the promisee, performed in reliance upon, and as a consequence of the promise contained in the collateral contract.[40]

3. Problems[41]

(a) Inconsistency[42]

An oral collateral contract which varies or modifies a written contract will not be given effect.[43] Such may not be the view adopted by courts in other parts of the

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38 *Ibid.*, at 856.

39 See those cited above in note 8.

40 This sentence, in part, was quoted by Schulman J. at first instance, in *Dale v. Manitoba* (1995), 105 Man. R. (2d) 282 at 290 (Man. Q.B.); affirmed [1997] 8 W.W.R. 447 (Man. C.A.).

41 One is the need to overcome the parol evidence rule: above pp. 440-448. See *Crowe v. Saskatchewan Indian Gaming Authority Inc.* (2006), 276 Sask. R. 218 at 224-225 (Sask. Q.B.); see also *Ceapro Inc. v. Saskatchewan* (2008), 45 B.L.R. (4th) 35 at 67 (Sask. Q.B.) *per* Popescul J., where evidence was admissible to show there was no collateral contract.

42 *Corporate Cars v. Parlee* (2002), 27 B.L.R. (3d) 267 (Ont. S.C.J.); *Wind Power Inc. v. Saskatchewan Power Corp.* (1999), 179 Sask. R. 95 (Sask. Q.B.); affirmed [2002] 7 W.W.R. 73 (Sask. C.A.); leave to appeal refused (2002), 238 Sask. R. 159 (note) (S.C.C.).

43 *Hawrish v. Bank of Montreal*, [1969] S.C.R. 515; *Bauer v. Bank of Montreal* (1980), 110 D.L.R. (3d) 424 (S.C.C.); applied in *Chant v. Infinitum Growth Fund Inc.* (1986), 28 D.L.R. (4th) 577 (Ont. C.A.) to negate a collateral oral agreement, with which contrast *Chrispen v. Topham* (1986), 28 D.L.R. (4th) 754 (Sask. Q.B.); affirmed (1987), 39 D.L.R. (4th) 637 (Sask. C.A.), where oral evidence established such an agreement to govern the relations between a cohabiting man and woman. Contrast *Taylor v. Eisner* (1996), 144 Sask. R. 234 (Sask. C.A.); leave to appeal to S.C.C. refused (1997), 158 Sask. R. 320 (note) (S.C.C.), no admission of parol evidence to prove the existence of an oral collateral contract regarding and affecting the price of the elks which were the subject of a contract of sale.

For examples of inconsistency which resulted in the exclusion of an alleged oral collateral contract, see *Jetaway Invts Ltd. v. Salah* (1986), 73 N.S.R. (2d) 12 (N.S.T.D.); *C.I.B.C. v. Cooper*