EXHIBIT 4

Date: 20010727
Docket: CI 00-01-20164
Indexed as: Manitoba Capital Fund Limited Partnership et al v. Royal Bank of Canada
Cited as: 2001 MBQB 197
(Winnipeg Centre)

COURT OF QUEEN'S BENCH OF MANITOBA

B E T W E E N:

MANITOBA CAPITAL FUND LIMITED PARTNERSHIP, by its General Partner, MCF CAPITAL INC., VISION CAPITAL FUND LIMITED PARTNERSHIP, by its General Partner, MSBG LIMITED, GOVERNMENT OF MANITOBA, FORMATIONS INC., and SAUDER INDUSTRIES LIMITED,	plaintiffs,	For the plaintiffs: Kenneth A. Filkow, Q.C., Robert J. Graham and Diane M. Stasiuk
- and -		For the defendant: Paul A. MacDonald, David R.M. Jackson and Gina Rogakos
ROYAL BANK OF CANADA,	defendant.	For KPMG Inc., Trustee: R.A. Dewar, Q.C.
		JUDGMENT DELIVERED: JULY 27, 2001

MACINNES, J.

[1] The defendant moves:

(1) for a declaration pursuant to s. 69.4 of the ***Bankruptcy and Insolvency Act*** ("BIA") that the stay of proceedings ("BIA Stay") against Delano Cabinetry Inc., Schmidtke Millwork (1993) Ltd., Northstar Gaming Ltd., Form-Right Countertops Ltd., Century Craft Marine Products Ltd., Mark Trent Commercial Furnishings Inc., and

TSG Capital Corp. (collectively "TSG Companies"), no longer operates against the defendant; and

(2) for an order granting the defendant leave to amend its Statement of Defence, assert a counterclaim, and join the TSG Companies and KPMG Inc. in its capacity as trustee of the estates of each of the TSG Companies, as defendants to the counterclaim.

[2] The plaintiffs move for an order to expunge paragraph 19 of the Statement of Defence filed in this action by the defendant.

[3] For the reasons which follow, I allow the defendant's application to amend its Statement of Defence, to assert a counterclaim, and to join the TSG Companies and KPMG Inc. in its capacity as trustee of the estates of each of the TSG Companies as defendants to the counterclaim, all as requested in the defendant's Notice of Motion. I also grant the declaration pursuant to s. 69.4 of the BIA that the BIA Stay against TSG Companies no longer operates against the defendant for purposes of this litigation. As well, I dismiss plaintiffs' application to strike or expunge paragraph 19 of the defendant's Statement of Defence.

[4] By orders made June 27, 2000 in the bankruptcy estates of Northstar, Schmidtke and Delano, Manitoba Capital Fund Limited Partnership ("MCF") was authorized under s. 38 of the BIA to commence and prosecute proceedings (the "s. 38 action") in its own name, at its own expense and risk:

(a) challenging the validity and enforceability of a loan arrangement made between the Royal Bank as lender and the Bankrupt (Northstar, Schmidtke and Delano), as it then was, *inter alia* as

> borrower and the security taken by the Royal Bank from the Bankrupt, as it then was, under the said loan arrangement;
>
> (b) challenging the integrity at law of an off-set by the Bank of monies in the account of the Bankrupt, prior to the bankruptcy, as against overdrafts, and the integrity at law of related transactions.

[5] Following the making of such orders, MCF wrote to each of the creditors of the TSG Companies advising of the orders, of its intent to proceed with action and of the effect and consequences of an action brought under s. 38 of the BIA. As well, it invited other creditors to indicate whether they wished to join in such action as plaintiffs with MCF. Four other creditors, namely, Vision Capital Fund Limited Partnership, Government of Manitoba, Formations Inc., and Sauder Industries Limited, signified their intention to join in the s. 38 action.

