Court of Appeal File No. M41654
Superior Court File No. CV-12-9667-00-CL

COURT OF APPEAL FOR ONTARIO

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

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

Applicant

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

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August 17, 2012

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Court File No. CV-12-9667-00-CL

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

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1. *Blue Range Resource Corporation*, 2000 ABQB 4 (CanLII).

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3. *Re Earthfirst Canada Inc.*, 2009 ABQB 316 (CanLII).

4. *Central Capital Corp.*, (1996), 132 D.L.R. (4^{th}) 223 (Ont. C.A.).

5. *Return on Innovations* v. *Gandi Innovations,* 2011 ONSC 5018.

6. *ROI Fund Inc.* v. *Gandi Innovations Ltd.*, 2012 ONCA 10.

7. Bill C-12, Clause by Clause Analysis.

8. Senate Committee on Banking, Trade and Commerce, Debtors and Creditors Sharing the Burden: A Review of the *Bankruptcy and Insolvency Act* and *Companies' Creditors Arrangement Act*, Nov. 2003.

9. *Re De Laurentiis Entertainment Group Inc.*, 1991, (CD Cal), 124 B.R. 305.

10. *Nelson Financial Group Ltd.,* 2010 ONSC 6229.

11. *Re Canadian Airlines Corp.* (2000), 19 C.B.R. (4^{th}) 33 (Alta. C.A.).

12. *RJR MacDonald Inc. v. Canada (Attorney General)* (1994), 111 D.L.R. (4th) 385.

13. *Kane v. Board of Governors of University of British Columbia*, [1980] I S.C.R. 1105.

14. *Apotex Fermentation Inc. v. Novopharm Ltd.*, [1994] 95 Man. R. (2d) 241 (C.A.).

Tab 1

Indexed as:

Blue Range Resource Corp. (Re)

IN THE MATTER OF The Companies' Creditors Arrangement Act, R.S.C. 1985, C. C-36, as amended AND IN THE MATTER OF Blue Range Resource Corporation

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Action No. 9901-04070

Alberta Court of Queen's Bench
Judicial District of Calgary

Romaine J.

Judgment: filed January 10, 2000.

(84 paras.)

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REASONS FOR JUDGMENT

ROMAINE J.:--

INTRODUCTION

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

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

FACTS

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

(a) it purchased shares of Blue Range for cash through The Toronto Stock Exchange on October 27 and 29, 1998;
(b) it undertook a hostile takeover bid on November 13, 1998, by which it sought to acquire all of the issued and outstanding Blue Range shares;
(c) it paid for the Blue Range shares sought through the takeover bid by way of a share exchange: Blue Range shareholders accepting Big Bear's offer received 11 Big Bear shares for each Blue Range share;
(d) it issued Big Bear shares from treasury to provide the shares used in the share exchange.

4 The takeover bid was accepted by Blue Range shareholders and on December 12, 1998, Big Bear acquired control of Blue Range. It is now the sole shareholder of Blue Range.

5 Big Bear says that its decision to undertake the takeover was made in reliance upon information publicly disclosed by Blue Range regarding its financial situation. It says that after the takeover, it discovered that the information disclosed by Blue Range was misleading, and in fact the Blue Range shares were essentially worthless.

6 Big Bear as the sole shareholder of Blue Range entered into a Unanimous Shareholders'

Agreement pursuant to which Big Bear replaced and took on all the rights, duties and obligations of the Blue Range directors. Using its authority under the Unanimous Shareholders' Agreement, Big Bear caused Blue Range to apply for protection under the CCAA. An order stipulating that Blue Range is a company to which the CCAA applies was granted on March 2, 1999.

7 On April 6, 1999, LoVecchio, J. issued an order which provides, in part, that:

(a) all claims of any nature must be proved by filing with the Monitor a Notice of Claim with supporting documentation, and
(b) claims not received by the Monitor by May 7, 1999, or not proved in accordance with the prescribed procedures, are forever barred and extinguished.

8 Big Bear submitted a Notice of Claim to the Monitor dated May 5, 1999 in the amount of $151,317,298 as an unsecured claim. It also filed a Notice of Motion on May 5, 1999, seeking an order lifting the stay of proceedings granted by the March 2, 1999 order for the purpose of filing a statement of claim against Blue Range. Big Bear's application for leave to file its statement of claim was denied by LoVecchio, J. on May 11, 1999.

9 On May 21, 1999, the Monitor issued a Notice of Dispute disputing in full the Big Bear claim. Big Bear filed a Notice of Motion on May 31, 1999 for:

(a) a declaration that the unsecured claim of Big Bear is a meritorious claim against Blue Range; and
(b) an order directing the expeditious trial and determination of the issues raised by the unsecured claim of Big Bear.

10 On October 4, 1999, LoVecchio, J. directed that there be a determination of two issues in respect of the Big Bear unsecured claim by way of a preliminary application. On October 28, 1999, I defined the two issues and added a third one.

11 Big Bear's Notice of Claim sets out the nature and amount of its claim against Blue Range. The amount is particularized by the schedule attached to the Notice of Claim, which identifies the claim as being comprised of the following components:

(a) the price of shares acquired for cash on October 27 and 29, 1998 ($724,454.91);
(b) the value of shares acquired by means of the share exchange of Big Bear treasury shares for Blue Range shares held by Blue Range shareholders ($147,687,298); and
(c) "transaction costs," being costs incurred by Big Bear for consultants, professional advisers, filings, financial services, and like matters incidental to the share purchases generally, and the takeover bid in particular

($3,729,498).

ISSUE #1

12 With respect to the alleged share exchange loss, without considering the principle of equitable subordination, is Big Bear:

(a) an unsecured creditor of Blue Range that ranks equally with the unsecured creditors of Blue Range; or

(b) a shareholder of Blue Range that ranks after the unsecured creditors of Blue Range.

13 At the hearing, this question was expanded to include reference to the transaction costs and cash share purchase damage claims in addition to the alleged share exchange loss.

Summary of Decision

14 The nature of the Big Bear claim against Blue Range for an alleged share exchange loss, transaction costs and cash share purchase damages is in substance a claim by a shareholder for a return of what it invested qua shareholder. The claim therefore ranks after the claims of unsecured creditors of Blue Range.

Analysis

15 The position of the Applicants is that the share exchange itself was clearly an investment in capital, and that the claim for the share exchange loss derives solely from and is inextricably intertwined with Big Bear's interest as a shareholder of Blue Range. The Applicants submit that there are therefore good policy reasons why the claim should rank after the claims of unsecured creditors of Blue Range, and that basic corporate principles, fairness and American case law support these policy reasons. Big Bear submits that its claim is a tort claim, allowable under the CCAA, and that there is no good reason to rank the claim other than equally with unsecured creditors. Big Bear submits that the American cases cited are inappropriate to a Canadian CCAA proceeding, as they are inconsistent with Canadian law.

16 There is no Canadian law that deals directly with the issue of whether a shareholder allegedly induced by fraud to purchase shares of a debtor corporation is able to assert its claim in such a way as to achieve parity with other unsecured creditors in a CCAA proceeding. It is therefore necessary to start with basic principles governing priority disputes.

17 It is clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full: Re: Central Capital Corp. (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at page 245; Canada Deposit Insurance Corp. v. Canadian Commercial Bank (1992), 97 D.L.R. (4th) 385 (S.C.C.) at pages 402 and 408. In that sense, Big Bear acquired not only rights but restrictions under corporate law when it acquired the Blue Range shares.

18 There is no doubt that Big Bear has exercised its rights as a shareholder of Blue Range. Pursuant to the Unanimous Shareholders' Agreement, it authorized Blue Range to file an application under the CCAA "to attempt to preserve the equity value of [Blue Range] for the benefit of the sole shareholder of [Blue Range]" (Bourchier November 1, 1999 affidavit). It now attempts to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim. The issue is whether this is a collateral attempt to obtain a return on an investment in equity through equal status with ordinary creditors that could not be accomplished through its status as a shareholder.

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

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

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

22 In this case, the true nature of Big Bear's claim is more difficult to characterize. There may well be scenarios where the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, such as where a shareholder is also a regular trade creditor of a

corporation, or slips and falls outside the corporate office and thus has a claim in negligence against the corporation. In the current situation, however, the very core of the claim is the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder, as it suffered no damage until it acquired such shares. This tort claim derives from Big Bear's status as a shareholder, and not from a tort unrelated to that status. The claim for misrepresentation therefore is hybrid in nature and combines elements of both a claim in tort and a claim as shareholder. It must be determined what character it has in substance.

23 It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value - in other words, money back from what Big Bear "paid" by way of consideration. Although the matter is complicated by reason that the consideration paid for Blue Range shares by Big Bear was Big Bear treasury shares, the Notice of Claim filed by Big Bear quantifies the loss by assigning a value to the treasury shares. A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principal that shareholders rank after creditors in respect of any return on their equity investment. Whether payment of the tort liability by Blue Range would affect Blue Range's stated capital account is irrelevant, since the shares were not acquired from Blue Range but from its shareholders.

24 In considering the question of the characterization of this claim, it is noteworthy that Mr. Tonken in his March 2, 1999 affidavit in support of Blue Range's application to apply the CCAA did not include the Big Bear claim in his list of estimated outstanding debt, accounts payable and other liabilities. The affidavit does, however, set out details of the alleged mispresentations.

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

26 Given the true nature of the claim, where should it rank relative to the claims of unsecured creditors?

27 The CCAA does not provide a statutory scheme for distribution, as it is based on the premise that a Plan of Arrangement will provide a classification of claims which will be presented to creditors for approval. The Plan of Arrangement presented by CNRL in the Blue Range situation has been approved by creditors and sanctioned by the Court. Section 3.1 of the Plan states that claims shall be grouped into two classes: one for Class A Claimants and one for Class B Claimants, which are described as claimants that are "unsecured creditors" within the meaning of the CCAA, but do not include "a Person with a Claim which, pursuant to Applicable Law, is subordinate to claims of trade creditors of any Blue Range Entities." The defined term "Claims" includes indebtedness, liability or obligation of any kind. Applicable Law includes orders of this Court.

28 Although there are no binding authorities directly on point on the issue of ranking, the Applicants submit that there are a number of policy reasons for finding that the Big Bear claim should rank subordinate to the claims of unsecured creditors.

29 The first policy reason is based on the fundamental corporate principle that claims of shareholders should rank below those of creditors on an insolvency. Even though this claim is a tort claim on its face, it is in substance a claim by a shareholder for a return of what it paid for shares by way of damages. The Articles of Blue Range state that a holder of Class A Voting Common Shares is entitled to receive the "remaining property of the corporation upon dissolution in equal rank with the holders of all other common shares of the Corporation". As pointed out by Laskin, J. in Central Capital (supra at page 274):

> Holding that the appellants do not have provable claims accords with sound corporate policy. On the insolvency of a company the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment. Creditors rely on these protections in making loans to companies.

30 Although what is envisaged here is not that Blue Range will pay out funds to retract shares, the result is the same: Blue Range would be paying out funds to the benefit of its sole shareholder to the prejudice of third-party creditors.

31 It should be noted that this is not a case, as in the recent restructuring of Eatons under the CCAA, where a payment to the shareholders was clearly set out in the Plan of Arrangement and approved by the creditors and the court.

32 As counsel for Engage Energy, one of the trade creditors, stated on May 11, 1999 during Big Bear's application for an order lifting the stay order under the CCAA and allowing Big Bear to file a statement of claim:

> We've gone along in this process with a general understanding in our mind as to what the creditor pool is, and as recently as middle of April, long after the evidence will show that Big Bear was identifying in its own mind the existence of this claim, public statements were continuing to be made, setting out the creditor pool, which did not include this claim. And this makes a significant difference in how people react to supporting an ongoing plan...

33 Another policy reason which supports subordinating the Big Bear claim is a recognition that creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of an insolvency. This assumption was referred to by Laskin, J. in Central

Capital (supra), in legal textbooks (Hadden, Forbes and Simmonds, Canadian Business Organizations Law Toronto: Butterworths, 1984 at 310, 311), and has been explicitly recognized in American case law. The court in In the Matter of Stirling Homex Corporation, 579 F. 2d 206 (1978) U.S.C.A. 2nd Cir. at page 211 referred to this assumption as follows:

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

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

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

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

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

38 The court in McAskill (supra at page 419) in obiter dicta refers to a claim of recission for fraud, and comments that the right to rescind in such a case may be lost due to a change of circumstances making it unjust to exercise the right. Duff, J. then refers to the long settled principle that a shareholder who has the right to rescind his shares on the ground of misrepresentation will lose that right if he fails to exercise it before the commencement of winding-up proceedings, and comments:

> The basis of this is that the winding-up order creates an entirely new situation, by altering the relations, not only between the creditors and the shareholders, but also among the shareholders inter se.

39 This is an explicit recognition that in an insolvency, a corporation may not be able to satisfy the claims of all creditors, thus changing the entire complexion of the corporation, and rights that a shareholder may have been entitled to prior to an insolvency can be lost or limited.

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

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

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

43 The first of these cases is Stirling Homex (supra). The issue dealt with by the United States Court of Appeals, Second Circuit, is directly on point: whether claims filed by allegedly defrauded shareholders of a debtor corporation should be subordinated to claims filed by ordinary unsecured creditors for the purposes of formulating a reorganization plan. The court referred to the decision of Pepper v. Litton (308 U.S. 295 at page 305, 60 S.Ct. 238, 84 L. Ed. 281 (1939)) where the Supreme

Court commented that the mere fact that a shareholder has a claim against the bankrupt company does not mean it must be accorded pari passu status with other creditors, and that the subordination of that claim may be necessitated by principles of equity. Elaborating on this, the court in Stirling Homex (supra at page 213) stated that where the debtor corporation is insolvent, the equities favour the general creditors rather than the allegedly defrauded shareholders, since in this case, the real party against which the shareholders are seeking relief is the general creditors whose percentage of realization will be reduced if relief is given to the shareholders. The court quotes a comment made by an earlier Court of Appeals (Newton National Bank v. Newbegin, 74 F. 135, 140 (8th Cir. 1896):

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

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

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

46 The Applicants also cite the case of In re U.S. Financial Incorporated 648 F. 2d 515 (1980)(U.S.C.A. 9th Cir.). This case is less useful, as it was decided primarily on the basis of the absolute priority rule, but while the case was not decided on equitable grounds, the court commented that support for its decision was found in the recognition of the importance of recognizing differences in expectations between creditors and shareholders when classifying claims (supra at page 524). The court also stated that although both creditors and shareholders had been victimized by fraud, it was equitable to impose the risks of insolvency and illegality on the shareholders whose investment, by its very nature, was a risky one.

47 The final case cited to me on this issue is In re THC Financial 679 F. 2d 784 (1982) (U.S.C.A. 9th Cir.), where again the court concluded that claims of defrauded shareholders must be subordinated to the claims of the general creditors. The court commented that the claimant shareholders had bargained for equity-type profits and equity-type risks in purchasing their shares, and one such risk was the risk of fraud. As pointed out previously, Big Bear had an appreciation of

the risks of proceeding with its takeover bid without access to the books and records of Blue Range and took the deliberate risk of proceeding in any event.

48 In THC Financial, the claimants argued that since they had a number of possible causes of action in addition to their claim of fraud, they should not subordinated merely because they were shareholders. The court found, however, that their claim was essentially that of defrauded shareholders and not as victims of an independent tort. All of the claimants' theories of recovery were based on the same operative facts - the fraudulent scheme.

49 Big Bear submits that ascribing some legal impediment to a shareholder pursuing a remedy in tort against a company in which it holds shares violates the principle set out in Salomon v. Salomon and Company, Limited [1897] A.C. 22 (H.L.) that corporations are separate and distinct entities from their shareholders. In my view, this is not in issue. What is being sought here is not to limit a tort action by a shareholder against a corporation but to subordinate claims made qua shareholder to claims made by creditors in an insolvency situation. That shareholder rights with respect to claims against a corporation are not unlimited has already been established by the cases on rescission and recognized by statutory limitations on redemption and retraction. In this case, the issue is not the right to assert the claim, but the right to rank with creditors in the distribution of the proceeds of a pool of assets that will be insufficient to cover all claims. No piercing of the corporate veil is being suggested or would result.

50 Counsel for Big Bear cautions against the adoption of principles set out in the American cases on the basis that some decisions on equitable subordination require inequitable conduct by the claimant as a precondition to subordinating a claim, referring to a three-part test set out in a number of cases. This discussion of the inequitable conduct precondition takes place in the broader context of equitable subordination for any cause as it is codified under Section 510 of the US Bankruptcy Code. In any event, it appears that more recent American cases do not restrict the use of equitable subordination to cases of claimant misconduct, citing, specifically, that stock redemption claims have been subordinated in a number of cases even when there is no inequitable conduct by the shareholder. "Stock redemption" is the term used for cases involving fraud or misrepresentation: U.S. v. First Truck Lines, Inc. (1996) 517 U.S. 535; SPC Plastics Corporation et al v. Griffiths et al (1998) 6th Circuit Case No. 88-21236. Some of the American cases draw a distinction between cases where misconduct is generally required before subordination will be imposed and cases where "the claim itself is of a status susceptible to subordination, such as...a claim for damages arising from the purchase ... of a security of the debtor": U.S. v. First Truck Lines, Inc. (supra, at paragraph 542).

51 The issue of whether equitable subordination as codified in Section 510 of the U.S. Bankruptcy Code should form part of the law in Canada has been raised in several cases but left undecided. Big Bear submits that these cases establish that if equitable subordination is to be part of Canadian law, it should be on the basis of the U.S. three-part test which includes the condition of inequitable conduct. Again, I cannot accept this submission. It is true that Iacobucci, J. in Canada

Deposit Insurance Corp., while he expressly refrains from deciding whether a comparable doctrine should exist in Canada, refers to the three-part test and states that he does not view the facts of the Canada Deposit Insurance Corp. case as giving rise to inequitable conduct. It should be noted, however, that that case did not involve a claim by a shareholder at all, since the lenders had never received the securities that were an option under the agreements, and that the relationship had at this point in the case been characterized as a debtor/creditor relationship.

52 At any rate, this case, together with Olympia and York Developments Ltd. v. Royal Trust Co. [1993] O.J. No. 181 (Ont. G.D.) and Unisource Canada Inc. v. HongKong Bank of Canada [1998] O.J. No. 5586 (Ont. H.C.) all refer to the doctrine of equitable subordination codified in the U.S. Bankruptcy Code which is not in issue here. The latter two cases appear to have accepted the erroneous proposition that inequitable misconduct is required in all cases under the American doctrine.

53 Big Bear also submits that the equitable principles that exist in U.S. law which have led the courts to ignore separate corporate personality in the case of subsidiary corporations are related to equitable principles used to subordinate shareholder claims. The basis for this submission appears to be a reference by the British Columbia Court of Appeal in B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd. et al (1989) 43 B.L.R. 68 (1989) to the Pepper v. Litton case (supra) and the so-called "Deep Rock doctrine" under American law. I do not see a link between the comments made in Pepper v. Litton and referred to in B.C. Preeco on an entirely different issue and comments concerning the court's equitable jurisdiction in the case of claims by shareholders against insolvent corporations.

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

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

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

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

ISSUE #2

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

Summary of Decision

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

Analysis

60 The Applicants submit that negligence is only actionable if a plaintiff can prove that it suffered damages, as the purpose of awarding damages in tort is to compensate for actual loss. This is a significant difference between damages in tort and damages in contract. In order for a plaintiff to have a cause of action in negligent misrepresentation, it must satisfy the court as to the usual elements of duty of care and breach thereof, and it must establish that it has sustained damages from that breach.

61 The Applicants argue that Big Bear did not suffer any damages arising from the share exchange. The Big Bear shares used in the share exchange came from treasury: Big Bear did not use any corporate funds or corporate assets to purchase the Blue Range shares. As the shares used in the exchange did not exist prior to the transaction, Big Bear was essentially in the same financial position pre-issuance as it was post-issuance in terms of its assets and liabilities. The nature and composition of Big Bear's assets did not change as the treasury shares were created and issued for the sole purpose of the share exchange. Therefore, Big Bear did not sustain a loss in the amount of the value of the shares. The Applicants submit that the only potential loss is that of the pre-takeover shareholders of Big Bear, as the value of their shares may have been diluted as a result of the share exchange. However, even if there was such a loss, Big Bear is not the proper party to pursue such an action. Just as shareholders may not bring an action for a loss which properly belongs to the corporation, a corporation may not bring an action for a loss directly incurred by its shareholders.

62 Big Bear claims that it is entitled to recover the value of the Big Bear shares that were issued in furtherance of the share exchange. It says that it can prove all the elements of negligent misrepresentation: there was a special relationship; material misrepresentations were made to Big Bear; those representations were made negligently; Big Bear relied on those representations; and Big Bear suffered damage.

63 It submits that damages for negligent misrepresentation are calculated as the difference between the represented value of the shares less their sale value. Big Bear contends that it matters not that the consideration for the Blue Range shares was Big Bear shares issued from treasury. As long as the consideration is adequate consideration for legal purposes, its form does not affect the measure of damages awarded by the courts for negligent misrepresentation. Big Bear says that it bargained for a company with a certain value, and, in doing so, it gave up its own shares worth that value. Therefore, Big Bear submits that it clearly incurred a loss.

64 Big Bear submits that it is the proper party to pursue this head of damages. While the corporation has met the test for negligent misrepresentation, the shareholders likely could not, as the representations in questions were not made to them. In any event, Big Bear indicates that it does not claim for any damages caused by dilution of the shares. It also notes that a claim for dilution would not be the same as the face value of the shares issued in the share exchange, which is the amount claimed in the Notice of Claim.

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

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

67 The proper measure of damages in cases of misrepresentation is discussed in S.M. Waddams, The Law of Damages (Toronto: Canada Law Book Inc., Looseleaf, Dec. 1998), where the author states:

> The English and Canadian cases have consistently held that the proper measure [with respect to fraudulent misrepresentation] is the tortious measure, that is the amount of money required to put the plaintiff in the position that would have been occupied not if the statement had been true but if the statement had not been made. The point was made clearly in McConnel v. Wright , [1903] 1 Ch. 546

(C.A.):

> It is not an action for breach of contract, and, therefore, no damages in respect of prospective gains which the person contracting was entitled by his contract to expect come in, but it is an action of tort - it is an action for a wrong done whereby the plaintiff was tricked out of certain money in his pocket; and therefore, prima facie, the highest limit of his damages is the whole extent of his loss, and that loss is measured by the money which was in his pocket and is now in the pocket of the company. That is the ultimate, final, highest standard of his loss. (at 5-19, 5-20)

...

Since the decision of the House of Lords in 1963 in Hedley Byrne Ltd. v. Heller & Partners Ltd., [1964] A.C. 465 (H.L.) it has been established that an action lies for negligent misrepresentation causing economic loss. It naturally follows from acceptance of out-of pocket loss rather than the contractual measure as the basic measure of damages for fraud, that the same basic measure applies to negligent misrepresentation. (at 5-28).

68 Big Bear claims to be entitled to the difference between the actual value and the exchange value of the shares. The flaw in this assertion is that it focuses on what Big Bear bargained for as opposed to what it actually received, which is akin to a contractual measure of damages. Big Bear clearly states that it is not maintaining an action in contract, only in tort. Damages in tort are limited to the losses which a plaintiff actually incurs as a result of the misrepresentation. Thus, Big Bear is not entitled to recover what it expected to receive as a result of the transaction; it is entitled to be compensated only for that which it actually lost. In other words, what did Big Bear have before the loss which it did not have afterwards? To determine what losses Big Bear actually sustained, its position after the share exchange must be compared with its position prior to the share exchange.

69 The situation at hand is unique. Due to a negligent misrepresentation, Big Bear was induced to give up something which, although it had value, was of substantially no cost to the corporation, and in fact did not even exist but for the misrepresentation. Big Bear created shares which had a value for the purpose of the share exchange, in that Blue Range shareholders were willing to accept them in exchange for Blue Range shares. However, outside of transaction costs, those shares had no actual cost to Big Bear, as compared to the obvious costs associated with a payment by way of cash or tangible assets. Big Bear cannot say that after the share exchange, it had lost approximately $150 million dollars, because the shares essentially did not exist prior to the transaction, and the cost of creating those shares is not equivalent to their face value. Big Bear retains the ability to issue a limitless number of shares from treasury in the future; any loss in this regard would not be equivalent to the actual value of the shares. Therefore, all that is required to return Big Bear to its pre-misrepresentation position is compensation for the actual costs associated with issuing the shares.

70 That Big Bear has not incurred a loss in the face value of the exchanged shares is demonstrated by comparing the existing facts with hypothetical situations in which such a loss may be found. Had Big Bear been required to pay for the shares used in the exchange, for instance, by purchasing shares from existing Big Bear shareholders, there would have been a clear loss of funds evidenced in the Big Bear financial statements. Big Bear's financial position prior to the exchange would have been significantly better than its position afterwards. However, no such difference results from the mere exchange of newly-issued shares. If there had been evidence that Big Bear was or could be compelled to redeem or retract the new shares at the value assigned to them at the time of the share exchange, Big Bear may have a loss in the amount of the exchange value of the shares. However, there is no evidence of such a redemption or retraction feature attaching to these shares.

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

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

73 Finally, there may also be a loss in the form of dilution of the value of the Big Bear shares.

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

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

ISSUE #3

74a Is Big Bear entitled to make or advance by way of argument in these proceedings the claims represented by the heads of damage specified in the draft Statement of Claim set out at Exhibit "F" to the affidavit of A. Jeffrey Tonken dated June 25, 1999?

[The Court did not paragraph number Issue #3. Quicklaw has assigned the number 74a.]

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

Summary of Decision

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

Analysis

77 Big Bear submits that it is clear that, in an appropriate case, a complex liability issue that arises in the context of CCAA proceedings may be determined by a trial, including provision for production and discovery: Algoma Steel Corp. v. Royal Bank of Canada [1992] O.J. No. 889 (Ont. C.A.). Big Bear also submits that the court has the jurisdiction to overlook technical complaints about the contents of a Notice of Claim. The CCAA does not prescribe a claim form, nor set the rules for completion and contexts of a claim form, and it is common ground that in this case, the form used for the "Notice of Claim" was not approved by any order of the court. At any rate, Big Bear submits that it is not seeking to amend its claim to add new claims or to claim additional amounts.

78 It makes that assertion apparently on the basis that the major parties concerned with CCAA proceedings in the Blue Range matter were aware of the nature of Big Bear's additional claims by reason of the draft Statement of Claim attached to Mr. Tonken's May 5, 1999 affidavit, although that affidavit was filed in support of an application to lift the stay imposed under the CCAA, an application which was dismissed by LoVecchio, J. on May 11, 1999.

79 Big Bear characterizes the issue as whether it must prove the exact amount claimed in its Notice of Claim or otherwise have its claim barred forever. It submits that the bare contents of the Notice of Claim cannot be construed as a fixed election barring a determination and assessment of an unliquidated claim for tort damages, and that it would be inequitable to deny Big Bear a hearing on the substance of its claim based on a perceived technical deficiency in the contents of the Notice of Claim.

80 In summary, Big Bear asks that the court direct an expedited trial for the hearing of its claim as outlined in the draft Statement of Claim.

81 The Applicants submit that, by attempting now to make claims other than the claims set out in the Notice of Claim, Big Bear is attempting to indirectly and collaterally attack the orders of LoVecchio, J. dated April 6, 1999 and May 11, 1999, specifically:

a) by adding claims for alleged heads of damage other than those specified in the Notice of Claim contrary to the claims bar order of April 6, 1999; and
b) by attempting to include portions of the draft Statement of Claim relating to other alleged heads of damage in the Notice of Claim contrary to the May 11, 1999 order dismissing leave to file the draft Statement of Claim.

82 While it is true that a court has jurisdiction to overlook technical irregularities in a Notice of Claim, the issue is not whether the court should overlook technical non-compliance with, or ambiguity in, a form, but whether it is appropriate to do so in this case where previous orders have been made relating to these issues. Here, Big Bear chose to pursue its claims through two different routes. It filed a Notice of Claim alleging damages for a share exchange loss, transaction costs and the cost of shares purchased before the takeover bid, all damage claims that can reasonably be identified as being related to an action for negligent misrepresentation. At about the same time, it brought an application to lift the stay granted under the CCAA and file a Statement of Claim that alleged other causes of action. That application was dismissed, and the order dismissing it was never appealed. This is not a situation as in Re Cohen (1956) 19 W.W.R. 14 (Alta. C.A.) where a claim made on one basis was later sought to be made on a different basis, nor an issue of Big Bear lacking the necessary information to make its claim, although quantification of damage may have been difficult to determine. Given the previous application by Big Bear, this is a collateral or indirect attack on the effectiveness of LoVecchio, J.'s orders, and should not be allowed: Wilson v. The Queen (1983) 4 D.L.R. (4th) at 599). The effect of the two orders made by LoVecchio, J. is to prevent Big Bear from advancing its claim other than as identified in its Notice of Claim, which cannot reasonably be interpreted to extend beyond the claims for damages for negligent misrepresentation.

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

84 I note that LoVecchio, J. issued a judgment after this application was heard relating to claims for relief from the impact of the claims procedure established by the court by a number of creditors who filed late or wished to amend their claims after the claims bar date of May 7, 1999 had passed. Although LoVecchio, J. allowed these claims, and found that it was appropriate in the circumstances to grant flexibility with respect to the applications before him, he noted that total amount of the applications made to him would be less than 1.4 million dollars, and the impact of allowing the applications was minimal to the remaining creditors. The applications before him do not appear to involve issues which had been the subject of previous court orders, as in the current situation, nor would they have the same implication to creditors as would Big Bear's claim. The decision of LoVecchio, J. in the circumstances of the applications before him is distinguishable from this issue.

ROMAINE J.

cp/i/qljpn

Tab 2

Indexed as:
National Bank of Canada v. Merit Energy Ltd.

IN THE MATTER OF the bankruptcy of Merit Energy Ltd.
Between
National Bank of Canada, Bank One, NA and Bank One, Canada, plaintiffs, and
Merit Energy Ltd., defendant

[2001] A.J. No. 918

2001 ABQB 583

[2001] 10 W.W.R. 305

95 Alta. L.R. (3d) 166

294 A.R. 15

28 C.B.R. (4th) 228

107 A.C.W.S. (3d) 182

Action No. 0001-04994

Bankruptcy No. 073154

Alberta Court of Queen's Bench
Judicial District of Calgary

LoVecchio J.

Heard: April 30, 2001.
Judgment: filed July 3, 2001.

(83 paras.)

Counsel:

Frank Dearlove and Chris Simard, for Arthur Andersen Inc.

William E. McNally and David A. Klein, for Larry Delf, Representative Flow-Through Shareholder.
Jim G. Shea, for the Flow-Through Shareholders who are not members of the Representative Class.
Norman D. Anderson, agent for Magellan Aerospace Limited and Canada Dominion Resources Limited Partnership III.
Matthew R. Lindsay and Phil J. Schreiber, for the Underwriters except First Energy Capital Corporation.
Tristram Mallet, for First Energy Capital Corporation.
Douglas G. Stokes, for certain Directors.
D. Detomasi, for Barry Stobo.
Jeff Sharpe, for Duncan Chisholm and Laurence Waller.
Graham McLennan, for PriceWaterhouseCoopers LLP.
Steven H. Leitl, for National Bank of Canada, Bank One, NA and Bank One, Canada.

[Quicklaw note: Errata were released from the Court July 5 and 9, 2001. The corrections have been made to the text and the Errata are appended to this document.]

REASONS FOR JUDGMENT

LoVECCHIO J.:--

INTRODUCTION

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

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

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

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

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

6 I heard argument on that issue on April 30, 2001 but reserved my decision until the results of the appeal were known. On May 18, 2001, the appeal was heard and dismissed[1], so it is now appropriate to make the requested determination.

7 The Trustee takes the position that the claims in issue are in substance claims by shareholders for the return of equity and, on the basis of the decision in Re: Blue Range Resource Corp.[2], must rank behind the claims of Merit's unsecured creditors.

8 Alternatively, the Trustee argues that their claims are too contingent to constitute provable claims under the Bankruptcy and Insolvency Act.[3]

9 The Flow-Through Shareholders, the Underwriters and the Directors and Officers[4] submitted that their claims were in substance creditor claims and that they were not too contingent, thus qualifying them to rank as unsecured creditors in Merit's insolvency. If that position is sustained, the quantification of those claims will be a separate issue.

BACKGROUND

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

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

> The Corporation shall indemnify and save each of the Indemnified Persons harmless against and from all liabilities, claims, demands, losses, (other than losses of profit in connection with the distribution of common shares), costs, damages and expenses to which any of the Indemnified Persons may be subject or which any of the Indemnified Persons may suffer or incur, whether under the provisions of any statute or otherwise, in any way caused by, or arising directly or indirectly from or in consequence of:
>
> (a) any information or statement contained in the Public Record (other than any information or statement relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) which is or is alleged to be untrue or any omission or alleged omission to provide any information or state any fact

the omission of which makes or is alleged to make any such information or statement untrue or misleading in light of all the circumstances in which it was made;

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

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

[Merit] agrees:

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

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

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

...

(e) that, during the period commencing with the date hereof and ending on the conclusion of the distribution of the Common Shares, the Preliminary Prospectus and the Prospectus will fully comply with the requirements of Applicable Securities Laws of the Filing Jurisdictions and, together with

> all information incorporated therein by reference, will provide full, true and plain disclosure of all material facts relating to the Corporation and the Common Shares and will not contain any misrepresentation; provided that the Corporation does not covenant with respect to information or statements contained in such documents relating solely to one or more of the Underwriters and furnished to the Corporation by one or more of the Underwriters for inclusion in such documents or omissions from such documents relating solely to one or more of the Underwriters and the foregoing covenant shall not be considered to be contravened as a consequence of any material change occurring after the date hereof or the occurrence of any event or state of facts after the date hereof if, in each such case, the Corporation complies with subparagraphs 3(a), (b), (c) and (d).

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

14 The Prospectus indicated that:

> The gross proceeds of this Offering will be used to incur CEE in connection with the Corporation's ongoing oil and natural gas exploration activities. The Underwriters' fee and the expenses of this Offering will be paid from Merit's general funds...
>
> The Flow-through Common Shares will be issued as Flow-through Shares' under the Act. The Corporation will incur on or before December 31, 2000, and renounce to each purchaser of Flow-through Common Shares, effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price equal to the aggregate purchase price paid by such purchaser.
>
> Subscriptions for Flow-through Common Shares will be made pursuant to one or more subscription agreements ('Subscription Agreements') to made between the Corporation and one or more of the Underwriters or one or more sub-agents of the Underwriters, as agent for, on behalf of and in the name of the purchasers of Flow-through Common Shares...

15 The Prospectus also indicated that:

> ... Pursuant to the Subscription Agreements, the Corporation will covenant and agree (i) to incur on or before December 31, 2000 and renounce to the purchaser,

> effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price paid by such purchaser for the Flow-Through Common Shares and (ii) that if the Corporation does not renounce to such purchaser, effective on or before December 31, 1999, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provision of the Act and as the sole recourse of the purchaser for such failure or reduction, the Corporation shall indemnify the purchaser as to, and pay in settlement thereof to the purchaser, an amount equal to the amount of any tax payable or that may become payable under the Act...by the purchaser as a consequence of such failure or reduction...
>
> In respect of CEE renounced effective on December 31, 1999, and not incurred prior to the end of the period commencing on the date that the Subscription Agreement is entered into and ending on February 29, 2000, the Corporation will be required to pay an amount equivalent to interest to the Government of Canada. Any amount of CEE renounced on December 31, 1999 and not incurred by December 31, 2000 will result in a reassessment of deductible CEE to subscribers. However, interest in respect of additional tax payable under the Act by a purchaser of Flow-Through Common Shares will generally not be levied in respect of such reassessment until after April 30, 2001.

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

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

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

> To the full extent allowed by law, [Merit]...agrees to indemnify and save harmless the Indemnified Party, his heirs, successors and legal representatives from and against any and all damages, liabilities, costs, charges or expenses suffered or incurred by the Indemnified Party, his heirs, successors or legal representatives as a result of or by reason of the Indemnified Party being or having been a director and/or officer of [Merit] or by reason of any action taken by the Indemnified Party in his capacity as a director and/or officer of [Merit],

> including without limitation, any liability for unpaid employee wages, provided that such damages, liabilities, costs, charges or expenses were not suffered or incurred as a direct result of the Indemnified Party's own fraud, dishonesty or wilful default.

19 Merit, the Underwriters and the Directors and Officers have been named as defendants in several actions commenced throughout Canada by or on behalf of the Flow-Through Shareholders. These actions allege that Merit, the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are liable to the Plaintiffs because of misrepresentations made in the Prospectus. The Plaintiffs seek, inter alia, damages against all defendants, recision of their purchase of the Flow-Through Shares and damages for lost tax benefits associated with the Flow-Through Shares. The Underwriters have third-partied Merit and the Directors and Officers. As noted, the Underwriters and the Directors and Officers previously sought recognition as equitable lien holders (which was denied) and now they seek recognition as ordinary creditors.

20 PriceWaterhouseCoopers was at all material times the auditor of Merit. As PriceWaterhouseCoopers had not yet filed a proof of claim at the time the Trustee filed its motion, the Trustee's materials did not address its claim as part of its application. However, the Trustee did not object to PriceWaterhouseCoopers participating in this application.

21 PriceWaterhouseCoopers is in a similar position as the Underwriters and the Directors and Officers as it too has an indemnity from Merit and has also been sued by the Flow-Through Shareholders for misrepresentation. Its indemnity states that:

> Merit Energy Ltd. hereby indemnifies PriceWaterhouseCoopers LLP ("PriceWaterhouseCoopers")...and holds them harmless from all claims, liabilities, losses, and costs arising in circumstances where there has been a knowing misrepresentation by a member of Merit Energy Ltd.'s management, regardless of whether such a person was acting in Merit Energy Ltd.'s interest. This indemnification will survive termination of this engagement letter. This release and indemnification will not operate where PriceWaterhouseCoopers ought to have uncovered such knowing misrepresentation but failed to, due the gross negligence or willful misconduct of PriceWaterhouseCoopers, its partners and/or employees.

ISSUES

1. Are the claims of the Flow-Through Shareholders subordinate to the claims of Merit's unsecured creditors?
2. Are the claims of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers subordinate to the claims of Merit's unsecured creditors?

DECISION - ISSUE 1

> The claims of the Flow-Through Shareholders are subordinate to the claims of Merit's unsecured creditors as they are in substance shareholder claims for the return of an equity investment.

ANALYSIS

22 Central to this application are the reasons of my sister Romaine J. in Re: Blue Range Resource Corp.

23 In that case, Big Bear Exploration Ltd. completed a hostile takeover for all of the shares of Blue Range Resource Corporation. After the takeover was completed, Big Bear alleged that the publicly disclosed information upon which it had relied in purchasing the Blue Range shares was misleading and that the shares were worthless. As sole shareholder, Big Bear authorized Blue Range to commence CCAA proceedings and then submitted a claim as an unsecured creditor in Blue Range's CCCA proceedings, based on the damages it alleged it had suffered as a result of Blue Range's misrepresentations.

24 Romaine J. rejected Big Bear's attempt to prove as an unsecured creditor and held that Big Bear's claim was "in substance" a shareholder claim for a return of an equity investment and therefore ranked after the claims of unsecured creditors according to the general principles of corporate law, insolvency law and equity.

25 Romaine J. stated at pp. 176-177:

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

> return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value - in other words, money back from what Big Bear "paid" by way of consideration...A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment. ...
>
> I find that the alleged share exchange loss derives from and is inextricably intertwined with Big Bear's shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested qua shareholder, rather than an ordinary tort claim.

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

- (i) the claims of shareholders rank behind the claims of creditors in insolvency;
- (ii) creditors do business on the assumption that they will rank ahead of shareholders in the event of their debtor's insolvency;
- (iii) shareholders are not entitled to rescind their shares on the basis of misrepresentation after the company has become insolvent;
- (iv) United States jurisprudence supports the priority of creditors in "stockholder fraud" cases; and
- (v) to allow the shareholders to rank pari passu with the unsecured creditors could open the floodgates to aggrieved shareholders launching misrepresentation actions.

27 Re Canada Deposit Insurance v. Canadian Commercial Bank[5] is also central to this application. That case involved an issue of priorities with respect to the insolvency of the Canadian Commercial Bank. In an effort to preserve the bank, a participation agreement was entered into among the governments of Canada and Alberta, the Canada Deposit Insurance Corporation and six commercial banks. The sum of $255 million was advanced and it was to be repaid by CCB out of certain portfolio assets and pre-tax income. The agreement promised an indemnity in the event of insolvency, and gave the participants a right to subscribe for shares in CCB at a named price.

28 The Supreme Court of Canada held that although the participation agreement contained both debt and equity features, it was, in substance, a debt transaction. Iacobucci J. stated at p. 406:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeon-hole the entire agreement between

> the Participants and C.C.B. in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a creditor-debtor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore those features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to coexist in the given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement. [emphasis added]

29 As noted, the Flow-Through Shareholders have commenced several actions. Against Merit, they seek recision or damages due to an alleged misrepresentation in the Prospectus (based on their statutory rights to these remedies as disclosed in the Prospectus). They also claim damages relating to lost tax benefits associated with the Flow-Through Shares. While this is a contractual remedy based on the Subscription and Renunciation Agreements, it also has elements of misrepresentation flowing from certain descriptive statements made in the Prospectus.

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

i. The Trustee's Position

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

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

ii. The Flow-Through Shareholders' Position

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

The Representative Flow-Through Shareholders Group's Position

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

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

36 Mr. McNally suggested that this latter claim for tax losses was also a claim provable in bankruptcy. He referenced Laskin J.A.'s recognition in Re Central Capital Corporation[6] that shareholders may participate as creditors in the context of declared dividends because the liquidity provisions of corporate legislation would not have been triggered if the dividends had been declared prior to insolvency and would therefore be enforceable debts. Laskin J.A. stated at p.536:

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

37 Mr. McNally also relied on Re G.M.D. Vending Co.[7] where the British Columbia Court of Appeal allowed declared but unpaid dividends to rank with other unsecured claims in a bankruptcy.

38 He also emphasized that the CEE aspect of the relationship between the Flow-Through Shareholders, on the one hand, and Merit, the Underwriters and the Directors and Officers, on the other, possesses many of the indicia of debt mentioned by Weiler J.A. in Re Central Capital Corporation in that: (1) Merit is obliged to expend the funds raised by the Prospectus on CEE and the funds are advanced by Flow-Through Shareholders for this specific purpose alone, (2) there is an indemnity provision in the Prospectus itself to the Flow-Through Shareholders if this does not occur, evidencing an intention that the investors are to be fully repaid for the loss of the tax benefit,[8] and (3) interest becomes due for the amount of the failed tax write-off and is covered by the indemnity provision as tax payable.

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

The Other Flow-Through Shareholders Group's Position

40 Mr. Shea suggested that not only were the claims for tax losses relating to the CEE provable claims, the tort/statutory aspects of their claims were also provable claims, albeit they would be dealt with as "contingent" claims within the meaning of ss. 121 and 135 of the BIA[9]. He further submitted that the fact they are claims by shareholders is irrelevant.

41 He relied on Gardner v. Newton[10] as authority for the proposition that a contingent claim is a claim that may or may not ripen into a debt depending on the occurrence of some future event. Mr. Shea also suggested that so long as the claim is not too remote or speculative, a claim, even though it has not yet been reduced to judgment, may still be a contingent claim. Mr. Shea pointed out that the Ontario Court of Appeal in Re Confederation Treasury Services Ltd.[11] departed from the earlier cases relied upon by the Trustee, including Claude Resources (Trustee of) v. Dutton[12]. The Court of Appeal stated they imposed too high of a threshold for the establishment of a contingent claim and held that it was not necessary to demonstrate probability of liability but merely to show they were not too remote or speculative.

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

43 Mr. Shea then argued that it would not be equitable to subordinate these claims while other

claims based on tort, breach of contract or statutory remedy are allowed to rank as unsecured claims and concluded that the traditional principles for subordinating claims by shareholders do not apply to this case.

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

iii. The Underwriters' Position

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

46 The Underwriters also suggested that Re: Blue Range Resource Corp turned on its unique facts of a purchaser of Blue Range shares having knowledge of misrepresentations yet exercising shareholder rights, such as authorizing the company to take CCAA proceedings and then making an unsecured claim in those proceedings for the loss associated with its share purchase. The shareholder in that case did not claim recision and did not deny or attempt to avoid its shareholder status. Moreover, there was no contractual right to be treated by the company as anything but a shareholder.

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

Resolution- ISSUE 1

48 I agree with Romaine J. that the correct approach is to first examine the substance of the claim made against the insolvent. There are the two claims mentioned by counsel for the Flow-Through Shareholders. The first is an alternate remedy for damages or recision based on the alleged misrepresentations contained in the Prospectus. I was advised that some have advanced only one of these alternative claims. The second is cast as a claim in damages under the indemnity in the Subscription and Renunciation Agreements for the failure to renounce CEE.

49 The Flow-Through Shareholders' claims for recision or damages based on misrepresentation derive from their status as Merit shareholders. Regardless of how they are framed[13], the form the actions take cannot overcome the substance of what is being claimed. It is plain from the Prospectus and the Subscription and Renunciation Agreements that the Flow-Through Shareholders invested in equity. It is equally plain from their actions that what they seek to recoup, in substance, is their investments. As in Re: Blue Range Resource Corp, the "very core" of these claims arises from the circumstances surrounding the acquisition of Merit shares. The Flow-Through Shareholders had no cause of action until they acquired the Flow-Through Shares and their claims include a direct claim for return of capital in their request for recision and in the case of a damage claim, just as in Re: Blue Range Resource Corp, the measure of damages enables them to recover the purchase price of the shares.