[6] After obtaining an extension of time for the purpose of considering and determining its position, the defendant signified its intention to likewise participate in the s. 38 action and sought leave to do so. One of the concerns that had to be addressed in the defendant's application was that it was to be the defendant in the proposed s. 38 action. While the defendant wished to preserve its interest in the proceeds of the s. 38 litigation and was prepared to contribute pro rata to the cost of prosecuting the action, it could not participate as a full plaintiff in the sense of participating in the strategy and prosecution of the action given its status as defendant. By orders made September 8, 2000, the Court varied the July 27, 2000 orders to provide that the defendant could maintain a contingent interest in the monetary benefits which might be derived from the s. 38 action, subject to the terms of the September 8, 2000 orders.

[7] On October 5, 2000, the s. 38 plaintiffs issued their Statement of Claim. In it, they alleged that the loan agreements and related security which the defendant holds with respect to the TSG Companies contravene s. 42 of ***The Corporations Act*** (Manitoba), and being illegal are therefore void and unenforceable.

[8] On November 2, 2000, the defendant filed its defence. It denied any contravention of s. 42 of ***The Corporations Act***. In addition, in para. 19 of its Statement of Defence, it pled:

> 19. The defendant specifically denies the allegations contained in para. 22 of the Statement of Claim. In any event, regardless of the validity and enforceability of the lending arrangement, each of Delano, Northstar and Schmidtke and the other TSG Companies is jointly and severally liable to the defendant for damages suffered by the defendant as a consequence of an unlawful conspiracy engaged in by the TSG Companies and their directing mind, Michael Shamray, to defraud the defendant (the "Conspiracy to Defraud"). The damages suffered by the defendant as a result of the Conspiracy to Defraud, for which each of Delano, Northstar and Schmidtke is jointly and severally liable, exceeds $35,000,000.00. If the lending arrangement or any part thereof is void and unenforceable (which is expressly denied), the bank is entitled to recover the said damages from the estates in bankruptcy of each of Delano, Northstar and Schmidtke.

[9] As previously indicated herein, the defendant now moves to amend its defence, to advance a counterclaim, and to add the TSG Companies and KPMG as trustee as party defendants to the counterclaim. The proposed amendments to the defence can be grouped into five broad categories:

(a) general "clean-up" amendments;

(b) amendments to plead the defendant's right to recover overdraft advances under Financial Services Agreements signed by the defendant with each of the TSG Companies;

(c) amendments relating to the alleged insolvency of the TSG Companies and the "no notice" defence afforded by s. 42(3) of ***The Corporations Act***;

(d) amendments relating to the alleged fraudulent activities of the TSG Companies; and

(e) amendments relating to equitable principles of unjust enrichment.

[10] The plaintiffs take no issue with the amendments proposed under (a), (b) or (c) above. The contest on this motion relates to the proposed amendments under (d) and (e) and the consequent adding of parties, and the request to lift the BIA Stay which would necessarily follow.

[11] On the motions before me, defendant's counsel first argued its motion for leave to amend and then its motion to lift the stay. In these reasons I propose to deal with those issues in the order in which they were argued.

LEAVE TO AMEND

[12] As a general rule, the law is clear that the Court on motion at any stage of an action may grant leave to amend a pleading on such terms as are just, unless prejudice would result that could not be compensated for by costs or an adjournment. This simple statement has been amplified in the leading case of ***Ranjoy Sales & Leasing Ltd. v. Deloitte, Haskins & Sells Ltd.*** (1989), 35

C.P.C. (2d) 117, a decision of my colleague Jewers J., affirmed by the Manitoba Court of Appeal (1990), 41 C.P.C. (2d) 280 and, in my view, has been further usefully amplified by the decision of my colleague Oliphant A.C.J.Q.B. in ***Lloyd's Bank Canada v. Sherwood*** (1990), 64 Man. R. (2d) 288.

[13] This action is somewhat out of the ordinary in that it is an action within or related to certain bankruptcy estates and commenced by the plaintiffs pursuant to court orders granted under s. 38 of the BIA.