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

51 Now what about the second aspect of the claims?

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

53 While the discussion in Re Central Capital Corporation regarding the claim for declared dividends is appealing, it does not precisely apply in these circumstances. The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares[14]. In essence, what happens in a flow-through share offering (as sanctioned by the Income Tax Act[15]) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes) by the amount of the deductions utilized by the purchaser.

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

55 In summary, the Flow-Through Shareholders' claims, regardless of the basis chosen to support them, are in substance claims for the return of their equity investment and accordingly cannot rank with Merit's unsecured creditors.

DECISION - ISSUE 2

The claims of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are not subordinate to the claims of Merit's unsecured creditors as they are in substance creditors' claims that are not too contingent to constitute provable claims.

i. The Trustee's Position

56 The Trustee argued that while on their face, the Underwriters' and the Directors and Officers' claims are not shareholder claims, "in substance", they are shareholders' claims and are no more than an indirect passing-on to Merit of the Flow-Through Shareholders' claims. As a result, the Trustee submitted, equity dictates that since the Flow-Through Shareholders' claims must rank behind those of the unsecured creditors, the claims of the Underwriters and the Directors and Officers must fail as well. The Trustee suggested this subordination follows from the policy considerations set out by Romaine J. in Re: Blue Range Resource Corp. Alternatively, the Trustee asserted that the claims of the Underwriters and the Directors and Officers are so contingent they must be valued at nil.

ii. The Underwriters' Position

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

iii. The Directors' and Officers' Position

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

59 In any case, the Directors and Officers face claims other than from Merit's shareholders, which include: (1) a Saskatchewan action alleging the Directors and Officers assented to or acquiesced in Merit not paying its accounts and ought to be held liable for them, and (2) an Alberta action relating to ownership and lease payments on oilfield equipment. The Directors and Officers asserted that the existence of these claims demonstrate that they are not simply attempting to pass on shareholder claims, but rather they are making a contractual claim for all the potential liability they face, as the indemnity intends.

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

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

Resolution - ISSUE 2

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

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

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

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

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

right against Merit.

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

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

1. Shareholders rank behind creditors in insolvency - the issue here is whether the Underwriters are properly characterized as equity stakeholders or creditors. This is done by considering the substance of their claim. Regardless of how the Flow-Through Shareholders' claims are characterized, the substance of the Underwriters' claims against Merit are contractual. They arise out of a contract for indemnity between Merit and the Underwriters. This is clearly distinct from a claim for return of shareholders' equity. The Trustee asked the court to consider the fact of a possible future payment from the Underwriters to the Flow-Through Shareholders in characterizing the claim of the Underwriters against Merit. Given the nature of the obligations under an indemnity, this is inappropriate. Describing the Underwriters' claims as "no more than and indirect passing-on of the Flow-Through Shareholders' claims" is based on a flawed analysis of the obligations under an indemnity and ignores the statutory duty of the Underwriters to the Flow-Through Shareholders. There are two distinct obligations.

   The first obligation relates to the Flow-Through Shareholders' claims against the Underwriters and any obligations that may be imposed on the Underwriters as a result. This obligation is completely unrelated to, and unaffected by the Underwriters' indemnity. The second obligation is between Merit, as indemnifier, and the Underwriters. This second obligation is the obligation that must be characterized in this application. The Flow-Through Shareholders are strangers to this claim.

2. Creditors do business with companies on the assumption they will rank ahead of shareholders on insolvency - the focus of this analysis is the degree of risk-taking respectively assumed by shareholders and creditors. Unlike shareholders who assume the risks of insolvency, the Underwriters bargained, as any other creditor,

for their place at the creditor table in an insolvency. An indemnity is a well-known commercial concept business people routinely use to eliminate or reduce risk and should be recognized as a necessary and desirable obligation.

To subordinate the Underwriters' claim would amount to a reversal of the expectations of the parties to the indemnities. The evidence before me suggests that the Underwriters would not have participated in Merit's offering without the indemnity. I need not decide whether that is true.

Subordinating the Underwriters would fundamentally change the underlying business relationship between underwriters and issuers, and would be unexpected in the industry. Such a result might make it impossible for an underwriter to recover under an indemnity from a bankrupt issuer in respect of an equity offering.

3. Shareholders are not entitled to rescind shares after insolvency - this consideration has no bearing on the Underwriters as they are not shareholders seeking to rescind shares. Their claims against the bankrupt are for damages under a contract for indemnity. Further, I was not asked to determine this particular question in this application.
4. The principles of equitable subordination - In Re Canada Deposit Insurance v. Canadian Commercial Bank, the Supreme Court of Canada expressly left open the question of whether equitable subordination formed part of Canadian insolvency law, but expressed its opinion as to the applicable test as developed in the United States:

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

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

Although the Trustee suggested that the Underwriters may have "participated" in the misrepresentation, there is no evidence before me of inequitable conduct on their part. It is perhaps significant that the Flow-Through Shareholders have not alleged any such misconduct as against the Underwriters, but rather they have only advanced the statutory causes of action available to them under securities legislation.

As there is no evidence of inequitable conduct on the part of the Underwriters, there can be no corresponding injury to Merit's other creditors, or enhancement of the Underwriters' position.

Finally, the application of equitable subordination of the Underwriters' claims in this case would be inconsistent with the established priority scheme contained in the BIA. The United States Supreme Court addressed this third requirement of consistency in United States v. Noland[16]:

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

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

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

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

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

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

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

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

Contingent claims

73 While the Trustee's primary argument was the claims of the Underwriters and the Directors and Officers are merely indirect shareholder claims, alternatively, it argued that these claims are too contingent and cannot constitute a provable claim on that basis.[17]

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

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

Underwriters and/or the Directors and Officers to the Flow-Through Shareholders would qualify for indemnification.

76 The fact that a claim is contingent does not mean it is not "provable"[18]. Provable claims include contingent claims as long as they are not too speculative: Negus v. Oakley's General Contracting[19]. Section 121 defines provable claims to include "all debts and liabilities, present or future,...to which the bankrupt may become subject...".

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

78 On a plain reading of the Underwriting Agreement, the indemnity appears to be engaged by the Flow-Through Shareholders' actions. The actions are under case management and are proceeding through discoveries at this time. Further, there are several authorities that suggest an indemnity becomes enforceable as soon as a claim of the type indemnified is alleged.[20] Finally, at least one part of the Underwriters' claim is not contingent - they have incurred costs and disbursements in defence of the Flow-Through Shareholders' claims and according to the terms of the indemnity are currently entitled to reimbursement for those costs, regardless of the outcome of the litigation.

iv. PriceWaterhouseCoopers

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

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

81 I am aware that the indemnities of the Flow-Through Shareholders are not being accorded creditor status, while those of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are. However, as noted, the indemnity feature of the Flow-Through

Shareholders' claims is related to certain deductions and those deductions were part of the purchase price for the shares. This in my view is more analogous to Re Canada Deposit Insurance v. Canadian Commercial Bank than to Re Central Capital Corporation and that to me is sufficient to justify the distinction.

CONCLUSION

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

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

LoVECCHIO J.

* * * * *

ERRATUM

Released: July 5, 2001

The Appearances have been revised to include Mr. David A. Klein. Mr. Klein of Klein Lyons attended with Mr. William E. McNally of McNally and Cuming, for Larry Delf, Representative Flow-Through Shareholder.

ERRATUM

Released: July 9, 2001

Please replace page 2 of your copy of the Judgement.

The initials Q.C. should not follow the name of Douglas G. Stokes, of Rooney Prentice.

cp/i/qlrds/qlcas/qlhjk

1 Reasons followed the dismissal from the bench, [2001] A.J. No. 760, 2001 ABCA 138.

2 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.).

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

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

5 (1992), 97 D.L.R. (4th) 385 (S.C.C)

6 (1996), 27 O.R. (3d) 494 (C.A.)

7 (1994), 94 B.C.L.R. (2d) 130 (B.C.C.A.)

8 See Ontario Securities Commission v. Consortium Construction Inc. (1993), 1 C.C.L.S. 117 at 138-139.

9 121(1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupts discharge ...shall be deemed to be claims provable in proceedings under this Act.(2) The determination whether a contingent or unliquidated claim is a provable claim and the valuation of such a claim shall be made in accordance with section 135.

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

10 (1916), 29 D.L.R. 276 (Man.K.B.)

11 (1997), 43 C.B.R. (3d) 4.

12 (1993), 22 C.B.R. (3d) 56 (Sask.Q.B.), referred to favourably by Farley J. in Canadian Triton International Ltd. (Re) (1997), 49 C.B.R. (3d) 192 (Ont. Gen. Div.) and followed in Re Wiebe (1995), 30 C.B.R. (3d) 109 (Ont. Gen. Div.)

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

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

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

16 (1996), 517 U.S. 535 at 539.

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

18 ibid.

19 (1996), 40 C.B.R. (3d) 270 (N.S.S.C.)

20 See for example, Re Froment; Alta. Lumber Co. v. Department of Agriculture, [1925] 2 W.W.R. 415 (Alta. S.C.)

Tab 3

Case Name:

Earthfirst Canada Inc. (Re)

IN THE MATTER OF the Companies' Creditors Arrangement Act R.S.C. 1985, c. C-36, as Amended AND IN THE MATTER OF a Plan of Compromise or Arrangement of Earthfirst Canada Inc.

[2009] A.J. No. 749

2009 ABQB 316

56 C.B.R. (5th) 102

2009 CarswellAlta 1069

Docket: 0801 13559

Registry: Calgary

Alberta Court of Queen's Bench
Judicial District of Calgary

B.E.C. Romaine J.

Heard: May 13, 2009.
Judgment: May 27, 2009.

(5 paras.)

Counsel:

Kelly J. Bourassa and Scott Kurie, for Indemnity Claimants of Earthfirst Canada Inc.

Howard A. Gorman, for Earthfirst Canada Inc.

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

[Editor's note: A corrigendum was released by the Court on July 8, 2009; the corrections have been made to the text and the corrigendum is appended to this document.]

Reasons for Judgment

B.E.C. ROMAINE J.:--

INTRODUCTION

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

FACTS

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

> 6.(b) to incur, during the Expenditure Period, Qualifying Expenditures in such amount as enables the Corporation to renounce to each Subscriber, Qualifying Expenditures in an amount equal to the Commitment Amount of such Subscriber;
>
> (c) to renounce to each Subscriber, pursuant to subsection 66(12.6) and 66(12.66) of the Tax Act and this Subscription Agreement, effective on or before December 31, 2007, Qualifying Expenditures incurred during the Expenditure Period in an amount equal to the Commitment Amount of such Subscriber;
>
> ...
>
> (g) if the Corporation does not renounce to the Subscriber, Qualifying Expenditures equal to the Commitment Amount of such Subscriber effective on or before December 31, 2007 and as the sole recourse to the Subscriber for such failure, the Corporation shall indemnify the Subscriber as to, and pay to the Subscriber, an amount equal to the amount of any tax payable under the Tax Act (and under

any corresponding provincial legislation) by the Subscriber (or if the Subscriber is a partnership, by the partners thereof) as a consequence of such failure, such payment to be made on a timely basis once the amount is definitively determined, provided that for certainty the limitation of the Corporation's obligation to indemnify the Subscriber pursuant to this Section shall not apply to limit the Corporation's liability in the event of a breach by the Corporation of any other covenant, representation or warranty pursuant to this Agreement or the Underwriting Agreement;

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

ISSUE

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

ANALYSIS

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

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

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

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

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

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

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

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

The Court of Appeal in dismissing the appeal commented:

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

The decision in Merit Energy thus determines the issue in this case, which is not distinguishable on any basis that is relevant to the issue. I also note that, while it is not determinative of the issue as the legislation has not yet been proclaimed, section 49 of Bill C-12, *An Act to amend the Bankruptcy and Insolvency Act,* the *Companies' Creditors Act*, the *Wage Protection Program Act* and Chapter 47 of the *Statues of Canada*, 2005, 2nd Sess., 39th Parl., 2007, ss. 49, 71 [Statute c.36] provides that a creditor is not entitled to a dividend in respect of any equity claim until all other claims are satisfied. Equity Claims are defined as including:

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

CONCLUSION

I therefore grant:

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

B.E.C. ROMAINE J.

* * * * *

Corrigendum
Released: July 8, 2009

The citation "Earthfirst Canada Inc. *(Companies' Creditors Arrangement Act)* 2009 ABQB 316" was corrected to read "Earthfirst Canada Inc. (Re) 2009 ABQB 316"

cp/e/qlcct/qlpwb/qlltl/qlaxr

Tab 4

Case Name:

Royal Bank of Canada v. Central Capital Corp.

RE: Royal Bank of Canada et al., and Central Capital Corporation

[1996] O.J. No. 359

27 O.R. (3d) 494

132 D.L.R. (4th) 223

88 O.A.C. 161

26 B.L.R. (2d) 88

38 C.B.R. (3d) 1

61 A.C.W.S. (3d) 18

Nos. C21479 and C21477

Ontario Court of Appeal
Toronto, Ontario

Finlayson, Weiler and Laskin JJ.A.

February 7, 1996.

(154 paras.)

Counsel:

Bryan Finlay, Q.C., and John M. Buhlman, for appellants, James W. McCutcheon and Central Guaranty Trust.

James H. Grout and Anne Sonnen, for appellant, Consolidated S.Y.H. Corp.

Terrence J. O'Sullivan and Paul G. Macdonald, for the unsecured creditors of Central Capital Corp.

Neil C. Saxe, for Peat Marwick Thorne Inc.

Raesons for judgment were delivered by Finlayson J.A., concurred in by Weiler J.A. Separate reasons were delivered by Laskin JJ.A.

1 **FINLAYSON J.A.** (dissenting): -- The appellant James W. McCutcheon and Central Guarantee Trust Company as Trustee for the Registered Retirement Savings Plan of James W. McCutcheon (hereinafter sometimes referred to collectively as "McCutcheon") and the appellant Consolidated S.Y.H. Corporation ("SYH") appeal from the order of the Honourable Madam Justice Feldman of the Ontario Court (General Division) dated January 9, 1995 (reported as Re Central Capital Corp. (1995), 29 C.B.R. (3d) 33, 22 B.L.R. (2d) 210). Feldman J. dismissed appeals from decisions dated January 20, 1993 and February 16, 1993 of the respondent Peat Marwick Thorne Inc., in its capacity as Interim Receiver, Manager and Administrator ("Administrator") of certain assets of Central Capital Corporation ("Central Capital"). The Administrator disallowed proofs of claim submitted by the appellants with respect to a plan of arrangement under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 ("CCAA"). Leave to appeal the order of Feldman J. was granted on March 17, 1995 by the Honourable Mr. Justice Houlden.

Overview of the Proceedings

2 These appeals arise out of the insolvency of Central Capital which in and prior to December 1991 defaulted under its obligations to various unsecured lenders, note holders and subordinated debt holders. In early December of 1991, Central Capital advised its creditors that, pending implementation of new financial arrangements, it had decided to discontinue payment of all interest and principal due under outstanding loans, with the exception of indebtedness due under secured notes issued to the Royal Trust Company. In an agreed statement of facts, which was prepared by the parties for the purposes of appeals from the disallowances of the Administrator, it was agreed that at all material times since in or prior to December 1991, Central Capital was insolvent. It had a total unsecured debt of $1,577,359,000 and, among other things:

(a) it was unable to pay its liabilities as they became due; and
(b) the realizable value of its assets was less than the aggregate of its liabilities.

3 By notice of application issued June 12, 1992, 39 of the creditors commenced an application pursuant to the CCAA for an order declaring the following: that Central Capital was a debtor company to which the CCAA applied; that Peat Marwick Thorne Inc. be appointed Administrator of the property, assets and undertaking of Central Capital; that a stay of proceedings against Central Capital, except with leave of the court, be granted; and that the applicants be authorized and permitted to file a plan of compromise or arrangement under the CCAA.

4 By order of Houlden J. made June 15, 1992, Central Capital was declared to be a company to which the CCAA applied and all proceedings against Central Capital were stayed. By further order of Houlden J. made July 9, 1992, it was provided, among other things, that:

(a) Peat Marwick Thorne Inc. was appointed Administrator, Interim Receiver and Manager of such of the undertaking, property and assets of Central Capital as necessary for the purpose of effecting the transaction described in the order pursuant to which specified significant assets of Central Capital would be transferred to a newly incorporated company called Canadian Insurance Group Limited ("CIGL");

(b) the Administrator was authorized to enter into and carry out a subscription and escrow agreement with creditors of Central Capital pursuant to which creditors of Central Capital would be entitled to elect to exchange a portion of the indebtedness owing to them by Central Capital for shares and debentures to be issued by CIGL;

(c) the Administrator was authorized and directed to supervise the calling for claims of creditors of Central Capital who elected to exchange a portion of the indebtedness from Central Capital for shares and debentures to be issued by CIGL as aforesaid; and

(d) Central Capital was authorized and permitted to file with the court a formal plan of compromise or arrangement with Central Capital's secured and unsecured creditors and shareholders in accordance with the CCAA and the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (the "CBCA"), which would provide for the restructuring and reorganization of the debt and equity of Central Capital in the manner set out in the said order.

5 According to the agreed statement of facts, the order of Houlden J. was made without prejudice to the rights of the appellants to assert claims as creditors in the CIGL transaction. Pursuant to the terms of the July 9, 1992 order, all claims of creditors of Central Capital who wished to participate in CIGL were required to be submitted to the Administrator by September 8, 1992, or such other date fixed by the court. The Administrator received claims from various persons who wished to participate, including the claims submitted by the appellants herein.

6 The Administrator disallowed the claims of McCutcheon and SYH by notices of disallowance dated January 20, 1993 and February 16, 1993 in which various reasons were cited as to why the appellants did not qualify as creditors. The effect of this disallowance was that McCutcheon and SYH could participate only as shareholders in the plan of compromise and arrangement under the CCAA to be put forward by Central Capital. In dismissing the appeals from this disallowance, Feldman J. found that the appellants were not creditors because they did not have a claim provable under the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 ("Bankruptcy and Insolvency Act").

Issue

7 The agreed statements of facts sets out the issue in the appeal in the following language:

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

8 The determination of this issue was deferred by Houlden J.'s order of October 27, 1992. He ordered therein that preferred shareholders who had filed claims against Central Capital as creditors were not permitted to vote at the meeting of creditors called to consider the plan of arrangement "but such is without prejudice to the rights of those claimants to prosecute their claims as filed". The last paragraph in the order ended:

> For greater certainty, the validity of any claim filed by a preferred shareholder shall not be affected by the terms of this paragraph.

Overview of the Restructuring of Central Capital

9 The order of Houlden J. of July 9, 1992 directed the restructuring of Central Capital under the aegis of the court. The order, and others that would follow, contemplated that the restructuring would take place in two stages. The first stage involved the transfer to the Administrator of certain major assets of Central Capital to a company to be incorporated called Central Insurance Group Limited (CIGL). This company is frequently referred to in the documentation and the reasons of Feldman J. as "Newco". CIGL was then to be owned by those Central Capital creditors who chose to participate in the reorganization by accepting a reduction in their debts due from Central Capital and exchanging this reduced indebtedness for debentures in CIGL. Subscription for debentures by this means additionally entitled the creditors to subscribe for shares in CIGL. Our understanding from counsel is that the assets transferred to CIGL included the assets acquired by Central Capital from the appellants in purchase agreements described later in these reasons.

10 The court approved a subscription and escrow agreement setting out this arrangement. In order to participate, the creditors were required to file with the Administrator a proof of claim in the prescribed form along with other documents confirming the creditor's intention to reduce its claim against Central Capital and to subscribe for debentures and shares of CIGL. Claims were to be based on Central Capital's indebtedness to creditors as of June 15, 1992, the date of the court-ordered stay of proceedings. This transaction was completed on October 1, 1992 and resulted in CIGL being owned by the creditors of Central Capital in exchange for a reduction in Central Capital's unsecured debt in the amount of $603 million.

11 The second stage of the restructuring involved a plan of arrangement under the CCAA. That plan as put forward by Central Capital recognized four classes of creditors, only one of which, namely that of "Senior Creditors", could apply to the appellants. The plan of arrangement, as amended, provided that Central Capital would issue to Senior Creditors pro rata on the basis of their senior claims a class of secured promissory notes in the aggregate principal amount of $20 million of secured debt, which were to be known as first secured notes. A similar arrangement was made for the issuance of $1 million of second secured promissory notes to subordinated creditors. Senior and subordinated creditors included any creditor whose claim had been allowed under the CIGL claims procedure in the first stage, to the extent of that creditor's reduced claim.

12 The plan of arrangement also called for the creation of a new class of shares in Central Capital to be called the Central New Common Shares. Central Capital would issue to the above Senior and Subordinated Creditors 90 per cent of the new share capital of Central Capital in extinguishment of the balance of their debt. The Central Capital shareholders of all classes would have their existing shares converted into the remaining 10 per cent of the Central New Common Shares. All of the existing preferred and common shares would be cancelled upon implementation of the plan.

13 The amended plan of arrangement was ultimately voted on and approved by all four classes of creditors of Central Capital. On December 18, 1992, Houlden J. sanctioned this plan of arrangement under the CCAA. He authorized and directed Central Capital to apply for articles of reorganization pursuant to s. 191 of the CBCA, so as to authorize the creation of the Central New Common Shares for implementation of the amended plan of arrangement. He also lifted the stays of proceedings affecting Central Capital and its ability to carry on business as of January 1, 1993.

14 The effect of the amended plan of arrangement after approval was that all remaining debts and obligations owed by Central Capital to its creditors on or before June 15, 1992 were extinguished and all outstanding and unissued shares of any kind in Central Capital were cancelled and replaced by Central New Common Shares. Central Capital was then free to carry on business. It was no longer insolvent.

Facts as they Relate to the Claim of McCutcheon

15 By a share purchase agreement dated June 15, 1987 between Central Capital and Gormley Investments Limited ("Gormley") and Heathley Investments Limited ("Heathley"), Central Capital agreed to purchase all Class "B" voting shares of Canadian General Securities Limited ("CGS") that were owned by Gormley and Heathley. James W. McCutcheon and his brother, who were the sole shareholders of Gormley, represented to Central Capital that CGS owned substantially all of the shares of Canadian Insurance Sales Limited, which in turn owned substantially all of the shares in a number of operating insurance, credit and trust companies. The consideration for the purchase of the CGS shares was $575 per share. The vendors were to be paid $400 per share in cash on closing and were to receive seven Series B senior preferred shares of Central Capital. These shares contained a retraction clause entitling the holder to retract each preferred share on July 1, 1992 for

$25. Failing issuance of the shares by Central Capital, the vendors were to receive an additional $175 for each CGS share. The share purchase agreement and later the Articles of Central Capital further provided that the holders of Series B Senior Preferred Shares were entitled to receive dividends as and when declared by the directors of Central Capital out of moneys of the corporation properly applicable to the payment of dividends and in the amount of $1.90625 per share per annum (being 7 5/8 per cent per annum on the stated capital of $25 per share) payable in equal quarterly payments. No dividends were in fact declared.

16 The certificate of amendment for Central Capital dated July 30, 1987, and the articles of amendment setting out the provisions attaching to the Series B Senior Preferred Shares contain all the terms and conditions governing the said shares. I am setting out below a description of those that are relevant to this appeal.

17 Pursuant to art. 4.1 of the Senior Series B Provisions, each holder of Series B Senior Preferred Shares was entitled, subject to and upon compliance with the provisions of art. 4, to require Central Capital to redeem all or any part of the Series B Senior Preferred Shares registered in the name of that holder on July 1, 1992 at a price equal to $25 per share, plus all accrued and unpaid dividends thereon, calculated to but excluding the retraction date.

18 Article 4.2 of the Senior Series B Provisions sets out the procedure for retraction of the shares. Article 4.3 of the Senior Series B Provisions provides that if the redemption by Central Capital of all of the Series B Senior Preferred Shares required to be redeemed on the retraction date would be contrary to applicable law or the rights, privileges, restrictions and conditions attaching to any shares of Central Capital ranking prior to Series B Senior Preferred Shares, then Central Capital shall redeem only the maximum number of Series B Senior Preferred Shares which it determined was permissible to redeem at that time. Article 4.3 provides the mechanism for a pro rata redemption from each holder of the tendered Series B Senior Preferred Shares and redemption of the tendered Series B Senior Preferred Shares by Central Capital at further dates.

19 Article 4.4(a) provides that subject to s. 4.4(b), the election of any holder to require Central Capital to redeem any Series B Senior Preferred Shares shall be irrevocable upon receipt by the transfer agent of the certificates for the shares to be redeemed and the signification of election of the holder of the Series B Senior Preferred Shares.

20 Article 4.4(b) of the Senior Series B Provisions provides that if the retraction price is not paid by Central Capital, Central Capital shall forthwith notify each holder of the Series B Senior Preferred Shares who has not received payment for his deposited shares of the holder's right to require Central Capital to return all (but not less than all) of the holder's deposited share certificates and the holder's rights under art. 4.3 outlined above.

21 Article 4.5 of the Senior Series B Provisions provides that the inability of Central Capital to effect a redemption shall not affect or limit the obligation of Central Capital to pay any dividends accrued or accruing on the Series B Senior Preferred Shares from time to time not redeemed and remaining outstanding.

22 Article 7 of the Series Senior B Provisions provides that in the event of the liquidation, dissolution or winding-up of Central Capital, whether voluntary or involuntary, or any other distribution of assets of Central Capital among its shareholders for the purposes of winding up its affairs, the holders of the Series B Senior Preferred Shares shall be entitled to receive, from the assets of Cental Capital, $25 per Series B Senior Preferred Shares, plus all accrued and unpaid dividends thereon, to be paid prior to payment to junior ranking shareholders. Upon payment of such amounts, the holders of the Series B Senior Preferred Shares shall not be entitled to share in any further distribution of assets of Central Capital.

23 A notice of retraction privilege was sent by Central Capital to the holders of Series B Senior Preferred Shares with a cover letter dated April 23, 1992. The letter stated, among other things, that Central Capital would not redeem any shares because the redemption of such shares would be contrary to applicable law in the context of Central Capital's then current financial situation. McCutcheon and Central Guaranty Trust deposited for redemption 406,800 and 26,000 Series B Senior Preferred Shares, respectively, in accordance with the Senior Series B Provisions and the notice of retraction privilege. The shares were deposited on May 28, 1992, with Montreal Trust Company of Canada, pursuant to the notice of retraction privilege. The shares were properly tendered for redemption in the manner and within the time required by Central Capital's articles of amendment.

24 Central Capital did not pay the redemption price on July 1, 1992 and on July 20, 1992 it notified each holder of Series B Senior Preferred Shares of its right to require Central Capital to return all of the holder's deposited share certificates as required by art. 4.4(b) of the Senior Series B Provisions. McCutcheon and Central Guaranty Trust did not exercise that right.

25 Pursuant to the terms of Houlden J.'s order of July 9, 1992 directing the restructuring of Central Capital, McCutcheon submitted to the Administrator, as a creditor of Central Capital, proofs of claim dated September 3, 1992 and September 4, 1992, respectively. McCutcheon claimed the amount of $10,913,593.69 in respect of his Series B Senior Preferred Shares tendered for redemption. Central Guaranty Trust claimed the amount of $697,526.68 in respect of its tendered 26,000 Series B Senior Preferred Shares. McCutcheon also executed and submitted the restated subscription and escrow agreement and other documents electing to participate in CIGL. These claims were completed and submitted in the prescribed form and within the time required by Houlden J.'s order.

26 As was previously noted, these claims were disallowed by the Administrator. The substance of the Administrator's reasons for disallowance was that the ability of Central Capital to redeem these preference shares is restricted by the provisions of the CBCA and it would be contrary to applicable law to redeem the shares in the context of Central Capital's financial position. The relevant provision of the CBCA provides:

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

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

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
(b) the realizable value of the corporation's assets would after the payment be less than the aggregate of

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

Evidently, the Administrator equated redemption by the corporation with the right of retraction by the preferred shareholder. It agreed with Central Capital's position that once it became insolvent in December of 1991, Central Capital no longer had the ability to redeem the shares tendered for retraction and thus McCutcheon was restricted to exercising what rights it might have as a shareholder.

Facts as they Relate to the Claim of SYH

27 Pursuant to an agreement of purchase and sale made as of June 30, 1989, as amended, Scottish & York Holdings Limited (the predecessor to SYH) sold to Central Capital the shares of Central Canada Insurance Services Limited, Eaton Insurance Company, Scottish & York Insurance Co. Limited and Victoria Insurance Company of Canada (collectively the "Insurance Companies"), except for certain preference shares held by the directors of those corporations. In consideration of this transfer, Central Capital issued to Scottish & York Holdings Limited 60,116,000 Series A Junior Preferred Shares and 9,618,560 Series B Junior Preferred Shares.

28 The articles of Central Capital provided that it would pay on each dividend payment date prior to the fifth anniversary of this issue, as and when declared by the directors out of the assets of the corporation properly applicable to the payment of dividends, a dividend of $.08 for each outstanding Series A Junior Preferred Share. The dividend was payable quarterly by the issuance of .02 Series B Junior Preferred Shares for every outstanding Series A Junior Preferred Share. No dividends were in fact declared.

29 The Articles also provided that Central Capital was obligated to retract the Series A Junior Preferred Shares and Series B Junior Preferred Shares, at the option of the holders of those shares, on the fifth anniversary of their issuance. The retraction price was $1.00 per share plus all accrued and unpaid dividends. Payment of the retraction price of these shares by Central Capital was subject to the provisions of the CBCA, which governs the affairs of Central Capital. For the purposes of this appeal, I believe that we can treat the balance of the provisions relating to these preferred shares as being the same as those governing the McCutcheon Series B Senior Preferred Shares.

30 Given that the operative date for proving claims against Central Capital was June 15, 1992, the retraction date governing the preferred shares of SYH was some two years removed. Notwithstanding, on September 8, 1992 SYH executed and delivered to the Administrator a proof of claim, a counterpart of the restated subscription and escrow agreement, an initial share subscription and an instrument of claims reduction form, all in the prescribed form and within the time required. The claim was that SYH was holding or entitled to hold the following shares of Central Capital:

(a) 60,116,000 Junior Preferred Series A shares;
(b) 9,618,560 Junior Preferred Series B shares;
(c) 4,611,095 Junior Preferred Series B shares accrued to June 15, 1992 but not yet issued to SYH;

for a total of 74,345,655 shares, each having a retraction value of $1.00. However, because of some adjustments in favour of Central Capital to the purchase price of the shares sold by SYH to Central Capital under the June 30, 1989 agreement of purchase and sale, the net claim as of June 15, 1992 was reduced from $74,345,655 to $72,388,836.

31 By notice of disallowance dated January 20, 1993, the Administrator disallowed the claim by SYH to subscribe for debentures and common shares to be issued by CIGL. The reasons for the disallowance are similar to those provided for disallowing the claims of McCutcheon. The Administrator found that SYH's right to require Central Capital to retract the Series A and B Junior Preferred Shares only arose on the expiry of the fifth anniversary of their issuance and that Central Capital was precluded from retracting those shares by virtue of its insolvency and the provisions of the CBCA. Hence SYH, like McCutcheon, was limited to exercising what other rights it might have as a shareholder.

Analysis

32 Although the factual groundwork is necessary for putting in perspective the sole issue before the court, the final question confronting us is a narrow one. Did the retraction clauses in the appellants' shares create a debt owed by Central Canada as of June 15, 1992 within the meaning of the Bankruptcy Act? I think that they did.

33 It is agreed that the operative section of the Bankruptcy and Insolvency Act is s. 121(1). It reads as follows:

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

There was no bankruptcy in this case and thus the relevant date was agreed to be June 15, 1992. The obligations of Central Capital to the appellants were incurred before that date, and so the only question becomes whether the obligations created a debt between the appellants and Central Capital.

34 What then is a debt? All the parties turn to Black's Law Dictionary, quoting different editions. The following is from the Sixth Edition (1990), at p. 403:

> Debt. A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only the obligation of debtor to pay but right of creditor to receive and enforce payment ...
>
> A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future.

35 The above is consistent with what is defined as a debt by Jowitt's Dictionary of English Law, 2d ed. (1977), at p. 562:

> A debt exists when a certain sum of money is owing from one person (the debtor) to another (the creditor). Hence "debt" is properly opposed to unliquidated damages; to liability, when used in the sense of an inchoate or contingent debt; and to certain obligations not enforceable by ordinary process. "Debt" denotes not only the obligation of the debtor to pay, but also the right of the creditor to receive and enforce payment.

And finally, The Shorter Oxford Dictionary, 3d ed. (1973), at p. 497:

> Debt 1. That which is owed or due; anything (as money, goods or service) which one person is under obligation to pay or render to another, 2. A liability to pay or render something; the being under such liability.

36 I have no difficulty in finding that the claims of the appellants in the case under appeal fall

within all of the above definitions. As will be discussed herein, concern was expressed in this case over whether or not the appellants as creditors were entitled to "receive and enforce payment" on the "debt" because of the insolvency of Central Capital on June 15, 1992. I will deal with the specific arguments relating to the effect of insolvency on this particular indebtedness in due course, but for the moment I am content to observe that the above definitions contemplate only that the creditor's right to recover is the reciprocal of the debtor's obligation to pay. For every debtor there must be a creditor. There may be cases where it is difficult to identify the person who in law may receive and enforce payment, but this is not such a one.

37 With great respect to the judge of first instance and to the submissions of counsel for the unsecured creditors, I believe that the fundamental error that has been made in these proceedings arises from the conception that the preferred shares in question can either be debt instruments or equity participation instruments, but they cannot have the attributes of both. Feldman J. had this to say at p. 48 of her judgment:

> Although the right of retraction at the option of the preferred shareholder may be less common than the usual right of the company to redeem at its option, that right is one of the incidents or provisions attaching to the preferred shares, but does not change the nature of those shares from equity to debt. The parties have characterized the transaction as a share transaction. The court would require strong evidence that they did not intend that characterization in order to hold that they rather intended a loan.
>
> In my view, this case turns on whether the right of retraction itself creates a debt on the date the company becomes obligated to redeem even if it cannot actually redeem by payment on that date, or a contingent future debt on the same analysis, not on whether the preferred shares themselves with the right of retraction are actually debt documents.
>
> Because the preferred shares remain in place as shares until the actual redemption, the appellants are not creditors and have no claim provable under the Bankruptcy Act (Canada), and the appeals are therefore dismissed.

38 As I read these reasons, the learned judge is in effect stating that these instruments are preferred shares in the corporation because the parties have so described them. In the first place, I do not think that describing the documents as preferred shares is conclusive as to what instrument the parties thought they were creating. In the second place, it is not what the parties call the documents that is determinative of their identity, but rather it is what the facts require the court to call them. The character of the instrument is revealed by the language creating it and the circumstances of its creation. Although these instruments may "remain in place as shares" until they are actually redeemed, they also contain a specific promise to pay at a specified date. This is the language of debt. I cannot accept the proposition that a corporate share certificate cannot create a corporate debt in addition to the certificate holder's rights as a shareholder.

39 The rules relating to the competing rights of shareholders and creditors of an insolvent corporation have become so regulated by governmental action that one can readily lose sight of the common law basis for making a distinction. To understand the difference in treatment, we must re-examine what a share of a corporation represents. Initially, a share is issued by the corporation to raise share capital. The price of the share is money or the promise of money. Accordingly, an individual share is one of a number of separate but integral parts of the authorized capital of a corporation. Even though it is the shareholders who contribute to the capital of the corporation, the capital remains the property of the corporation. The shareholders, however, as owners of the shares of capital, effectively control the corporation. They have the responsibility of managing its affairs through their control over the board of directors and in popular terminology are considered to be the owners of the corporation. However, the corporation is a separate entity in law, and if in the course of carrying out its business it incurs debts to third parties, those debts are those of the corporation. A corporation is an intangible and its capital therefore represents its substance to third parties having business dealings with the corporation. A preferred share is simply a share of a class of issued shares which contains a preference over other classes of shares, whether preferred or common: see Sutherland, Fraser and Stewart on Company Law of Canada, 6th ed. (1993), at pp. 157 and 195 for further discussion.

40 The rights of shareholders are conveniently summarized by R.M. Bryden in his chapter, "The Law of Dividends", contained in Ziegel ed., Studies in Canadian Company Law (1967), at p. 270:

> The purchaser of a share in a business corporation acquires three basic rights: he is entitled to vote at shareholders' meetings; he is entitled to share in the profits of the company when these are declared as dividends in respect of the shares of the class of which his share forms a part; and he is entitled, upon the winding-up of the corporation, to participate in the distribution of the assets of the company that remain after creditors are paid. A fourth right which should be noted is the right to transfer ownership in his share, whereby the owner for the time being may realize upon the increase in value of the company's assets, or its favourable prospects, by selling his share at a price reflecting the buyer's estimation of the value of the rights he will acquire. Unless the shareholder chooses to sell his share, he can realize a return upon his investment only through receipt of dividends or by the return of his capital upon an authorized reduction of capital or winding up.

41 Shareholders are variously characterized as entrepreneurs, investors or risk-takers and as such they have the opportunities of benefitting from the successes of the corporation and suffering from its failures. While the corporation is an operating entity, the shareholders receive their rewards, if there are any, through the payment of dividends declared from time to time by the board of directors. While the source of these dividends is not restricted to surplus funds, the result of the payment of the dividend must not result in a return of capital to the shareholders. The classic justification for this rule was stated by Sir George Jessel, Master of the Rolls, in Flitcroft's Case (1882), 21 Ch. D. 519 at pp. 533-34, 52 L.J. Ch. 217 (C.A.):

> The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor ... gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders ...

42 Creditors, on the other hand, do not have an ownership or equity interest in the corporation. They are third parties who have loaned money or otherwise advanced credit to the corporation. They look to the company for payment in accordance with the terms of the contract creating the indebtedness. They are also restricted in their recovery to the amounts stipulated in the terms of indebtedness. They are entitled to payment regardless of the financial circumstances of the debtor corporation and accordingly are not restricted to receiving payment of the debt from surplus. They can be paid out of assets or through the creation of further indebtedness. It is immaterial how the corporation records this indebtedness in its internal books. In some circumstances the indebtedness could properly reflect the acquisition of property from a creditor as a capital asset. This does not, however, convert the creditor into an investor. The vendor of the property remains a creditor and retains priority over shareholders in the event of a bankruptcy or insolvency.

43 In my view, the reasons under appeal do not reflect a sensitivity to the circumstances which gave rise to the issuance of the preference shares. The shares were not issued by Central Capital to the general public in order to raise capital and do not represent an investment by the public in the capital of the corporation. They were issued to specific persons as payment for the acquisition of specified assets. While the corporation was authorized by its articles of incorporation to issue preferred shares generally, the shares issued to the appellants were structured to meet the requirements of the appellants as vendors of the controlling interest in the operating companies that Central Capital was acquiring. In my view, these preference shares are the equivalent of vendor shares in that the appellants received them in exchange for the transfer of assets to Central Capital.

44 In the case of McCutcheon, the retraction provision in the preferred shares represented only partial payment of an agreed value for the assets, but in the case of SYH, they represented the full value. In both cases, the agreed value as reflected in the retraction price was guaranteed by Central Capital to be retractable at a fixed price at a predetermined date. By postponing the obligation to pay the purchase price in this way, Central Capital was using the retraction provisions of the preference shares as a vehicle for the financing of its expanding asset base. The appellants, for their part, deferred the realization of the purchase price of their assets to the agreed dates and thereby extended credit to the corporation. In return for extending credit for some or all of the selling price, the appellants agreed to receive dividends calculated in advance but payable as and when declared by the board of directors.

45 Thus, in looking at the substance of the transaction that led to the issuance of the preference shares, it appears to me that the retraction clauses were promises by Central Capital to pay fixed amounts on definite dates to the appellants. They evidenced a debt to the appellants. The fact that the appellants as holders of the preference shares had rights as shareholders in the corporation up to the time when the retraction clauses were exercisable did not affect their right to enforce payment of the retraction price when it became due.

46 The validity of an analysis directed to the substance of the transaction is supported by Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385, a judgment of the Supreme Court of Canada delivered by Iacobucci J. The case involved a number of corporations constituting a support group which entered into an arrangement to provide emergency financial assistance to Canadian Commercial Bank ("CCB"). On the ultimate failure of the bank, the issue arose as to whether the moneys advanced to CCB under this support arrangement were in the nature of a loan or in the nature of a capital investment. I find instructive to our situation Iacobucci J.'s observation at pp. 590-91:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the <u>substance</u> of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.

(Emphasis in original)

47 I have no difficulty in finding that the appellants' preferred shares with their retraction clauses are of "a hybrid nature, combining elements of both debt and equity". As to the equity component, the appellants are shareholders prior to exercising their retraction rights in that they have the right to vote in certain circumstances and have a right to receive dividends when and if they are declared by the board of directors. The debt component is more significant however. The shares were not issued to investors, but to vendors of property. The vendors were entitled to receive a fixed sum at a specified time in payment therefor. Pending payment, the vendors were entitled to receive dividends which were the equivalent of interest on the unpaid balance.

48 I can think of no reason why the holders of these preferred shares should not be treated as both shareholders and creditors. It does not concern me that these appellants act as shareholders before their retraction rights are exercisable. Nor do I see any hardship to other creditors of Central Capital arising from the ability of these appellants to claim as creditors in the restructuring of the company given that the appellants are unpaid with respect to substantial assets sold to the corporation and now transferred on the restructuring to CIGL.

49 Much was made in argument of the fact that the retraction amounts could not be paid on the retraction dates. In the case of McCutcheon, the corporation was insolvent and subject to court administration on the due date of July 1, 1992. In the case of SYH, the retraction date did not arrive before the reorganization was complete.

50 The narrow issue of the effect of insolvency on a debt has been dealt with by the British Columbia Court of Appeal in Re East Chilliwack Agricultural Co-Operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11. In this case, the appellants were one-time members of three co-operative associations. The rules of the co-operatives permitted a member to withdraw upon written notice to the board of directors to that effect. The member was entitled to elect to have his shares redeemed either in equal instalments over five years or in one payment with interest at the end of five years. In April of 1987, the superintendent of co-operatives, under the authority of the Cooperative Association Act, R.S.B.C. 1979, c. 66, suspended the co-operatives' right to redeem their shares until their financial situation was no longer impaired. The three co-operatives subsequently went bankrupt and a two-fold issue came before the bankruptcy court: (1) whether those members whose notices of withdrawal had been accepted by the board of directors but who had not yet received the value of the shares were entitled to rank as unsecured creditors, and (2) whether those who had delivered notices that had not been accepted were to be treated as unsecured creditors. The court of first instance found that the members were shareholders and answered both questions in the negative. That judge was reversed on appeal with the majority of the court deciding that the answer to both questions was yes. Hutcheon J.A. for the majority stated at p. 13:

> I shall use Mr. Neels [a co-operative member] as my example. According to R. 3.06 he ceased to be a shareholder in May 1983. In May 1984 the

> Agricultural Co-operative owed him the first of five payments, or $686.40. I know of no principle of law that would support the proposition that Neels could not sue for that amount if the Agricultural Co-operative failed to pay in May 1984. Of course, the superintendent of co-operatives has power under s. 15(2) to suspend payments if, in his opinion, the financial position of the co-operative was impaired. Subject to that power, the position of Neels and the Agricultural Co-operative would be that of ordinary creditor and debtor. In my opinion, the order made by the judge cannot be sustained on the first ground.

From this case, I extract the proposition that the fact of an insolvency, whether declared or not, does not change the nature of the relationship between debtor and creditor. It continues notwithstanding the inability of the debtor to pay or the creditor to collect.

51 It appears to me, with deference, that the issue of the effect of Central Capital's insolvency on the character of the retraction payments is something of a red herring. The contest in this appeal is between those who are conceded to be unsecured creditors and those whose claim to such status is contested. In both cases, any right to payment was suspended by Central Capital's announcement in December of 1991 that it was insolvent and that it had suspended all payments of principal and interest to unsecured creditors. This course of action was not freely chosen but was required by law. Any payments to creditors after the date of insolvency would be voidable at the instance of creditors on the basis that they were fraudulent preferences. In addition to ss. 95 and 96 of the Bankruptcy Act dealing with fraudulent preferences generally, there is provincial legislation in the form of the Fraudulent Conveyances Act, R.S.O. 1990, c. F-29, and the Assignments and Preferences Act, R.S.O. 1990, c. A-33, that would be applicable. Counsel for the unsecured creditors maintains that the right to redeem shares, including preference shares, was postponed by s. 36(2) of the CBCA, supra. I am not certain that s. 36(2) applies to the retraction provisions of the appellants' preference shares as opposed to the redemption privileges of Central Capital, but in my opinion the point is irrelevant to this appeal. Once Central Capital acknowledged its insolvency, it could neither redeem its shares nor honour its retraction obligations. The whole purpose for the creditors applying to the court for a stay of Central Capital's obligations, including those of the acknowledged unsecured creditors, was to arrange for a scheme of payments to all creditors that could not be subject to attack as preferences. There is no suggestion on the evidence before us that the claims of unsecured creditors accepted by the Administrator were claims that had crystallized prior to the insolvency of Central Capital. Nor is it suggested that any creditors were rejected because some or all of their claims were not payable until after the date of the insolvency. The fact of insolvency, by itself, does not provide a rational basis for distinguishing the claims of the appellants from those of other unsecured creditors.