[14] As a result the plaintiffs, in opposing the application for leave to amend, assert that the terms of the s. 38 orders circumscribe the defendant's interest in the litigation and foreclose the defendant from entitlement to amend either to raise the defences which it seeks to raise or, more particularly, to advance the counterclaim and add parties as defendants by counterclaim, which the defendant likewise seeks to do. The plaintiffs assert that pursuant to the terms of the s. 38 orders, the defendant's only entitlement is to raise as defences to the action those defences which would fall squarely within the parameters of s. 42 of ***The Corporations Act*** and, further, that any claim which the defendant might advance in the action should relate only to direct advances made by the defendant to the TSG Companies under the lending agreements executed between them. The plaintiffs argue that at the time they agreed to commit as s. 38 plaintiffs and to agree to share pro rata in the financing of the litigation, they did so on the understanding that the defendant would be so restricted in the action. The s. 38 plaintiffs further assert that the defendant, as far back as the

fall of 1998, had knowledge of and believed the TSG Companies to be guilty of the fraudulent conduct it now wishes to allege, yet made no mention of any intention to advance a defence or counterclaim based upon that fraud at the time of the court appearances leading to the June 27 or September 8, 2000 orders. The s. 38 plaintiffs argue that for that reason and based upon the language of those orders, the defendant should be precluded from now doing so.

[15] My recollection is similar to that enunciated by plaintiffs' counsel. On the motions leading to the June 27 and September 8, 2000 orders, there was no discussion or assertion by the defendant of any fraudulent conduct on the part of the TSG Companies, nor any suggestion that it intended to raise any defence(s) nor to advance any counterclaim based upon this conduct. However, I am not aware of any agreement between plaintiffs and defendant which would limit the scope of this litigation, and the orders were not consent orders. Both orders were granted on the basis of the issues argued before me at the time. Furthermore, I see nothing in the orders which limits the rights of the defendant as to the scope of its defence, or as to the advancing of any counterclaim. I conclude, therefore, that neither the materials filed nor the submissions made by counsel in obtaining the July 27 and September 8, 2000 orders, nor the language of the orders themselves, limit the defendant from attempting to advance, or (subject to meeting the requirements for leave to amend) from advancing, the defences and/or counterclaim which it now proposes.

[16] Ordinarily, the estate, rights and obligations of a bankrupt become vested in its trustee. In this case, KPMG refused to commence the action which the s. 38 plaintiffs desired and those plaintiffs then sought and obtained the orders in question. In ***Re Zammit*** (1998), 3 C.B.R. (4th) 193 the Court stated:

> In a s. 38 proceeding, the creditor obtaining a s. 38 order advances not his or her own cause of action, but the trustee's cause of action. Section 38 does not create a cause of action in the creditor, but merely allows the creditors standing in the trustee's place to advance a cause of action vested in the trustee which the trustee has refused to take.

[17] In effect, the s. 38 plaintiffs in this action are in essence representatives of the trustee. It seems clear to me that if the trustee had advanced this action against the defendant, attacking, as the s. 38 plaintiffs do, the defendant's loan agreements and resulting security with the TSG Companies, the defendant would be entitled to advance any defences or counterclaims against the TSG Companies which might assist it in defending the action, and/or providing it with a basis in law for recovery of all of the monies which it has lost whether as a secured or unsecured creditor. Where, as here, the plaintiffs pursuant to s. 38 of the BIA are, in essence, advancing not their own cause of action but the cause of action vested in the trustee which the trustee has refused to take, it follows logically, in my view, that the defendant ought to be entitled to advance any defence and/or counterclaim which it would have been able to advance in an action commenced by the trustee. In my view, therefore, the defendant should be entitled to advance any such defence or counterclaim in this s. 38 action and, subject to the lifting of the BIA Stay, should be entitled to add the trustee in the TSG Companies as party defendants to the counterclaim.