52 Much also was made of the provision in the Articles authorizing the shares in question, which states that if the obligation to redeem "would be contrary to applicable law", then Central Capital "shall redeem only the maximum number of [shares] it is then permitted to redeem". Counsel for the unsecured creditors submits that the reference to "applicable law" is to s. 36 of the CBCA. The reference certainly embraces the CBCA, but it is not restricted by its terms to that statute. For example, "applicable law" would also capture s. 101 of the Bankruptcy and Insolvency Act, which provides for penalties against directors and shareholders where insolvent companies redeem shares or pay dividends.

53 There was no evidence led as to why this provision was placed in the articles and the share certificates. It appears to be a standard clause in all the preference shares issued by the corporation and not just those that were adapted to the appellants' situations where specific retraction clauses were drafted to satisfy the particular asset acquisitions. For my part, I have difficulty in understanding how a consideration of this provision assists the process of determining the underlying character of the retraction obligations. The statement is so self-evident that it is almost banal. I can only assume that the statement was included in the share provisions of a corporation marketing its securities world-wide so as to inform purchasers that legal restrictions in this jurisdiction apply to the company's right to redeem shares.

54 In summary then regarding the insolvency argument, these various statutes prohibit payments of any kind to shareholders by an insolvent company. As I understand it, counsel does not question that when a dividend has been lawfully declared by a corporation, it is a debt of the corporation and each shareholder is entitled to sue the corporation for his proportion: see Fraser and Stewart, supra, at p. 220 for a list of authorities. However, once a company is insolvent it cannot make payments to shareholders or creditors so long as it continues to be insolvent. On the other hand, nowhere in the CBCA or elsewhere will we find authority for the proposition that once a corporation is insolvent, it is no longer obliged to pay its debts. The obligation is postponed until the insolvency is corrected or the corporation makes an accommodation with its creditors and obtains a release with or without the assistance of the various statutes dealing with insolvency.

55 The existence of provisions prohibiting payment to shareholders and creditors on insolvency does not in any way assist the determination of whether the retraction obligations at issue in this appeal constitute a debt or a return of capital at the time they are payable. Speaking of the obligation to honour the retraction in terms of the corporation redeeming its shares also introduces the wrong emphasis. The corporation is not redeeming the shares at its option as contemplated by most redemptions. It is being forced to redeem them because of a prior contractual obligation for which the preferred shareholder gave good consideration. It is for this reason that I question whether s. 36 of the CBCA is the appropriate reference point. This is not the type of payment which concerned Jessel M.R. in Flitcroft's Case, supra.

56 At the risk of oversimplifying this case, it appears to me that many of the arguments made against the appellants' claims to be creditors of Central Capital are impermissible in the context of the agreed statement of facts. The issue in appeal is frozen in time by the stipulation that the court is to determine if these retraction clauses created a debt within the meaning of the Bankruptcy and Insolvency Act on June 15, 1992. The arguments against the appellants' claims also ignore that debts under s. 121(1) of the Bankruptcy Act need not be payable at the date of the bankruptcy (or

June 15, 1992 in our scenario). They need only come beneath the broad umbrella of "debts and liabilities, present and future, to which [Central Capital] is subject" on June 15, 1992. The fact that the debts could not be paid after June 15, 1992, does not mean that they were not provable claims pursuant to s. 121 of the Bankruptcy and Insolvency Act. Moreover, assuming the retraction clauses created a debt payable on a future date, neither the order of Houlden J. nor the restrictions in the articles creating the shares themselves purported to extinguish that debt.

57 There is nothing in either the articles of Central Capital or in the law that excuses the obligation to pay the retraction amounts. Rather, discharge of the obligation is simply postponed until the cessation of the disabling event of insolvency. Article 4.3 of the Senior Series B Provisions provides the mechanism for future redemption of tendered shares that are not redeemed because such redemption would be contrary to law. Article 4.5 provides that the inability to effect a redemption does not affect the obligation to pay dividends accrued or accruing on the unredeemed shares.

58 So far as SYH is concerned, the retraction price was not payable until the fifth anniversary of the June 1989 sale of assets. Therefore, no issue of the effect of insolvency arose in 1992. The orders of Houlden J. of June 15 and July 9, 1992 changed the rules of the game. If this appellant is a creditor, it does not have to wait until the retraction date. It can claim as a creditor now. It did and the claim was disallowed. However, if this court holds that the claim should have been allowed, then in accordance with the narrow issue put to us, SYH is entitled to be accepted as a full creditor in the entire reorganization of Central Capital.

59 An additional factor raised by counsel during argument was that art. 7, supra, provides that in the event of the liquidation, dissolution or winding-up of Central Capital, whether voluntary or involuntary, or any other distribution of assets among its shareholders for the purpose of winding up its affairs, the holders of these preferred shares are entitled to recover "from the assets of Central Capital" the retraction price plus all accrued and unpaid dividends thereon. Such amount is to be paid prior to payment to junior ranking shareholders. The article further provides that "[u]pon payment of such amounts, the holders of [the preferred shares] shall not be entitled to share in any further distribution of assets of [Central Capital]". Because it is trite law that shareholders are entitled to recover from assets only after all ordinary creditors have been paid in full, counsel for the unsecured creditors submits that the fact that the clause contemplates priorities between shareholders on a winding-up or a liquidation of assets is clear evidence that they were shareholders only.

60 I have two responses to this submission. The first is the obvious, that we are not dealing with this contemplated event. We are dealing with a reorganization in which the parties have put a single question to the court: are the appellants creditors? Consideration of issues of priority or the valuation of claims have been taken away by the narrow scope of the agreed question. If the answer to the question posed is yes, then in accordance with the agreed statement of facts, the appellants are entitled to have their claims as creditors allowed under the subscription and escrow agreement and to participate in the amended plan of arrangement as senior creditors. If the answer is no, they are to be treated as the Administrator has treated them: they are not creditors at all and are restricted to receiving Central New Common Shares under the amended plan of arrangement.

61 My second response is that counsel for the unsecured creditors misses the significance of the clause. He assumes that there will be a deficiency in all circumstances leading up to a liquidation, dissolution or winding-up that will necessitate a pro rata distribution, first to creditors and then to shareholders of all classes. However, the clause does not say that those with retraction rights are not creditors. It says that the retraction amounts are to be paid out of assets, not surplus. Once the retraction amounts have been paid in full, the appellants are not entitled to share in any further distribution. This contemplates a surplus after all creditors, including the appellants, have been paid in full. Accordingly, far from classifying the appellants as shareholders, the clause provides that they are not entitled to be treated as shareholders under a winding-up or liquidation but only as creditors.

62 Finally, with respect to SYH's claims, it was submitted that these claims were so contingent as to be virtually non-existent. The claims anticipate a retraction date that as of June 15, 1992 was some two years into the future. Upon approval of the amended plan of arrangement on December 18, 1992, the shares of SYH were cancelled and replaced by a new issue of shares, the Central New Common Shares. Counsel relied upon the finding of Feldman J. that there was then no discernable basis upon which the retraction could occur. Once again, with respect, this conclusion misses the point. Following the final order of Houlden J. approving the amended plan of arrangement, all the shares and all the debts of Central Capital disappeared. There was thereafter no discernable basis upon which any event contemplated by any debt or share instruments could occur. We are only concerned with the status of shareholders and creditors as of June 15, 1992.

63 Based on the reasons set out above, I have concluded that the retraction amounts do fall within the definition of debts and liabilities, present or future, to which Central Capital was subject on June 15, 1992. This does not apply to undeclared dividends, however, because until a dividend is declared no action on behalf of a shareholder lies to enforce its payment: see Fairhall v. Butler, [1928] S.C.R. 369 at p. 374, [1928] 3 D.L.R. 161. If undeclared dividends have been claimed by any of the appellants they should be disallowed. In all other respects the claims should be allowed.

64 Accordingly, I would allow the appeals, set aside the order of Feldman J. and order that the appellants have provable claims that are to be allowed by the Administrator. The record does not disclose what order if any Feldman J. made as to costs. Certainly the appellants are entitled to their costs of this appeal. If the parties are unable to agree with respect to any other disposition of costs, I would suggest that they submit their positions to the court in writing.

65 WEILER J.A.: -- I have had the benefit of reading the reasons of Finlayson J.A. and for the reasons which follow I respectfully disagree with his conclusion that the appellants are entitled to prove a claim pursuant to the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 (the

"CCAA").

66 Section 12(1) of the CCAA requires that persons wishing to participate in a reorganization have claims which would be provable in bankruptcy. Section 121(1) of the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, states that "[a]ll debts and liabilities, present or future ... shall be deemed to be claims provable in proceedings under this Act".

67 In order to decide whether the obligation of Central Capital to redeem the preferred shares of the appellants is a claim provable in bankruptcy, it is necessary to characterize the true nature of the transaction. The court must look to the surrounding circumstances to determine whether the true nature of the relationship is that of a shareholder who has equity in the company or whether it is that of a creditor owed a debt or liability by the company: Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385. In this case, the decision is not an easy one. Where, as here, the agreements between the parties are reflected in the articles of the corporation, it is necessary to examine them carefully to characterize the true relationship. It is not disputed that if the true nature of the relationship is that of a shareholder-equity relationship after the retraction date and at the time of the reorganization, then the appellants do not have a claim provable in bankruptcy. Consequently, they will not have a claim under the CCAA.

68 As I see it, three main questions need to be addressed:

(1) Was Feldman J. correct in characterizing the relationship between Central Capital and the companies owned by James McCutcheon ("McCutcheon"), and between Central Capital and Scottish and York Holdings Limited (the predecessor to S.Y.H., hereinafter referred to as "SYH"), as a shareholder relationship?

(2) Did the nature of the relationship change after the retraction date for redeeming the shares of McCutcheon or, in the case of SYH, at the time of the reorganization?

(3) If the nature of the relationship is not a shareholder-equity relationship, are the appellants entitled to prove a claim under the CCAA?

69 In addition, the appellants raise the question of whether they have a right to prove a claim for dividends, which have accrued but have not yet been declared payable. The price to be paid by Central Capital to McCutcheon on the retraction date, July 1, 1992, was $25 per share plus all accrued and unpaid dividends thereon. The dividends are therefore part of the retraction price. Similar provisions apply to SYH.

70 The reasons of Finlayson J.A. contain a comprehensive statement of the background to the litigation and I will therefore only refer to the facts in a summary fashion.

71 James McCutcheon and his brother sold their shares in Central Guarantee Trust Company to Central Capital Corporation ("Central Capital"), a trust company, for $575 a share. They received

$400 per share in cash. The balance of $175 owing on each share was paid through the issue of seven preferred shares in Central Capital, with each share having a par value of $25. Following this transaction, McCutcheon purchased his brother's shares. These preferred shares, known as Senior Series B Preferred Shares, were to be listed on the Toronto Stock Exchange. These shares carried with them a retraction privilege. The shareholder had the right to have his shares redeemed by Central Capital on July 1, 1992, for $25 a share, provided that such redemption would not be "contrary to law in the context of the Corporation's current financial position". McCutcheon chose not to sell his shares.

72 Scottish & York Holdings Limited (the predecessor to SYH) sold its shares in certain insurance companies which it owned to Central Capital. Central Capital paid for these shares by the issue of Series A Junior Preferred Shares. These shares were not posted on a stock exchange. SYH had the right to have its shares redeemed by Central Capital on or after September 1994 at a price of $1.00 per share, subject to the provisions of the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (the "CBCA").

73 It should be noted that the right of retraction was not unique to these two classes of shareholders. Even common shareholders had the right to have their shares retracted under certain circumstances.

74 By December 1991, Central Capital was unable to pay its liabilities as they became due and its total liabilities greatly exceeded the value of its assets. As a result, the various banks and subordinated debtholders, collectively referred to as the lenders, had a choice to make. Inasmuch as the definition of a corporation in s. 2 of the Bankruptcy and Insolvency Act precludes a creditor from bringing a petition against a trust company, they could either wind up Central Capital under the Winding-up Act, R.S.C. 1985, c. W-11, or they could try to restructure Central Capital under the CCAA. In a winding-up or liquidation, the trustee would sell the company's assets, either piecemeal or as a going concern, to third parties. The proceeds from the sale would then be distributed to those who proved a claim according to set priority rules. In a reorganization, existing fixed amounts owed to Central Capital's creditors would be traded for new claims and ownership interests in the reorganized corporation which would remain a going concern. The lenders chose to reorganize.

75 Two transactions were involved. In the Consolidated Insurance Group Limited transaction, or "CIGL transaction", Central Capital transferred some of its significant assets to a newly incorporated company, CIGL. Thirty-nine creditors of Central Capital then elected to exchange a portion of Central Capital's debt owing to them for equity in this newly incorporated company. In the second transaction, common shares were issued for the remaining assets of Central Capital. The creditors of Central Capital were given 90 per cent of the common shares of the reorganized company. The balance of 10 per cent was allocated to the shareholders of Central Capital. All of the preferred, common and subordinate voting shares in Central Capital were then converted into these "new" common shares. The reorganization was subsequently approved by the creditors and sanctioned by the court as required by the Act, but this approval was given without prejudice to any

claims that McCutcheon and SYH might have.

76 McCutcheon's position was that the right to have his shares retracted accrued before the reorganization, and that his exercise of this right of retraction in May 1992 constituted a present debt or liability entitling him to rank as a creditor in the CIGL transaction and in the reorganized Central Capital. SYH's position was that the right to have its shares retracted in 1994 created a future debt or liability and thus a provable claim. The administrator of Central Capital disallowed both claims. McCutcheon and SYH appealed the administrator's decision to Feldman J. In dismissing their appeals, she held that the appellants were shareholders and that the right of retraction attaching to the shares did not change the nature of the shares from equity into debt.

1. Was Feldman J. correct in characterizing the agreement between Central Capital and the companies owned by McCutcheon, and between Central Capital and SYH, as creating a shareholder relationship between the parties?

77 Feldman J. analyzed the transaction and came to the conclusion that it was an equity transaction.

78 Finlayson J.A. is of the opinion that the nature of this transaction is different and that Feldman J. erred in not showing sensitivity to the fact that she was dealing with the sale of a business by its owners. He is of the opinion that the shares issued by Central Capital are the equivalent to "vendor shares" in that the appellants received them in exchange for the transfer of assets to Central Capital. He does not see the transaction as being either a contribution to capital by McCutcheon and SYH or as a return of capital. Although the transaction has debt and equity features, Finlayson J.A. is of the opinion that the true nature of the transaction is that of a debt owing by Central Capital to McCutcheon and SYH for the shares in their companies.

79 My analysis of the transaction is that when McCutcheon sold his shares in Central Guaranty and took back preferred shares in Central Capital as part payment, he transferred part of his capital investment from a smaller entity to a larger entity. Similarly, SYH transferred its investment in the shares of the insurance companies for shares in the larger entity of Central Capital. Both appellants could look to a larger asset base than before to generate a return on their capital. Until the retraction date, McCutcheon chose to take the risk of continuing his investment in Central Capital, which offered the prospect of a stable, yet relatively high, annual return through the receipt of 7 5/8 per cent dividends. Because the shares traded on the Toronto Stock Exchange, he would have had the option of realizing upon his investment by selling his shares for what they would bring on the open market, but he did not do so. In the case of SYH, although these shares were not required to be publicly listed, the corporation's articles did not restrict their transfer. The corporation's articles indicate that these shares had some preference over other shares with respect to the right to receive dividends and in the distribution of assets after creditors are paid on a liquidation. As preferred shareholders, McCutcheon and SYH did not have a voice in company affairs unless the company failed to pay the dividends it had promised to pay. This is quite typical: see Welling, Corporate Law in Canada, 2d ed. (1991) at p. 604; Ziegel et al., Cases and Materials on Partnership and Canadian Business Corporations, 2d ed. (1989) at p. 1198. Risk-taking, profit-sharing, transferability of investment, and the right to participate in a share of the assets on a liquidation after the creditors have been paid are the hallmarks of a shareholder: see R.M. Bryden, "The Law of Dividends," contained in Ziegel ed., Studies in Canadian Company Law (1967) at p. 270. In my opinion, Feldman J. was correct that the true nature of the relationship between the parties initially was that of an equity transaction.

2. Did the nature of the relationship change after the retraction date for McCutcheon's shares and did the reorganization trigger a right of redemption respecting SYH's shares?

80 Ordinarily, shareholders cannot realize on their investment in a company except by transferring their shares. The retraction privilege attaching to the shares gives the preferred shareholders the option of realizing on their investment other than by transferring their shares to a third party.

81 Feldman J. found that McCutcheon continued to be a shareholder after the retraction date and that he remained a shareholder at the time of the reorganization. She found SYH's claim to be too remote inasmuch as the retraction date had not yet arrived at the time of the reorganization.

82 The appellants argue that Feldman J. erred in this conclusion. They submit that although McCutcheon and SYH may have been shareholders initially, this relationship changed. Upon McCutcheon's exercise of his right to have the corporation pay him the retraction price of his shares, he ceased to be a shareholder. When Central Capital failed to pay him, he became a creditor of the corporation. In the case of SYH, it is submitted that when the lenders opted to reorganize the company, they, in effect, triggered the obligation to redeem SYH's shares.

(a) Nature of the transaction's relationship to the capital structure of the corporation

83 Section 25(3) of the CBCA states that shares shall not be issued until the consideration for the shares is fully paid either in cash or with property having a fair market value equivalent to the shares issued. Therefore, by issuing preferred shares with a fixed par value, Central Capital paid McCutcheon for his shares of Central Guaranty and paid SYH for the shares of the insurance companies that Central Capital received. Central Capital could not issue preferred shares except as full payment for the shares it received. The preferred shares were part of the capital of Central Capital and the preferred shares were always shown as shareholders' equity on Central Capital's books. The capital of the corporation is representative of the assets available to pay creditors. If, on the date for redemption of McCutcheon's shares, or on the date of reorganization in the case of SYH, the shares are redeemed, the amount paid must be deducted from the stated capital of the corporation: s. 39 CBCA. Consequently, the total assets that Central Capital will have available to pay the lenders and other creditors outside the corporation will be reduced. A reduction of capital by the redemption of redeemable shares is permitted under the CBCA but only where the requirements of s. 36 are met.

(b) Section 36 of the CBCA

84 Section 36 of the CBCA makes the ability of a corporation to redeem its redeemable shares subject to (1) its articles and (2) a solvency requirement. For ease of reference s. 36 is reproduced below.

> 36(1) Notwithstanding subsection 34(2) or 35(3) [both of which deal with a corporation's acquisition of its own shares in other circumstances], but subject to subsection (2) and to its articles, a corporation may purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.
>
> (2) A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of
>
> (i) its liabilities, and
> (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateably with or prior to the holders of shares to be purchased or redeemed.

(Emphasis added)

85 There is no dispute that Central Capital was unable to redeem McCutcheon's shares on the retraction date. Nor could it redeem SYH's shares on the date of the reorganization. The appellants agree that the effect of s. 36 renders the agreement between themselves and Central Capital unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish a debt or liability which they say has been created. The appellants rely on the decision in Re East Chilliwack Agricultural Co-operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11 (B.C.C.A.), in support of their position that a debt or liability is created notwithstanding the solvency requirements of s. 36 respecting payment. The appellants' submission does not take into consideration the major differences between the decision in East Chilliwack and the present situation relating to the timing, effect of the solvency requirements and the provisions in the articles governing the relationship of the parties.

86 (1) In East Chilliwack, farmers who owned shares in an agricultural co-operative gave notice to the co-op of their intention to have their shares redeemed. After the notices had been given, the superintendent of co-operatives suspended the right of the co-op to redeem its shares. Here, the request to redeem the shares by McCutcheon and the retraction date occurred after Central Capital had sent out a notice that it would not be able to redeem the shares due to its financial position. SYH had no right to demand that its shares be retracted until the retraction date, which was some two years after the date of Central Capital's insolvency.

87 As in the instant case, the issue in East Chilliwack was whether the farmers were entitled to rank with the creditors of the co-op. Hutcheon J.A., with Toy J.A. concurring, held that they were entitled to be treated as creditors.

88 At the outset of his reasons, Hutcheon J.A. noted, at p. 11, that the effect of the superintendent's suspension on the farmers' rights was not argued on appeal and that the court had been asked to determine the status of the farmers without regard to the suspension.

89 Here, the effect of Central Capital's inability to redeem its shares due to insolvency is very much in issue and cannot be ignored. Although the articles provide for the redemption of all of the shares held by McCutcheon and SYH on or after the retraction date, the articles also state that Central Capital will only redeem so many of its shares as would not be "contrary to law". Pursuant to s. 36(1) of the CBCA, a corporation may purchase or redeem redeemable shares, but the corporation is prohibited from doing so if the corporation is unable to pay its liabilities as they become due or if the assets of the corporation are less than the total of its liabilities and the amount required for the redemption. Because Central Capital could not comply with the solvency requirements, redemption would be "contrary to law".

90 (2) In East Chilliwack, supra, at p. 13, the rules of the co-op provided that upon the giving of a notice of redemption, the farmer giving it ceased to be a shareholder. Central Capital's articles do not state that a request for redemption of the holder's shares terminates his status as a shareholder. McCutcheon continued to have the right to receive dividends pursuant to art. 4.5 while his shares were not redeemed. In effect, so long as Central Capital was unable to redeem the shares but had profits, McCutcheon continued to be entitled to a share of the profits through the declaration of dividends. If the dividends remained unpaid for eight consecutive quarters then, pursuant to art. 8, McCutcheon had the right to receive notice of, and to attend, each meeting of shareholders at which directors were to be elected and was entitled to vote for the election of two directors. The articles relating to the preferred shares held by SYH contain a similar provision. The result of insolvency as envisaged by the articles was that McCutcheon and SYH would continue as shareholders.

91 (3) In East Chilliwack, supra, Hutcheon J.A. held, at p. 13, that, subject to the power of the superintendent of co-operatives, the farmer's position would be that of an ordinary creditor.

92 Here, the terms attaching to McCutcheon's shares do not give him that right. Instead, he is given the right to continue to receive dividends so long as the company cannot pay him. The articles relating to the shares held by SYH contain a similar provision. In addition, art. 4.3(b), respecting the retraction of the shares, indicates that if the directors have acted in good faith in making a determination that the number of shares the corporation is permitted to redeem is zero, then the corporation is not liable in the event this determination proves inaccurate. This would hardly be the position vis-à-vis an ordinary creditor.

93 (4) Article 8 and a similar provision in the articles relating to the shares held by SYH provide that upon a sale of all or a substantial part of the company's undertaking, the preferred shareholders have a right to receive notice of and to be present at the meeting called to consider this sale. The farmers in East Chilliwack do not appear to have had any similar right.

94 (5) Article 7 provides that in the event of a liquidation, dissolution or winding-up of the corporation the preferred shareholders have a right to receive $25 per Series B Senior Preferred Shares before the corporation pays any money or distributes assets to shareholders in any class subordinate or junior to the Series B Senior Preferred Shares. Similarly, SYH, as the holder of Series A and B Junior Preferred shares, has the right, upon the dissolution or winding-up of the corporation, to receive a sum equivalent to the redemption amount for each series junior preferred share. This right is subject to the rights of shares ranking in priority to the shares of these series, but is ahead of the rights of the holders of common shares.

95 Nothing in the articles concerning the retraction date affects the right of McCutcheon and SYH to participate in Central Capital's liquidation. The participation of the farmer in East Chilliwack ceased once he had given notice to redeem. Article 4.4 of Central Capital provides that once the shares have been tendered for retraction this election is irrevocable on the part of the holder. In the event that payment of the retraction price was not made, however, the holder had the right to have all deposited share certificates returned. Central Capital offered to return McCutcheon's shares to him, but he refused. Because McCutcheon retained all the rights and privileges of a preferred shareholder after the retraction date, the fact that he refused to take back his share certificates cannot alter the true nature of the relationship. The refusal was merely evidence of a dispute concerning what the relationship was. SYH also retained its full status as a shareholder until the date of the reorganization. This was not the situation in East Chilliwack.

96 By way of summary, on the date of the reorganization McCutcheon and SYH had not ceased to be preferred shareholders of Central Capital. The rights attaching to their retractable preferred shares entitled them to continue to share in the profits of the company when these were declared as dividends, to vote at shareholders meetings to elect directors so long as dividends remained unpaid for a specified period of time, and, on a winding-up of the company, to participate in the distribution of assets that remained after the creditors were paid according to the ranking of the series of their shares. The company's obligation to redeem its shares was not absolute. Instead, the articles provided for what was realistically a "best efforts" buy-back based on solvency and continuation as a shareholder to the extent a buy-back could not take place. In East Chilliwack, because the farmer ceased to be a shareholder, the articles do not appear to make any provision for continued participation or for the postponement of payment depending on the solvency of the co-op.

(c) Evidence of a debtor-creditor relationship is lacking in the articles

97 Looked at another way, after the retraction date and at the time of the reorganization, the common features of a debtor-creditor relationship are not in evidence in Central Capital's articles. The agreements between the parties contain no express provision that the redemption of the shares is in repayment of a loan. The corporation was not obliged to create any fund or debt instrument to ensure that it could redeem the shares on the retraction date. There is no indemnity in the event that the money is not repaid on the retraction date. There is no provision for the payment of any interest after the retraction date in the event that the money is not repaid on the retraction date. There is no provision that after the retraction date and in the event of insolvency, the appellants would have the right to have the company wound up. (See R. v. Imperial General Properties Ltd., [1985] 2 S.C.R. 288, 21 D.L.R. (4th) 741, for a case where the articles of the company contained this right.) There is no provision that upon a winding-up or insolvency the parties are entitled to rank pari passu with the creditors as was the case in Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra.

(d) The effect of the reorganization

98 Finlayson J.A. is of the view that it is immaterial that the articles provide, in the event of the liquidation, dissolution or winding-up of the company, that the appellants are only entitled to rank after the creditors but ahead of the junior ranking shareholders. In his view, this provision is irrelevant because we are not dealing with a liquidation but with a reorganization. He finds it significant that, like debtors, the preferred shareholders are not entitled to participate in any surplus once they have been paid. I am of the view that this provision in the articles is significant. It represents a clear indication that the holders of the retractable shares were not to be dealt with on the same footing as ordinary creditors even after the retraction date. Instead, they were to be dealt with as shareholders, albeit an elevated class. Under the CBCA all shares carry equal rights. Words used in the articles to differentiate a class of shares are nothing more than authorized deviations from this statutory position of equality: Welling, supra, at p. 683.

99 The appellants submit that a winding-up or liquidation is not the same as a reorganization. This is true. Both, however, are methods of dealing with insolvency. Both are methods for secured creditors to enforce their claims by seizing the assets in which they hold security interests. If the value of the corporation as a going concern exceeds the liquidation value of the assets, it is in the interest of all the debt holders that the corporation be preserved as a going concern. The purpose of both a liquidation and a reorganization is to permit the rehabilitation of the insolvent person unfettered by debt: Vachon v. Canada Employment & Immigration Commission, [1985] 2 S.C.R.

417, 23 D.L.R. (4th) 641. By virtue of s. 20 of the CCAA, arrangements under the Act mesh with the reorganization provisions of the CBCA so as to affect the company's relations with its shareholders. Shareholders have no right to dissent to a reorganization: s. 191(7), CBCA. On a reorganization, among other things, the articles may be amended to alter or remove rights and privileges attaching to a class of shares and to create new classes of shares: s. 173, CBCA. These statutory provisions provide a clear indication that, on a reorganization, the interests of all shareholders, including shareholders with a right of redemption, are subordinated to the interests of the creditors. Where the debts exceed the assets of the company, a sound commercial result militates in favour of resolving this problem in a manner that allows creditors to obtain repayment of their debt in the manner which is most advantageous to them.

100 The similarities between a liquidation and a reorganization, together with the express statement in the articles of Central Capital with respect to what is to happen on a winding-up, dictate that the interests of the holders of retractable shares, McCutcheon and SYH, are subordinated to the creditors and they are not entitled to claim under the CCAA equally with the creditors. This position is also consistent with the provisions of the Bankruptcy and Insolvency Act and the Winding-up Act. In the case of an insolvency where the debts to creditors clearly exceed the assets of the company, the policy of federal insolvency legislation appears to be clear that shareholders do not have the right to look to the assets of the corporation until the creditors have been paid.

Dividends

101 Although dividends were payable on the shares of McCutcheon and SYH, no dividends were in fact declared. The appellants contend that the dividends, which have accrued but which were not declared, are a debt or liability because they were stipulated to be part of the retraction price.

102 Article 7 of Central Capital respecting McCutcheon's shares states that in the event of a liquidation, dissolution or winding-up of the corporation, the shareholders are entitled to receive not only the $25 per Series B preferred share, but "all accrued and unpaid dividends thereon, whether or not declared ... before any amount is paid by the Corporation or any assets of the Corporation are distributed to the holders of any shares ... ranking as to capital junior to the Series B Senior preferred Shares".

103 It is trite law that a dividend may only be declared if a company is solvent. For corporations governed by the CBCA, it appears that the common law tests for solvency have all been subsumed or overruled: R. v. McClurg, [1990] 3 S.C.R. 1020 at pp. 1039-40, [1991] 2 W.W.R. 244 at pp. 259-60.

104 Section 42 of the CBCA provides:

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

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

105 Section 42 prevents the corporation from declaring or paying a dividend when it does not meet certain solvency requirements. There was no declaration of a dividend in the present case. Any obligation to pay a dividend as part of the retraction price cannot therefore be enforced when the company is insolvent. Dividends which have accrued but which are unpaid are not considered to be a debt because, on reading the articles as a whole, the provision for payment is not one which is made independent of the ability to pay: see Welling, supra, at p. 689, citing International Power Co. v. McMaster University, [1946] S.C.R. 178, [1946] 2 D.L.R. 81, where it was held there was no guarantee of payment and hence the accrued but unpaid dividends were not a debt. Instead, accrued but unpaid dividends are considered to be akin to a return of capital. Making these accrued dividends part of the retraction price does not alter this.

106 By way of analogy to the treatment of dividends, it could be said that until the company has declared it will redeem the shares which are tendered to it the obligation to redeem them is not a debt or liability. The promise to pay in the articles of Central Capital is not made independent of any ability to pay.

107 In the event that I am wrong in my conclusion that the true nature of the relationship is one of equity, I shall now consider the position in the event that a debt has been created.

3. If the nature of the relationship is not an equity relationship are the appellants entitled to be claimants under the CCAA?

108 The parties agree that the effect of s. 36 renders the agreement to redeem their preferred shares unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish Central Capital's obligation to repay them. Their position is that Central Capital's obligation to repay them is a contingent liability and therefore gives them a claim provable in bankruptcy, bringing them under s. 12(1) of the CCAA.

The Meaning of Debt

109 Debt is defined in a very broad manner in Black's Law Dictionary, 6th ed. (1990) at p. 403. It is the position of the appellants that this definition of "debt" is broad enough to include McCutcheon's right to have Central Capital redeem his shares. In the case of SYH, it is submitted that the right to redemption constitutes a future liability. It is the appellants' position that Feldman J. erred in holding that to have a provable claim, McCutcheon and Central Capital must be able to obtain a judgment against Central Capital for the retraction price and be entitled to seek payment on the judgment. Finlayson J.A. agrees with the appellant's position.

110 Debt is defined in Black's Law Dictionary, supra, as:

> A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only obligation of debtor to pay but right of creditor to receive and enforce payment ...
>
> A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future. In a still more general sense, that which is due from one person to another, whether money, goods, or services. In a broad sense, any duty to respond to another in money, labor, or service; it may even mean a moral or honorary obligation, unenforceable by legal action. Also, sometimes an aggregate of separate debts, or the total sum of the existing claims against person or company. Thus we speak of the "national debt", the "bonded debt" of a corporation, etc.

111 It will be readily apparent that in Black's the term "debt" is defined in two distinct ways. In order to constitute a debt as defined in the first paragraph, the obligation must be enforceable. In the second paragraph debt is defined more broadly as any duty or obligation even if unenforceable by legal action. Feldman J. considered the first portion of the definition in her reasons. If the first portion of the definition applies, no debt is created because the obligation is not enforceable under the CBCA. The appellants rely on the second portion of the definition. They also rely on the definition of the word "liability" in Black's which is also defined very broadly.

112 In one sense, support for the position of the appellants is found in s. 40 of the CBCA. Section 40 states that a contract with a corporation providing for the purchase of shares of the corporation is specifically enforceable against the corporation except to the extent that the corporation cannot perform the contract without being in breach of ss. 34 or 35. Section 34 contains the solvency requirements concerning the redemption by a company of its own shares other than those carrying a right of redemption. Section 35 deals with shares which have been issued to settle or compromise a debt. In s. 2, "lability" is defined as including "a debt of a corporation arising under section 40".

113 Section 40 does not include any reference to the obligation of a company to repurchase redeemable shares under s. 36. As a result s. 36 is not incorporated by reference into the definition of liability. While it might be suggested that this is a legislative oversight, the omission is also consistent with the position that only the articles of the corporation govern the relationships between the company and the holders of the retractable shares under s. 36. I have already stated my opinion that the articles of Central Capital do not make the obligation to redeem the shares a debt or, for that matter, a liability. Moreover, even if a provision like s. 40 is implied with respect to redeemable preferred shares, it would also be necessary to imply a provision like s. 40(3) which states that in the event of liquidation where the company has not performed its contract to redeem, the other party is entitled to be ranked subordinate to the rights of creditors but in priority to the shareholders. This is a clear expression of legislative intention that on insolvency the claim of those entitled to have their shares redeemed should not be placed on the same footing with the claims of creditors but should rank subordinate to them: see Nelson v. Rentown Enterprises Inc., [1994] 4 W.W.R. 579, 16 Alta. L.R. (3d) 212 (C.A.), adopting the reasons of Hunt J. at 96 D.L.R. (4th) 586, 5 Alta. L.R. (3d) 149 (Q.B.). Policy reasons would again militate in favour of the result being the same on a reorganization.

Claims in Bankruptcy

114 Even if the broader definitions of a debt or liability in Black's are adopted, the appellants still do not have a claim provable in bankruptcy.

115 Persuasive authority already exists to the effect that in order to be a provable claim within the meaning of s. 121 of the Bankruptcy and Insolvency Act the claim must be one recoverable by legal process: Farm Credit Corp. v. Holowach (Trustee of), [1988] 5 W.W.R. 87 at p. 90, 51 D.L.R. (4th) 501 (Alta. C.A.), leave to appeal to the Supreme Court of Canada dismissed at [1989] 4 W.W.R. lxx.

116 In Holowach, the seven members of the court were dealing with a situation in which some persons borrowed money from a mortgagee and mortgaged certain lands as security for repayment of the loan. The mortgagors then made an assignment in bankruptcy. The mortgagee filed a proof of claim for the full amount of the deficiency, that is, the amount of the indebtedness less the value of the land which the mortgagee was permitted to purchase. The Alberta Law of Property Act, R.S.A. 1980, c. L-8, precluded deficiency claims against individuals in foreclosure actions, although the effect of the legislation was not to extinguish or satisfy the debt. The mortgagee argued that it had a claim provable in bankruptcy under s. 95(1) of the Bankruptcy Act, R.S.O. 1970, c. B-3, now s. 121(1) of the Bankruptcy and Insolvency Act. The court rejected this argument, holding that a provable claim must be one recoverable by legal process. In coming to its conclusion, the court relied on Reference re Debt Adjustment Act, 1937, [1943] 1 All E.R. 240, [1943] 1 W.W.R. 378 (P.C.), and a number of decisions at the trial level which are collected at p. 91 of the decision.

117 Here, the contract to repurchase the shares, while perfectly valid, is without effect to the extent that there is a conflict between the corporation's promise to redeem the shares and its statutory obligation under s. 36 of the CBCA not to reduce its capital where it is insolvent. As was the case in the Holowach decision, this statutory overlay renders Central Capital's promise to redeem the appellants' preferred shares unenforceable. Although there is a right to receive payment, the effect of the solvency provision of the CBCA means that there is no right to enforce payment. Inasmuch as there is no right to enforce payment, the promise is not one which can be proved as a claim.

118 It could be suggested that the decision in Holowach can be distinguished from the instant case on the basis that in Holowach the claim is made unenforceable forever by statute whereas under the CCAA the claim is unenforceable only so long as the corporation does not meet the solvency requirements of s. 36 of the CBCA. I do not believe this is a valid distinction for three reasons. First, the relevant date for determining any contingent liability is not the future but the past, namely, September 8, 1992, the date by which proofs of claim had to be submitted. On that date, Central Capital was insolvent. Second, it is only because the lenders were willing to convert their debt obligations into equity in the reorganization that Central Capital is now solvent. Central Capital is not the same company and its liabilities are not the same. The redeemable shares no longer exist. Third, in order to be profitable, the assets of a company must be managed. Any value in the assets after the insolvency of the company is, in this case, due to the new management and not to the preferred shareholders extending credit to the company by having their claim for redemption postponed.

119 Even if Central Capital's obligation to redeem the shares of the appellants created a debt or liability, the appellants do not have a claim provable within the meaning of s. 121 of the Bankruptcy and Insolvency Act.

CONCLUSION

120 I would dismiss the appeal. For the reasons I have given, the retraction amounts do not constitute a debt or liability within the meaning of s. 121 of the Bankruptcy and Insolvency Act. Even if I am wrong in my conclusion and a debt or liability is created, it is not a claim within the meaning of the CCAA. This is a case of first impression. For these reasons, I would not award any costs of this appeal.

121 LASKIN J.A. (concurring): -- I have read the reasons of my colleagues Justice Finlayson and Justice Weiler. Like Justice Weiler, I would affirm the decision of the motions judge, Feldman J., and dismiss these appeals. I prefer, however, to state my own reasons for upholding the position of the unsecured creditors of Central Capital Corporation.

The Issue

122 The application was argued before Madam Justice Feldman on an agreed statement of facts. My colleagues have summarized the relevant facts and important provisions of the documents. Each appellant holds preferred shares of Central Capital and each appellant's shares contain a right of retraction -- a right to require Central Capital to redeem the shares on a fixed date and for a fixed price. The retraction date for the appellants James McCutcheon and Central Guarantee Trust Company (collectively McCutcheon) was July 1, 1992, and before that date McCutcheon exercised his right of retraction and tendered his shares for redemption. The retraction date for the appellant SYH Corporation was September 1994 and although it could not tender its shares for redemption, it did file a proof of claim with the Administrator of Central Capital. The Administrator disallowed each appellant's claim and Feldman J. dismissed appeals from the Administrator's decisions.

123 The issue on these appeals is whether McCutcheon and SYH Corporation "have claims provable against Central Capital Corporation within the meaning of the Bankruptcy Act (Canada) as amended as of the date of the Restated Subscription and Escrow Agreement". Under the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 2, a claim provable "includes any claim or liability provable in proceedings under this Act by a creditor" and a creditor "means a person having a claim, preferred, secured or unsecured, provable as a claim under this Act". Section 121(1) of the Bankruptcy Act further defines claims provable as follows:

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

124 The date of the restated subscription and escrow agreement is May 1992.[1] at end of document.] By then, and indeed since December 1991, Central Capital had been insolvent and therefore was prohibited by s. 36(2) of the Canada Business Corporations Act, R.S.C. 1985, c. C-44, from making any payment to redeem the appellants' shares.

125 On June 15, 1992, Houlden J. provided that Central Capital could be reorganized under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, and he stayed proceedings against it. Houlden J.'s order of July 9, 1992, which approved the restructuring of Central Capital, was made without prejudice to the right of the appellants to assert claims as creditors. Thus the question for this court is whether the appellants' retraction rights created debts of Central Capital in May 1992. In other words were McCutcheon and SYH Corporation creditors of Central Capital in May 1992? If they were creditors, then like the other unsecured creditors of Central Capital, they can elect to take shares in the newly incorporated company, Canadian Insurance Group Limited; if they were not creditors, then they remain shareholders of Central Capital under the restructuring plan.

126 This is a question of characterization. I will address the question first, by considering the "substance" of the relationship between each appellant and the company; and second by considering s. 36(2) of the Canada Business Corporations Act, supra. In brief I conclude:

(1) Although the relationship between each appellant and the company has characteristics of debt and equity, in substance both McCutcheon and SYH Corporation are shareholders, not creditors of Central Capital. Neither the existence of their retraction rights nor the exercise of those rights converts them into creditors;

(2) Finding that the appellants were creditors of Central Capital would defeat the purpose of s. 36(2) of the statute.

I. The Relationship Between the Appellants and Central Capital

127 Preferred shares have been called "compromise securities" and even "financial mongrels":

Grover and Ross, Materials and Corporate Finance (1975), at p. 49. Invariably the conditions attaching to preferred shares contain attributes of equity and, at least in an economic sense, attributes of debt. Over the years financiers and corporate lawyers have blurred the distinction between equity and debt by endowing preferred shareholders with rights analogous to the rights of creditors. One example is the right of redemption -- the right of the corporation to compel preferred shareholders to sell their shares back to the corporation. Another example, and it is the case before us, is the right of retraction -- the right of shareholders to compel the corporation to buy back their shares on a specific date for a specific price.

128 I acknowledge, therefore, that redeemable or retractable preferred shares are somewhat different from conventional equity capital. What makes the appeals before us difficult is that although the appellants appear to hold equity, their right of retraction appears to be a basic characteristic of a debtor-creditor relationship: see Grover and Ross, supra, at pp. 47-49; Buckley, Gillen and Yalden, Corporations: Principles and Policies, 3d ed. (1995), at pp. 938-40.

129 If the certificate or instrument contains features of both equity and debt -- in other words if it is hybrid in character -- then the court must determine the "substance" of the relationship between the holder of the certificate and the company. This is the lesson of Justice Iacobucci's judgment in Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385. In that case the Supreme Court of Canada had to determine whether the financial assistance given by several lending institutions to try to rescue the Canadian Commercial Bank was "in the nature of a loan" or "in the nature of a capital investment". Justice Iacobucci discussed his approach to the problem at pp. 590-91 of his judgment:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and

> not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.

130 In determining the substance of the relationship, as in any other case of contract interpretation, the court looks to what the parties intended. In CDIC v. CCB, supra, Iacobucci J. put this proposition as follows at p. 588:

> As in any case involving contractual interpretation, the characterization issue facing this Court must be decided by determining the intention of the parties to the support agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention. When the words alone are insufficient to reach a conclusion as to the true nature of the agreement, or when outside support for a particular characterization is required, a consideration of admissible surrounding circumstances may be appropriate.

131 In these appeals what the parties intended is reflected mainly in the share purchase agreements and the conditions attaching to the appellants' shares, but also in the articles of incorporation and in the way Central Capital recorded the appellants' shares in its financial statements. These documents indicate that in substance the appellants are shareholders of Central Capital, not creditors. I rely on the following considerations to support my conclusion:

(i) Both appellants agreed to take preferred shares instead of some other instrument -- for example, a bond or debenture -- that would obviously have made them creditors. The appellant McCutcheon sold shares of one corporation (Canadian General Securities Limited) for cash and for shares of another corporation (Central Capital). Neither the share purchase agreements nor the share conditions support McCutcheon's contention that in taking preferred shares he was extending credit to Central Capital by deferring payment of the purchase price. He made an investment in the capital of Central Capital, no doubt because of the attractive dividend rate, the income tax advantages of preferred shares and "sweeteners" such as conversion privileges. Unlike Finlayson J.A., I place little weight on what he termed "the unique nature of the transaction". McCutcheon transferred assets to acquire his preferred shares rather than acquiring them with cash. But he nonetheless decided to invest in Central Capital and to take the risk and the profits (through dividends) of his investment.

Similarly, SYH Corporation exchanged its equity investment in four insurance companies for an equity investment in Central Capital. It too chose equity not debt. None of the contractual documents indicates that the appellants' retraction rights were intended to trigger an obligation on the part of Central Capital to repay a loan. Moreover, as Weiler J.A. points out, neither the share purchase agreements nor the share conditions provides for interest if Central Capital fails to honour its retraction obligations.

(ii) The senior preferred shares and junior preferred shares that the appellants own were part of the authorized capital of Central Capital before the appellants acquired them.

(iii) The appellants' shares were recorded in the financial statements of Central Capital as "capital stock", along with the company's issued and outstanding common shares, class "A" shares and warrants. The amount Central Capital might be obligated to pay the appellants if they exercised their retraction rights was not recorded as debt (even contingent debt) in the company's financial statements.

(iv) Both appellants had the right to receive dividends on their shares and McCutcheon had the right to vote his shares for the election of directors of Central Capital if dividends remained unpaid for a specified time. These rights -- to receive dividends and to vote -- are well recognized rights of shareholders. And these rights continue, even after the retraction dates, until the appellants' shares are redeemed.

(v) The preferred share conditions provide that on a liquidation, dissolution or winding-up, the holders rank with other shareholders and therefore, implicitly, behind creditors. The appellant McCutcheon, who holds senior preferred shares, would rank behind creditors but ahead of the holders of subordinate classes of shares; the appellant SYH Corporation, which holds junior preferred shares, would rank behind senior preferred shareholders but ahead of common shareholders.

132 These provisions in the preferred share conditions also state that on payment of the amount owing to them the appellants "shall not be entitled to share in any further distribution of assets of the corporation". Finlayson J.A. interprets this to mean that the appellants "are not entitled to be treated as shareholders under a winding-up or liquidation but only as creditors". I disagree. These are typical preferred share provisions, which limit the recovery of the holders but do not treat them as creditors: Sutherland, Fraser and Stewart on Company Law of Canada, 6th ed. (1993), at p. 198. At least on a liquidation, dissolution or winding-up, the preferred share conditions evidence that the appellants would be treated not as creditors but as shareholders. In CDIC v. CCB, supra, Iacobucci J. placed considerable weight on a provision in the participation agreement stating that each participant "shall rank pari passu with the rights of the depositors". No such provision exists in this case. Indeed the share conditions I have referred to state the opposite.