[18] Is there anything to prevent the defendant from receiving leave to amend its Statement of Defence and to advance a counterclaim at this time? In my view there is not. The law is clear that as a general rule, an amendment should be allowed unless it will cause prejudice to the other side which cannot be compensated for by costs or an adjournment. The material filed in support of the application to amend must indicate that the proposed amendments present issues worthy of trial and *prima facie meritorious*. An amendment should not be allowed which, if it were originally pleaded, would have been struck out as embarrassing. It is not for me on this application to consider the ultimate merits of the issues proposed to be raised by amendment. That is for the trial judge. My role on an application such as this is to determine only whether there is *prima facie* merit in the proposed amendments.

[19] Here, in addition to denying any contravention of s. 42 of ***The Corporations Act***, and alternatively raising the defence provided under s. 42(3) of that Act, the defendant proposes by amendment to raise the following defences:

(1) That the TSG Companies obtained credit by fraudulent misrepresentation. More specifically, that the TSG Companies fraudulently induced the defendant to extend credit by forging customer invoices, deliberately overstating receivables and deliberately delivering false financial statements, margin reports and compliance certificates upon which the defendant relied;

(2) The defendant asserts that if the Court finds a breach of s. 42 of ***The Corporations Act***, it must then consider whether it and the TSG Companies are in *pari delicto*. The defendant's intended argument is that the fraud of the TSG Companies is a relevant factor in considering the issue of *pari delicto*. It says that if the parties are found to be not in *pari delicto* in the sense that the TSG Companies were more at fault because of their fraudulent conduct, then the defendant ought to be entitled to enforce the lending agreement and its security against the TSG Companies despite any contravention of s. 42 of ***The Corporations Act***;

(3) Alternatively, the defendant wishes to plead that even if it loses its right to recover under the loan agreement, each of the TSG Companies is jointly and severally liable to it under the security agreements executed by them in favour of the defendant for damages that the defendant has suffered as a result of the fraudulent activities of the TSG Companies. The defendant asserts that these damages exceed $46,000,000.00 and are a secured liability, so that the defendant would be entitled to recover such damages as a secured creditor whether or not the loan agreements are void and unenforceable by reason of a breach of s. 42 of ***The Corporations Act***.

(4) Lastly, the defendant wishes to plead that regardless of its right to recover under the loan agreement, it is entitled to retain all of the funds which have been claimed by the s. 38 plaintiffs in their Statement of Claim based upon the application of the equitable principle of unjust enrichment.

[20] The fraud allegations are central to all of these proposed defences. Furthermore, the fraud allegations in each of the defences are the basis for the defendant's counterclaim. Whether the defendant can prove fraud and/or succeed on any of the defences it now proposes to advance will ultimately be a matter for the trial judge. For purposes of the present application before me, however, I am satisfied that there is *prima facie* merit in them.

[21] As regards the issue of prejudice, the current action is in its infancy. There has been no production of documents nor examinations for discovery. The onus is on the plaintiffs to show on a balance of probabilities that prejudice will result if the amendment is allowed and that the prejudice cannot be compensated by costs or an adjournment. Having considered the arguments advanced and the authorities provided, I am satisfied that there is no prejudice in law to the s. 38 plaintiffs if the application were allowed.

[22] There has been no delay of any significance on the part of the defendant in moving for its amendment and to the extent that there has been delay, it has been adequately explained. The defendant says two things in response to plaintiffs' assertion that it did not sooner advance the fraud issue or propose the

amendments which it now seeks. Firstly it asserts, quite rightly in my view, that until the s. 38 order was obtained there had been no attack against the defendant's lending agreement or its security, and being a secured creditor of such magnitude as to be entitled if not to all, to very nearly all of the monies available, there was no need to get into the issues now proposed. Furthermore, the s. 38 order required that, once granted, action be commenced and a defence filed within a strict time frame. The defendant filed its defence as required, but its counsel asserts that it did not have sufficient time in which to draft its defence or formulate a counterclaim as it now wishes to do. Further and in any event, given the infancy of the action itself and the total lack of prejudice to the plaintiffs by reason of the proposed amendments, the issue of delay is of no moment or merit.

SHOULD THE BIA STAY BE LIFTED?

[23] Section 69.4 of the BIA provides that the Court may grant a declaration to lift the BIA Stay if it is satisfied that:

(a) the creditor is likely to be materially prejudiced by the continued operation of the BIA Stay; or

(b) it is equitable on other grounds to make such a declaration.

[24] In ***Re Advocate Mines Ltd.*** (1984), 52 C.B.R. (N.S.) 277, the Court enunciated certain circumstances which warranted granting leave to commence or continue proceedings against a bankrupt. Two of those circumstances, the defendant asserts, are present here, namely:

(1) actions in respect of a contingent or unliquidated debt, the proof and valuation of which have the degree of complexity that makes the summary procedure prescribed by the BIA inappropriate;

(2) actions in which the bankrupt is a necessary party for the complete adjudication of the matters at issue involving other parties.

I agree. Having concluded that the defendant ought to be entitled to raise in this action any defences and to advance any counterclaim which it would be entitled to do against the trustee in respect of the bankrupt companies, it is in my view both appropriate and necessary to do so in this action and, consequently, to lift the stay and enable the defendant to add the trustee and the TSG Companies as parties.

[25] There is no question but that the allegations which the defendant now proposes to make involve only the bankrupt companies and do not involve the s. 38 plaintiffs. While this decision will undoubtedly make the s. 38 action more complex, lengthy and costly than would be the case if the defendant were required to commence separate proceedings against the trustee and the bankrupt companies, it is in my view, both from a legal and practical point of view, essential that all of these issues be resolved in one action rather than in separate proceedings. From a legal point of view, it is important that we avoid the possibility of two separate decisions perhaps inconsistent with one another, respecting the validity of the loan agreement and/or the security. From a practical standpoint, I note the following:

(1) If there were two separate actions, there would undoubtedly be no distribution of the bankrupts' estates until after both actions were completed. Accordingly, going ahead with the current action would not result in the plaintiffs' receiving payment of any distribution out of the bankrupts' estates until the second or separate action was completed;

(2) One would expect that the s. 38 plaintiffs would want to have some direct input into a proceeding whose outcome could materially affect the amount of their realization. Yet, if the defendant were not allowed to proceed with its claim in this action, but instead was required to commence a separate action against the trustee and the bankrupt companies, the result would be that the outcome of that action could materially affect the s. 38 plaintiffs' entitlement without their having had any opportunity to participate in that action. That is particularly so where, as in this case, the trustee declined to take the proceedings now commenced by the s. 38 plaintiffs and might decline to defend proceedings commenced against it and the bankrupt companies in any separate action. The bankrupt companies, being bankrupt, might do likewise. In the result, if the action were required to proceed separate and apart from this action, the issues of fraud and the consequences of such a finding could go by default. It may be that the s. 38 plaintiffs will

> decide not to participate in any way in respect of the fraud or consequent unjust enrichment defences or counterclaim. That is their choice. However, by including them in the present action, the s. 38 plaintiffs are allowed the opportunity to have direct input into these defences and/or the counterclaim, one decision will ultimately result, and at the conclusion of the one action distribution will be made accordingly without the need for it to be withheld pending the outcome of other litigation.

[26] In short, I conclude that this is a case where the amendments proposed by the defendant should be allowed, where the defendant should be entitled to advance the counterclaim which it proposes, and where the stay under BIA should be lifted so as to permit the defendant to add the trustee and bankrupt companies as party defendants.

[27] In light of the foregoing, there is in my view no merit in the plaintiffs' motion to expunge or strike paragraph 19 of the defendant's Statement of Defence, and plaintiffs' motion is therefore dismissed.

[28] If the parties cannot agree upon costs, they may be spoken to.

J.