133 Of course, Central Capital was reorganized, not liquidated, dissolved or wound up and the preferred share conditions are silent about what occurs on a reorganization. Still these conditions shed light on what the parties intended on the reorganization. Section 12(1) of the Companies' Creditors Arrangement Act, supra, defines 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 Act". The question the court has been asked to answer is the same question that would arise on a liquidation. It is illogical to conclude that the appellants could claim only as shareholders on a liquidation and yet can claim as creditors on the reorganization. Whether Central Capital's financial difficulties led to a liquidation or a reorganization, the issue is the same and the analysis and the result should also be the same.

134 The appellants argue, however, that they are shareholders only until they exercise their retraction rights but once they exercise these rights they become creditors. I do not agree with this argument. The share conditions provide that even after exercising their retraction rights, the appellants continue to be entitled to dividends and to vote until their shares are redeemed. In other words, they continue to enjoy the rights of shareholders. Moreover, if when the appellants exercised their retraction rights the company were insolvent and were to be subsequently liquidated (or dissolved or wound up), the appellants would rank as shareholders on the liquidation. And as I have indicated above the result should be no different on the reorganization.

135 It seems to me that these appellants must be either shareholders or creditors. Except for declared dividends, they cannot be both. Once they are characterized as shareholders, their rights of retraction do not create a debtor-creditor relationship. These rights enable them to call for the repayment of their capital on a specific date (and at an agreed-upon price) provided the company is solvent. Ordinarily shareholders have to recoup their investment by selling their shares to third parties. If they have retraction rights, however, they can compel the company (if solvent) to repay their investment at a given time for a given price. But the right of retraction provides for the return of capital not for the repayment of a loan. Certainly the Canada Business Corporations Act treats a redemption of shares as a return of capital because s. 39 of the statute requires a company on a redemption to deduct from its stated capital account an amount equal to the value of the shares redeemed. The shares redeemed are then either cancelled or returned to the status of authorized but unissued shares.

136 Putting it differently, a preferred shareholder exercising a right of retraction on the terms that exist here must rank behind the company's creditors. Grover and Ross make this point more generally in their Materials and Corporate Finance, supra, at pp. 48-49:

> On the other hand, the company cannot issue "secured" preferred shares in the sense that shares cannot have a right to a return of capital which is equal or superior to the rights of creditors. Preferred shareholders are risk-takers who are

> required to invest capital in the business and who can look only to what is left after creditors are fully provided for. Thus, in the absence of statutory authorization, the claims of shareholders cannot be secured by a lien on the corporate assets. They rank behind creditors but before common shareholders (if specified) on a voluntary or involuntary dissolution of the company.

137 Admittedly there is little authority in Canada on the issue confronting this court. Some of the cases that the respondent relies on -- for example, Re Patricia Appliance Shops Ltd. (1922), 52 O.L.R. 215, [1923] 3 D.L.R. 1160 (S.C.), Laronge Realty Ltd. v. Golconda Investments Ltd. (1986), 63 C.B.R. (N.S.) 74, 7 B.C.L.R. (2d) 90 (C.A.), and even Re Meade, [1951] 2 All E.R. 168, [1951] Ch. 774 (D.C.) -- are of limited assistance because the shareholders in those cases did not have retraction rights.

138 Perhaps the closest case -- and the appellants rely heavily on it -- is the judgment of the British Columbia Court of Appeal in Re East Chilliwack Agricultural Co-operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11. In that case a majority of the court (Craig J.A. dissenting) held that a withdrawing member of a co-operative association who elected to have his shares redeemed in instalments over a five-year period should be treated on the subsequent bankruptcy of the association as an ordinary creditor rather than as a shareholder. I decline to apply East Chilliwack for three reasons. First, because the case was decided in 1989, the British Columbia Court of Appeal did not have the benefit of the Supreme Court of Canada's reasons in CDIC v. CCB, supra. In East Chilliwack Hutcheon J.A., writing for the majority, did not focus on what the parties intended when the member contracted with the co- operative. Instead he only considered the relationship between the member and the co-operative after the member had withdrawn. I do not think his approach is consistent with Justice Iacobucci's judgment in CDIC v. CCB, supra.

139 Second, there are important factual differences between East Chilliwack and the appeals before us. Justice Weiler has referred to these factual differences in her reasons. The most important of these differences are the following: in East Chilliwack the rules of the association provided that a member had to withdraw from the association to trigger the right of redemption, whereas the appellants' share conditions provide that they continue to be shareholders of Central Capital until their shares are redeemed; in East Chilliwack the member elected to withdraw and redeem his shares when the association was solvent whereas when the appellant McCutcheon exercised his right of retraction Central Capital was insolvent; and in East Chilliwack Hutcheon J.A. expressly stated that he was not considering the effect of the superintendent's power to suspend payments if the financial position of the co-operative was impaired, whereas the effect of the statutory prohibition against Central Capital making payment, found in s. 36(2) of the Canada Business Corporations Act, is in issue in these appeals.

140 Third, the decision in East Chilliwack is at odds with most of the American case-law and I favour the American approach. When a company repurchases shares by instalment and bankruptcy intervenes, the prevailing American position is that the shareholder's claim is deferred to the claims of ordinary creditors. The decision of the Fifth Circuit Court of Appeals in Robinson v. Wangemann, 75 F. 2d 756 (1935), is frequently cited. The facts of that case are virtually identical to the facts in East Chilliwack. A company had agreed to repurchase a stockholder's stock by instalments. Although the company was solvent when the agreement was made it went bankrupt before the repurchase was completed. The stockholder sought to prove as an ordinary creditor for the unpaid purchase price. Foster, Circuit Judge, writing for a unanimous court, rejected the stockholder's claim at p. 757:

> A transaction by which a corporation acquires its own stock from a stockholder for a sum of money is not really a sale. The corporation does not acquire anything of value equivalent to the depletion of its assets, if the stock is held in the treasury, as in this case. It is simply a method of distributing a proportion of the assets to the stockholder. The assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full. When such a transaction is had, regardless of the good faith of the parties, it is essential to its validity that there be sufficient surplus to retire the stock, without prejudice to creditors, at the time payment is made out of assets.

141 At the heart of Robinson v. Wangemann is the finding that the selling stockholder is not a creditor in the sense of a person who loans money to a corporation, and therefore is not entitled to parity with the general creditors. The principle in Robinson v. Wangemann seeks to protect creditors by refusing to permit selling stockholders, who were risk investors, to withdraw their capital on the same terms as general creditors in the event of insolvency. Section 40(3) of the Canada Business Corporations Act -- a section to which I shall return when considering s. 36(2) of the same statute -- codifies the principle in Robinson v. Wangemann for share repurchases, though not for share redemptions. See also Blumberg, The Law of Corporate Groups (1987), at pp. 205-10 and see contra Wolff v. Heidritter Lumber Co., 163 A. 140 (N.J.Ch., 1932).

142 Quite apart from the instalment purchase price cases, American courts have often grappled with the question whether preferred stockholders can claim as creditors of the corporation. Although there are cases going both ways, most appear to come to the same conclusion as I do. The American cases are collected in Bjor and Solheim, Fletcher Cyclopedia of the Law of Private Corporations (1995), revised, vol. 11, and in Bjor and Reinholtz, Fletcher Cyclopedia of the Law of Private Corporations (1990), revised, vol. 15A. In volume 11 the authors of the text indicate -- as did the Supreme Court of Canada in CDIC v. CCB -- that "[w]hether or not the holder of a particular instrument or certificate is to be regarded as a shareholder or a creditor is a question of interpretation, and depends on the terms of the contract as evidenced by the instrument, the articles of incorporation, and the statutes of the state. The nature of the transaction is to be determined by the real substance and effect of the contract rather than by the name given to the obligations or its form" (at p. 566).

143 And in volume 15A the authors state at pp. 290 and 292 that even the arrival of a fixed redemption date does not change a preferred stockholder into a creditor:

> Holders of preferred stock of a corporation, in the absence of express provision to the contrary, are stockholders and not creditors of the corporation, except for dividends declared. They have no lien upon, and are not entitled to, any of the assets of the corporation when it becomes insolvent, until all debts are paid. Furthermore, there is authority that the status of a preferred stockholder is not changed to that of creditor, even though a dividend is guaranteed. Indeed it is beyond the power of a corporation to issue a class of stock, the holders of which are entitled to preference over general creditors.
>
> ***
>
> Even where preferred stock has a fixed redemption date, arrival of that date does not change the status of a preferred stockholder to that of a creditor.

144 I agree with these statements. I therefore conclude first that the appellants, in substance, were shareholders of Central Capital, not creditors; and second that neither the existence nor the exercise of their retraction rights turned them into creditors.

II. Provable Claims and Section 36(2) of the Canada Business Corporations Act

145 In May 1992 Central Capital was insolvent. It was unable to pay its liabilities as they became due and the realizable value of its assets was less than the aggregate of its liabilities. Because it was insolvent it was prohibited by s. 36(2) of the Canada Business Corporations Act from redeeming the appellants' shares. Section 36(2) of the statute provides:

> 36(2) A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of
>
> (i) its liabilities, and
> (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateably with or prior to the holders of the shares to be purchased or

redeemed.

146 As well, the appellants' share conditions provide that they are not permitted to redeem their shares if to do so would be "contrary to applicable law", in this case s. 36(2) of the statute.

147 To hold that the appellants have provable claims would defeat the purpose of s. 36(2) of the Canada Business Corporations Act. At common law a company could not repurchase its own shares on the open market or in the language of Trevor v. Whitworth (1887), 12 App. Cas. 409, [1886-90] All E.R. Rep. 46 (H.L.), a company could not "traffick in its own shares". The obvious reason was to prevent companies from using their assets to destroy the claims of their creditors. Modern corporate statutes, such as the Canada Business Corporations Act, modified the rule in Trevor v. Whitworth to permit repurchases provided the company's creditors would not be prejudiced. Thus the legislation insisted that the company could not repurchase its own shares unless it satisfied stated solvency tests. And so, s. 34(2) of the Canada Business Corporations Act provides:

> 34(2) A corporation shall not make any payment to purchase or otherwise acquire shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of its liabilities and stated capital of all classes.

148 In Nelson v. Rentown Enterprises Inc. (1993), 96 D.L.R. (4th) 586 at p. 589, 5 Alta. L.R. (3d) 149, affirmed (1994), 109 D.L.R. (4th) 608n, 16 Alta. L.R. (3d) 212 (C.A.), Hunt J. of the Alberta Queen's Bench wrote:

> The policy behind the s. 34(2) limitation upon a corporation's power to purchase its own shares seems obvious. It is intended to ensure that one or more shareholders in a corporation do not recoup their investments to the detriment of creditors and other shareholders. It has been observed that:
>
> > Corporate power to purchase its own stock has been frequently abused. Done by corporations conducting faltering businesses, it has been employed to create preferences to the detriment of creditors and of the other stockholders.
> >
> > (Mountain State Steel Foundries, Inc. v. C.I.R., supra, at p. 741 [284 F.2d 737 (1960)].)

> Modern business statutes permit these share purchases to take place provided that the position of creditors and other shareholders is protected, by virtue of the application of the s. 34(2) tests.

149 Redemptions of preferred shares, unlike repurchases, were always permitted at common law as long as they were not made in contemplation of bankruptcy. But the solvency test in s. 36(2) of the Canada Business Corporations Act has the same purpose as the solvency test in s. 34(2): to prevent redemptions if they would allow the company to prejudice the claims of creditors. See Buckley et al., Corporations: Principles and Policies, supra, at pp. 968-71. To hold that the appellants' retraction rights gave rise to provable claims in the face of s. 36(2), thereby allowing the appellants to rank equally with the unsecured creditors, would undermine the purpose of the section. If a claim in a bankruptcy or reorganization proceeding is unenforceable under the statute, the claim is not entitled to recognition on a parity with the claims of unsecured creditors: see Blumberg, supra, at pp. 205-06; and Farm Credit Corp. v. Holowach (Trustee of) (1988), 68 C.B.R. (N.S.) 255, 51 D.L.R. (4th) 501 (Alta. C.A.).

150 I draw comfort in this conclusion from s. 40 of the Canada Business Corporations Act. Section 40(1) provides that a contract with a corporation for the purchase of its shares is specifically enforceable against the corporation "except to the extent that the corporation cannot perform the contract without thereby being in breach of s. 34". Section 40(3) then states:

> 40(3) Until the corporation has fully performed a contract referred to in subsection (1), the other party retains the status of a claimant entitled to be paid as soon as the corporation is lawfully able to do so or, in a liquidation, to be ranked subordinate to the rights of creditors but in priority to the shareholders.

151 In other words, the section recognizes that if a company contracts to repurchase its shares but is prohibited from doing so because it is insolvent, the vendor of the shares is not a creditor and on a liquidation ranks subordinate to the rights of creditors. The shareholder cannot be repaid at the expense of the company's creditors. Although s. 40 does not expressly apply to s. 36, I think that the rationale for s. 40(3) applies to redemptions as well as to repurchases. Whether a repurchase or a redemption, the shareholder is not a creditor and is subordinate to the rights of creditors. More simply the shareholder does not have a provable claim.

152 The appellants rely on The Custodian v. Blucher, [1927] S.C.R. 420, [1927] 3 D.L.R. 40, but in my view this case does not assist them. In Blucher dividends were declared on stock but payment of the dividends was suspended during World War I. The Supreme Court of Canada held at p. 425 S.C.R., p. 43 D.L.R. that "[t]he right of recovery was in suspense during the war; but the debt nevertheless existed". In that case, however, the dividend was declared before the suspension of payment took place. Moreover, as Justice Finlayson points out in his reasons, courts have always accepted the proposition that when a dividend is declared it is a debt on which each shareholder can sue the corporation.

153 Holding that the appellants do not have provable claims accords with sound corporate policy. On the insolvency of a company the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. Case-law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment. Creditors rely on these protections in making loans to companies. Permitting preferred shareholders to be turned into creditors by endowing their shares with retraction rights runs contrary to this policy of creditor protection.

154 I would dismiss these appeals. I would not make any cost order. I am grateful to all counsel for their assistance on this interesting and difficult problem.

Order accordingly.

* * * * *

Note 1: There is a discrepancy in the materials before this court on the relevant date for establishing a claim provable against Central Capital: SYH Corporation used May 1992, the date of the restated subscription and escrow agreement whereas McCutcheon and the unsecured creditors of Central Capital Corporation used June 15, 1992, the date of the court-ordered stay of proceedings against Central Capital. I have used the May 1992 date but nothing turns on the use of this date as opposed to the June 15, 1992 date.

qp/e/qlgxc/qlbxr

Tab 5

Case Name:
ROI Fund Inc. v. Gandi Innovations Ltd.

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

[2011] O.J. No. 3827

2011 ONSC 5018

83 C.B.R. (5th) 123

2011 CarswellOnt 8590

206 A.C.W.S. (3d) 464

Court File No. 09-CL-8172

Ontario Superior Court of Justice
Commercial List

F.J.C. Newbould J.

Heard: August 18, 2011.
Judgment: August 25, 2011.

(62 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Directions -- Motion by Monitor for directions allowed -- Gandi Group was under creditor protection and assets were sold with court approval -- Lender claimed repayment of debt and equity advance to Group -- Three claimants were party to advance in personal capacities -- Lender commenced arbitration proceeding against claimants -- Claimants sought indemnity of related costs from Group -- Monitor sought directions -- No evidence existed that Group entities gave indemnities or otherwise acknowledged claimants' entitlement to indemnities -- For purpose of CCAA proceedings, lender's claim and indemnity claims constituted equity claims -- Companies' Creditors Arrangement Act, s. 2(1).

Motion by the Monitor for the Gandi Group for advice and directions regarding indemnity claims made against the Group. The Gandi Group was under creditor protection. The Monitor was appointed in May

2009. The business and assets of the Group were sold with court approval. The Monitor held the proceeds for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement. The indemnity claims arose from the 2007 reorganization of the Group's business structure. The claimants were officers and board members of Gandi Holdings. A lender advanced $75 million by way of debt and equity to the Group. The indemnity claimants were party to the advance in their personal capacities. In 2009, the lender commenced arbitration proceedings against the claimants for the total of the advance. The claimants asserted an entitlement to indemnification by the Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred in defending the arbitration. The claimants' proofs of claim relied on indemnity provisions set out in the limited liability company agreement and a separate indemnification made by Gandi Holdings at the time of the lender's advance. In 2011, the Monitor disallowed the claims on the basis that any claim would be made solely against Gandi Holdings rather than against other entities in the Group.

HELD: Motion allowed. There was no evidence that any indemnities from any other Gandi Group entities were made at the time of the advance. There were no corporate records supporting the contention that two of the claimants were an officer or director of Gandi Innovations. Thus, the third claimant was the only claimant entitled to identification from Gandi Innovations pursuant to the indemnity in the company's articles. Such claim was subject to a subordination agreement in respect of the debt portion of the advance, and thus the third claimant had no right to receive payment from Gandi Innovations in respect of his claim. There was no basis for inferring that the articles of the other Group entities contained the same indemnity as contained in the articles of Gandi Innovations. There was no prior acknowledgment of liability for indemnity by the Group. The claims of both the lender and the claimants were to be treated as equity claims for the purpose of the CCAA proceeding.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 2(1), s. 6(8)

Counsel:

Harvey Chaiton and Maya Poliak, for the Monitor, BDO Canada Limited.

Mathew Halpin and Evan Cobb, for TA Associates Inc.

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

ENDORSEMENT

1 **F.J.C. NEWBOULD J.**:-- This is a motion brought by BDO Canada Limited in its capacity as the Court-appointed Monitor of Gandi Innovations Limited, Gandi Innovations Holdings LLC, Gandi Innovations LLC, Gandi Innovations Hold Co, and Gandi Special Holdings LLC (the "Gandi Group") for advice and directions, and particularly to determine preliminary issues in connection with the indemnity claims made by Hary Gandy, James Gandy and Trent Garmoe (the "Claimants") against all of the Gandi Group.

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

3 The business and assets of the Gandi Group have been sold with court approval. The proceeds from the sale are being held by the Monitor for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement.

Arbitration proceedings and indemnity claims

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

5 TA Associates Inc. is a general partner for a number of TA partners. In conjunction with the reorganization of Gandi Holdings, it advanced approximately US $75 million on September 12, 2007 by way of debt and equity to the Gandi Group. The advance consisted of:

(i) an equity investment in the amount of US $50 million made pursuant to the terms of a Membership Interest Purchase Agreement in respect of Gandi Holdings dated as of September 12, 2007 made between, among others, Gandi Holdings, TA Associates and the Claimants in their personal capacities; and

(ii) an unsecured loan in the amount of US $25 million which amount was guaranteed by other members of the Gandi Group.

6 In January 2009, TA Associates commenced an arbitration proceeding against the Claimants. In the arbitration TA Associates claim damages against the Claimants in an amount of US $75 million with interest, being the total amount of TA Associates' investment in the Gandi Group. The arbitration has not yet been heard on its merits.

7 On December 20, 2010, the Monitor received proofs of claim of Hary Gandy and James Gandy against the Gandi Group in the approximate amount of $76 million and a proof of claim of Trent Garmoe against the Gandi Group in an approximate amount of $88 million. The Claimants assert an entitlement to indemnification by the Gandi Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred by the Claimants in defending the arbitration.

8 The proofs of claim filed by the Claimants rely on indemnity provisions set out in the Amended and Restated Limited Liability Company Agreement of Gandi Holdings and a separate Indemnification Agreement made by Gandi Holdings entered into in connection with the Membership Agreement made at the time of the TA Associates investment with Gandi Holdings. Gandi Holdings is the only Gandi entity that is a party to these indemnity agreements.

9 On March 11, 2011 the Monitor disallowed the indemnity claims and advised the Claimants that based on the evidence filed in support of the indemnity claims, any indemnity claim would be solely against Gandi Holdings.

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

11 There is also an indemnity of Gandi Innovations Hold Co ("Gandi Hold Co"). At the relevant times James Gandy was the sole director of the company.

12 There has been an extensive search for corporate documents. The Monitor made inquiries of Jaffe Raitt Heuer & Weiss Inc., former corporate counsel of the Gandi Group, and learned that all of corporate governance documents of the Gandi Group, at Hary Gandy's request, had been sent to Stikeman Elliot LLP, insolvency counsel for the Gandi Group, following the CCAA filing date. Counsel for the Monitor attended at the offices of Stikeman Elliott and reviewed the corporate governance documents in its possession.

13 In addition the Monitor contacted counsel for Agfa, the purchaser of the assets of the Gandi Group, to inquire if it has in its possession copies of the Gandi Group's corporate governance records. The Monitor was advised by counsel for Agfa that Agfa was not able to find any corporate governance documents of the Gandi Group entities.

14 The Monitor also reviewed the books and records of the Gandi Group in storage. In addition, the Monitor advised the Claimants that should they wish to undertake a review of the Gandi Group's records in storage, the Claimants were invited to contact the Monitor and arrange for such review. The review was arranged and conducted by the Claimants on June 3, 2011.

15 It is a fact that there are not in existence documents that support the Claimants all being entitled to indemnities from each corporate entity in the Gaudi Group.

Issues

16 Whether the Claimants will ever be with held liable in the arbitration is not yet known. However, whether the Claimants have rights to indemnification against all of the Gandi Group or against only Gandi Holdings and Gandi Hold Co will assist the Monitor in determining whether to proceed with a consolidated plan of arrangement or file an alternative plan excluding Gandi Holdings and/or Gandi Hold Co which would enable the Monitor to make a meaningful distribution to unsecured creditors prior to the completion of the arbitration.

17 There is another preliminary issue. In the arbitration, TA Associates seeks to recover against the Claimants their equity investment of US $50 million, for which the Claimants in turn have sought indemnification from the Gandi Group. The Monitor seeks a preliminary determination as to whether these claims for indemnification relating to the claim by TA Associates for its equity investment constitute "equity claims" under the CCAA. A determination of this issue will assist the Monitor in determining the maximum amount which can be claimed by the Claimants and may facilitate an earlier distribution of funds available to unsecured creditors.

Discussion

(a) Indemnity agreements

18 An Amended and Restated Limited Liability Company Agreement of Gandi Holdings dated September 12, 2007 provides for an indemnity by Gandi Holdings in section 6.8(a) for board members and officers. There is no dispute that the Claimants were officers and board members of Gandi Holdings. It also contains in section 7.6 an indemnity for Members as follows:

> (a) Without limitation of any other provision of this Agreement executed in connection herewith, the Company agrees to defend, indemnify and hold each Member, its affiliates and their respective direct and indirect partners (including partners of partners and stockholders and members of partners), members, stockholders, directors, officers, employees and agents and each person who controls any of them...

19 Superwide Limited Partnership is a Member and the Claimants are partners of Superwide. Thus the Claimants are indemnified by Gandi Holdings by that provision as well.

20 There is a form on indemnity agreement made between Gandi Holdings and indemnitees. The form in the record is an unsigned copy dated September 11, 2007. Neither the monitor nor any of the parties have been able to locate any of these agreements signed in favour of the Claimants. Hary Gandi, who swore an affidavit for the Claimants, said that a copy of this agreement was signed between Gandi Holdings and each of the Claimants on September 12, 2007. It contains the following:

> WHEREAS, the Company desires to provide Indemnitee with specific contractual assurance of Indemnitee's rights to full indemnification against litigation risks and related expenses (regardless, among other things, of any amendment to or revocation of the Company's LLC Agreement or any change in the ownership of the Company or the composition of its Board of Managers) ...
>
> ...
>
> 3. Agreement to indemnify... if Indemnitee was or is a party or is threatened to be made a party to any Proceeding by reason of Indemnitee's Corporate Status, Indemnitee shall be indemnified by the Company against all Expenses and Liabilities incurred . . . ."

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

22 The Claimants contend that each of the corporate entities in the Gandi Group signed an indemnity in favour of each of them. This is based on a statement in the affidavit of Hary Gandy that Gandi Holdings and the other CCAA Respondents provided additional indemnities to him, James Gandy and Trent Garmoe dated September 12, 2007. He attached to his affidavit a form of the indemnification agreement to be signed by Gandi Holdings. No affidavit was filed from James Gandy or Trent Garmoe.

23 There is no form of indemnity agreement in existence which names an indemnifier other than Gandi Holdings.

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

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

(b) Memorandum and articles of Gandi Hold Co

26 In the course of its investigation, the Monitor did locate an indemnity granted by Gandi Hold Co in its Memorandum and Articles in favour of its directors and officers. Those articles contain an indemnity in the same terms as the indemnity in the Gandi Innovations Limited articles, as discussed below. As the Monitor does not seek a determination regarding indemnities given by Gandi Hold Co, I need not discuss whether one or more of the Claimants is entitled to be indemnified by these articles.

(c) Articles of Association of Gandi Innovations Limited (Gandi Canada)

27 The articles of this company contain an indemnity as follows:

> Every director or officer, former director or officer, or person who acts or acted at the Company's request, as a director or officer of the Company, a body corporate, partnership or other association of which the Company is or was a shareholder, partner, member or creditor and the heirs and legal representatives of such person, in absence of any dishonesty on the part of such persons shall be indemnified by the Company...in respect of any claim made against such person ... by reason of being or having been a director or officer of the Company. [emphasis added]

28 The corporate records sent to the Monitor by the corporate solicitors who incorporated the company name James Gandy as the president, treasurer and secretary and as the sole director. Hary Gandy stated at the outset of his affidavit filed on behalf of the claimants that he was the president and chief executive officer and chairman of the board of the companies that made up the Gandi Group. There are no corporate records that support that assertion and on his cross-examination he acknowledged he had no documents, including board resolutions, contracts or appointment letters to show that he was ever a director or officer of Gandi Innovations Limited. He said that he was directing the business of all of the entities. On his cross-examination, he said that as far as he was concerned, James Handy and Trent Garmoe were directors and officers of the company.

29 James Gandy did not file any affidavit to say that he was not the president, treasurer and secretary of the company, as shown in the corporate records. Trent Garmoe did not file any affidavit. I think it fair to draw an adverse inference that their evidence would not have been helpful to their case.

30 The affidavit of Bruce Johnston filed on behalf of TA Associates states that Hary Gandy and Trent Garmoe were not directors or officers of Gandi Innovations Limited and that a document printed from the Nova Scotia Registry of Joint Stock Companies which was included in the closing documents for TA Associates' investment showed that James Gandy was the only director and officer of Gandi Innovations Limited.

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

32 It is argued that the indemnity in the articles of Gandi Innovations Limited is in favour not only of officers and directors, but also "persons who acted at the Company's request as a director or officer of the Company", and that Hary Gandy and Trent Garmoe acted as directors and officers at the Company's request. There is certainly no documentary evidence of that. Presumably the request would have had to come from James Gandy, who is the sole officer and director according to the corporate records. There is no evidence from any of the Claimants that any request was made to Hary Gandy or Trent Garmoe to act as an officer or director of Gandi Innovations Limited, which one would have expected if the assertion was to be made.

33 It is also argued that the board of managers (the Delaware concept of a board of directors) of Gandi Holdings operated the subsidiaries as if they were officers and directors of the subsidiaries. Again, there is no documentary evidence of that and no evidence from any of the Claimants to support the assertion. While Hary Gandy may have operated the business in a functional sense, that does not mean that he was acting as an officer or director of any subsidiary in the corporate sense. This is not mere semantics. TA Associates made a large investment, and one of the corporate documents provided on closing was the Nova Scotia Registry of Joint Stock Companies that showed only James Gandy as an officer and director. If all of the Claimants are entitled to be indemnified by Gandi Innovations Limited, it will impact the claim of TA Associates in the CCAA proceedings.

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

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

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

(d) Other Gaudi Group entities

37 It was asserted by the Claimants that because the Gandi companies operated essentially as one integrated company, it should be inferred that the constating documents of the other entities in the Gandi Group contained the same indemnity as contained in the bylaws of Gandi Innovations Limited and Gandi Hold Co. I do not agree.

38 Gandi Innovations LLC is a Texas company. Its Amended and Restated Operating Agreement contains the types of things normally contained in a general bylaw of an Ontario corporation. It contains no provision for indemnities. It was argued that as no articles were obtained from Texas, it could be assumed that the articles contained an indemnity provision similar to that contained in the bylaws of Gandi Innovations Limited and Gandi Hold Co. I asked counsel to obtain whatever documentation was available in Texas, and subsequently the Monitor received from its US counsel, Vinson & Elkins LLP, a copy of articles of organization for Gandi Innovations LLC dated August 2, 2004. There is nothing in these articles dealing with indemnities. Vinson & Elkins LLP advised that these articles, together with amending articles already in the possession of the Monitor, are the only corporate governance documents on file with the State of Texas.

39 Gandi Special Holdings LLC is a Delaware corporation. The Limited Liability Company Agreement of Gandi Special Holdings LLC, like the Texas company, contains the types of things normally contained in a general bylaw of an Ontario corporation. It contains no provision for indemnities. Following the hearing, the Monitor obtained through Vinson & Elkins LLP a Delaware Certificate of Formation of Gandi Special Holdings LLC. This document contains no provision for indemnities. A certificate of the Secretary of State of Delaware confirms that there were no other relevant documents on file and this was confirmed by Vinson & Elkins LLP.

40 I find that there is no indemnity in favour of the Claimants in the corporate documentation of Gandi Innovations LLC and Gandi Special Holdings LLC.

41 It is also argued on behalf of the Claimants that the Gandi Group have acknowledged an obligation to indemnify the Claimants and it is said that this arises from a meeting of the board of Gandi Holdings. It is argued that the Gandi Group through the Monitor is thus estopped from denying an indemnity for all of the Gandi Group companies. A document said to be minutes of a meeting of the board of managers of Gandi Holdings held on March 4, 2009 is relied on. That document contains the following paragraph:

> The next item on the agenda was the indemnification of the officers. It was generally agreed that all parties would follow the Purchase Agreement between Gandi Innovations and TA Resources dated September 12, 2007: Counsel for TA had previously expressed the opinion that indemnification was not allowed under the purchase agreement. Counsel for James Gandy, Hary Gandy and Trent Garmoe together with the Corporate Counsel, Matthew Murphy had previously expressed verbal opinions that the indemnification of the officers was permitted under the Purchase Agreement. Lydia Garay, as the only member not involved in the dispute between TA and the key holders, voted to follow the advice of Corporate Counsel, Matthew Murphy. To avoid any misunderstanding, Corporate Counsel would be requested to express that opinion in writing.

42 I do not see this paragraph in the informal minutes as assisting the Claimants. It is a meeting of the board of Gandi Holdings. It says that it was generally agreed that all parties would follow the purchase agreement between Gandi Holdings and TA resources dated September 12, 2007. That purchase agreement provides for an indemnity by only Gandi Holdings. Assuming that the minutes reflect a desire of some board members to indemnify officers of subsidiary corporations, and assuming that the Claimants thought they were officers of all of the subsidiary corporations, it is quite clear from the paragraph that there was a difference of view. The minute states that counsel for TA Associates had previously expressed the opinion that indemnification was not allowed under the purchase agreement and that counsel for the Claimants together with corporate counsel, Matthew Murphy, expressed the opposite opinion. The minute states that Lydia Garay, the only member not involved in the dispute between TA Associates and the key holders, voted to follow the advice of Corporate Counsel Terry Murphy and to avoid any misunderstanding, corporate counsel would be requested to express that opinion in writing.

43 The affidavit of Bruce Johnston on behalf of TA Associates, who attended that meeting of the board of managers of Gandi Holdings swears that the Claimants voted to place Lydia Garay, a longtime employee and officer of Gandi Holdings, on the board despite a verbal agreement that he had with the Claimants to leave that board seat vacant and to work with him to appoint an outside independent board member. He stated Ms. Garay was completely reliant on the Gandy family for her job security and compensation.

44 Mr. Johnston also states in his affidavit that the indemnification of the Claimants was discussed and that he and Mr. Taylor took the position that indemnification was not permitted. He said the Claimants took the position that indemnification was permitted, despite the language of the purchase agreement, and took the position that corporate counsel for Gandi Holdings had previously given a verbal opinion that indemnification was permitted under the purchase agreement. After hearing that, and during the meeting, Mr. Johnston sent an e-mail to Mr. Murphy who two minutes later responded that he had not advised on the question of an indemnity under the purchase agreement. Mr. Johnson states that he then read that e-mail at the meeting. I accept his evidence on this.

45 Whether or not Ms. Garay was a disinterested or proper member of the board of management of Gandi Holdings, the minute states that she voted to follow the advice of corporate counsel. At the next board meeting on May 4, 2009, Ms. Garay said that she had sought the written opinion of corporate counsel but had not received it. To date no opinion from Mr. Murphy has surfaced. On the face of those minutes from March 4, 2009, there has been no approval of any indemnities in favour of the Claimants for other corporations. I cannot find on the evidence that there was any agreement that the Claimants would be indemnified by subsidiary corporations, nor is there any evidence that any subsidiary corporation ever enacted any documentation of any kind to provide such indemnities. The opposite is the case, as has been discussed.

46 Finally, the Claimants allege that the Gandi Group has previously acknowledged their liability to indemnify the Claimants for any damage, award or legal costs incurred by the following actions:

(i) certain Gandi entities made payments of defence costs in connection with the arbitration both pre-and post the CCAA filing; and
(ii) the Monitor allegedly approved payment of post-filing defence costs.

47 Until the sale of the Gandi Group to Agfa was completed, this CCAA proceeding was a debtor in possession restructuring with the business and affairs of the Gandi Group being managed by their officers and directors, specifically Hary Gundy and Trent Garmoe. Payments of legal fees to Langley and Banack Inc., U.S. lawyers for the Gandi Group and the Claimants, were made by or on authorization of Trent Garmoe.

48 Pursuant to the terms of the Initial Order, the Monitor was required to approve all expenditures over $10,000 before payment was made. The Monitor approved payment of legal fees to counsel for the Gandi Group on the general understanding that such fees were incurred by the Gandi Group in connection with the Gandi Group's insolvency proceeding and for general corporate work for the Gandi Group.

49 I accept the statement of the Monitor that it did not knowingly approve the payment of the Claimants' defence costs in connection with the arbitration.

50 Subsequent to the completion of the sale to Agfa, the Monitor learned that a nominal amount of the legal fees approved by the Monitor was subsequently allocated to cover the costs of the arbitration. I accept the statement of the Monitor that it had no input, knowledge or control over such allocation, and had it been consulted, would have been opposed to such allocation as it did not involve any member of the Gandi Group.

51 In the circumstances there is no basis for the assertion that the Monitor is somehow estopped by reason of the payment of legal fees from denying that there are other indemnities in favour of the Claimants.

(e) Are the Claimants claims debt or equity claims?

52 This involves the application of provisions of the CCAA to the claims asserted by TA Associates in the arbitration.

53 Section 6(8) of the CCAA provides:

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

54 In s. 2(1) of the CCAA, equity claims are defined as follows:

> "equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
> (b) a return of capital,
> (c) a redemption or retraction obligation,
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d);

55 This definition of equity claim came into force on September 18, 2009. Although this provision does not apply to the Gandi Group's CCAA proceedings which commenced shortly prior to the legislative amendments, courts have noted that the amendments codified existing case law relating to the treatment of equity claims in insolvency proceedings. In *Re Nelson Financial Group Ltd.*, (2010) 75 B.L.R. (4th) 302, Pepall J. stated:

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

56 If the claims in the arbitration commenced by TA Associates against the Claimants are equity claims, the claims by the Claimants in the CCAA process for contribution or indemnity in respect of those claims would be equity claims. The Claimants contend that the claims in the arbitration are not equity claims.

57 The claims in the arbitration by TA Associates against the creditors include claims for various breaches of contract, fraud, rescission, or in the alternative, rescissory damages, negligent misrepresentation, breach of fiduciary duty and tortious interference with advantageous business relationships and prospective economic advantage.

58 In the arbitration TA Associates seeks to recover the investment that it made in Gandi Holdings, including the US $25 million debt secured by promissory notes and the US $50 million equity investment made by way of a membership subscription in Gandi Holdings.

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

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

> This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*, [2000] A.J. No. 14. In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.* concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent.

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

Order

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

F.J.C. NEWBOULD J.

cp/e/qlcct/qlvxw/qlced/qlhcs

Tab 6

Case Name:

ROI Fund Inc. v. Gandi Innovations Ltd.

Between
Return on Innovation Capital Ltd. as agent for ROI Fund Inc., ROI Sceptre Canadian Retirement Fund, ROI Global Retirement Fund and ROI high Yield Private Placement Fund and Any Other Fund Managed by ROI from time to time, Applicants/Respondents, and
Gandi Innovations Limited, Gandi Innovations Holdings LLC and Gandi Innovations LLC, Respondents/Appellants

[2012] O.J. No. 31

2012 ONCA 10

Docket: M40553

Ontario Court of Appeal
Toronto, Ontario

R.J. Sharpe, R.A. Blair and P.S. Rouleau JJ.A.

Heard: January 3, 2012 by written submissions.
Judgment: January 9, 2012.

(13 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Claims -- Claims against directors -- Motion by officers, directors and shareholders in Gandi Group for leave to appeal from order determining their entitlement to indemnity from Gandi Group companies arising out of arbitration proceedings brought against them by TA Associates dismissed -- TA Associates was major unsecured creditor in CCAA proceedings -- Issues raised by appeal were of no significance to practice -- Further, appeal with respect to these issues had little merit.

Motion by the officers, directors and shareholders in the Gandi Group for leave to appeal from an order determining their entitlement to indemnity from the Gandi Group companies arising out of arbitration proceedings brought against them by TA Associates, the major unsecured creditor in the CCAA proceedings. The Gandi Group companies were under CCAA protection. The order provided that the claimants were only entitled to indemnity from the direct and indirect parent company, that any claim of James Gandy was subordinated to the claim of TA Associates because of an earlier existing Subordination Agreement, and that the claims for indemnification in respect of the TA Associates claim in the arbitration were equity claims for purposes of the CCAA and therefore subsequent in priority to the claims of unsecured creditors.

HELD: Motion dismissed. The indemnification issue and subordination issues raised by the appeal were of no significance to the practice and the appeal with respect to these issues had little merit. The application judge's determination of the claimants' indemnity claims as equity claims was also not of significance to the practice since all insolvency proceedings commenced after the new provisions of the CCAA came into effect in September 2009 would be governed by those provisions, not by the prior jurisprudence.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 2(1), s. 6(8)

Counsel:

Christopher J. Cosgriffe and Natasha S. Danson, for James Gandy, Hary Gandy and Trent Garmoe.

Matthew J. Halpin and Evan Cobb, for TA Associates Inc.

Harvey Chaiton and Maya Poliak, for the Monitor.

ENDORSEMENT

The following judgment was delivered by

THE COURT:--

Overview

1 The moving parties (James Gandy, Hary Gandy and Trent Garmoe) are officers, directors and shareholders in the Gandi Group, a series of related companies currently under CCAA protection. In those proceedings they assert indemnity claims in the range of $75 - 80 million against each of the companies in the Gandi Group. The indemnity claims arise out of arbitration proceedings brought against them individually, as officers and directors, by TA Associates, a disgruntled investor in the

Gandi Group. TA Associates is the major unsecured creditor in the CCAA proceedings.

2 The assets of the Gandi Group have been sold and what remains to be done in the CCAA process is the finalization of a plan of compromise and arrangement for the distribution of the proceeds among the various creditors. Before settling on the most effective type of plan for such a distribution - a consolidated plan, a partial consolidation plan, or individual corporate plans - the Monitor and the creditors sought to have two preliminary issues determined by the Court:

a) whether the moving parties (the Claimants) are entitled to indemnity from all of the entities which comprise the Gandi Group, and, if so,
b) whether those indemnification claims are "equity" or "non-equity" claims for purposes of the CCAA (non-equity claims have priority).

3 On August 25, 2011, Justice Newbould, sitting on the Commercial List, ruled:

a) that the Claimants were only entitled to indemnity from the direct and indirect parent company, Gandi Holdings (except that the Claimant, James Gandy only was also entitled to indemnification from a second entity in the Group, Gandi Canada);
b) that any claim of James Gandy was subordinated to the claim of TA Associates because of an earlier existing Subordination Agreement; and
c) that the claims for indemnification in respect of the TA Associates claim in the arbitration were equity claims for purposes of the CCAA and therefore subsequent in priority to the claims of unsecured creditors.

4 The Claimants seek leave to appeal from that order.

5 We deny the request.

Analysis

<u>The Test</u>

6 Leave to appeal is granted sparingly in CCAA proceedings and only when there are serious and arguable grounds that are of real and significant interest to the parties. The Court considers four factors:

(1) Whether the point on the proposed appeal is of significance to the practice;
(2) Whether the point is of significance to the action;
(3) Whether the appeal is prima facie meritorious or frivolous; and
(4) Whether the appeal will unduly hinder the progress of the action.

See *Re Stelco (Re)*, (2005), 75 O.R. (3d) 5, at para. 24 (C.A.).

7 The Claimants do not meet this stringent test here.

The Indemnification Issue

8 Whether the Claimants are entitled to indemnification from all or just one or some of the entities in the Gandi Group was essentially a factual determination by the motion judge, is of no significance to the practice as a whole, and the proposed appeal on that issue is of doubtful merit in our view. We would not grant leave to appeal on that issue.

The Subordination Issue

9 The same may be said for the Subordination Agreement issue. The Claimants argue that by declaring that the indemnity claim of James Gandy is subordinate to the CCAA claim of TA Associates, the motion judge usurped the role of the pending arbitration. We do not agree. The subordination issue needed to be clarified for purposes of the CCAA proceedings. None of the criteria respecting the granting of leave is met in relation to this proposed ground.

The "Equity Claim" Issue

10 Nor do we see any basis for granting leave to appeal on the equity/non-equity claim issue.

11 "Equity" claims are subsequent in priority to non-equity claims by virtue of s. 6(8) of the CCAA. What constitutes an "equity claim" is defined in s. 2(1) and would appear to encompass the indemnity claims asserted by the Claimants here. Those provisions of the Act did not come into force until shortly after the Gandi Group CCAA proceedings commenced, however, and therefore do not apply in this situation. Newbould J. relied upon previous case law suggesting that the new provisions simply incorporated the historical treatment of equity claims in such proceedings: see, for example, *Re Nelson Financial Group Ltd.*, 2010 ONSC 6229 (CanLII), (2010), 75 B.L.R. (4th) 302, at para. 27 (Pepall J.). He therefore concluded that TA Associates was in substance attempting to reclaim its equity investment in the Gandi Group through the arbitration proceedings and that the Claimants' indemnity claims arising from that claim must be equity claims for CCAA purposes as well.

12 This issue in the proposed appeal is not of significance to the practice since all insolvency proceedings commenced after the new provisions of the CCAA came into effect in September 2009 will be governed by those provisions, not by the prior jurisprudence. The interpretation of sections 6(8) and 2(1) does not come into play on this appeal. To the extent that existing case law continues to govern whatever pre-September 2009 insolvency proceedings are still in the system, those cases will fall to be decided on their own facts. We see no error in the motion judge's analysis of the jurisprudence or in his application of it to the facts of this case, and therefore see no basis for granting leave to appeal from his disposition of the equity issue in these circumstances.

Disposition

13 The motion for leave to appeal is therefore dismissed. Costs to the Monitor and to TA Associates fixed in the amount of $5,000 each, inclusive of disbursements and all applicable taxes.

R.J. SHARPE J.A.
R.A. BLAIR J.A.
P.S. ROULEAU J.A.

cp/e/qllxr/qljxr/qlmll/qlana

Tab 7

Bill Clause No. 105
Section No. CCAA s.2
Topic: Definitions

Proposed Wording

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

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

"equity interest" means

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

Rationale

The definition of "**equity claim**" is added to provide greater clarity in subsequent provisions that deal with the rights of shareholders. An equity claim is defined to include any claim that is related to an equity interest.

The definition of "**equity interest**" is added to provide greater clarity in subsequent provisions that deal with the rights of shareholders. An equity interest is defined to include shares in corporations and units in income trusts and the right to acquire those except where the right is derived from a debt that is convertible into a share or unit. For example, a debenture witnessing a debt obligation that may, at the option of the holder, be converted into equity, should not be considered an equity interest - unless the holder has taken the steps necessary to have the conversion occur.

Present Law

None.

Tab 8

DEBTORS AND CREDITORS SHARING THE BURDEN:

A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*

Report of the Standing Senate
Committee on Banking, Trade and Commerce

Chair
The Honourable Richard H. Kroft

Deputy Chair
The Honourable David Tkachuk

November 2003

DEBTORS AND CREDITORS SHARING THE BURDEN:

A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*

Report of the Standing Senate
Committee on Banking, Trade and Commerce

S. Subordination of Equity Claims

Insolvency legislation in the United States has created the concept of "subordination of equity claims." Equity claims are those claims that are not based on the supply of goods, services or credit to a corporation, but rather are based on some wrongful or allegedly wrongful act committed by the issuer of an instrument reflecting equity in the capital of a corporation. Conceptually, this type of claim relates more to the loss of a claimant who holds shares or other equity instruments issued by a corporation, rather than the claims of traditional suppliers. In American legislation, such claims are subordinated to the claims of traditional suppliers.

Canadian insolvency law does not subordinate shareholder or equity damage claims.

Canadian insolvency law does not subordinate shareholder or equity damage claims. It is thought that this treatment has led some Canadian companies to reorganize in the United States rather than in Canada.

Mr. Kent, for example, told the Committee that "[i]f [a shareholders' rights claims by people who say that they have been lied to through the public markets] is filed in Canada, there is no facility in place to deal with it. They have no choice but to file in the U.S. where there is a vehicle to deal with these claims in a sensible, fair and reasonable way. In Canada, we have no mechanism. Thus, you end up with situations where it becomes difficult to reorganize a Canadian enterprise under Canadian law because our laws do not generally deal with shareholder claims."

He also indicated, however, that shareholder claims may be addressed within specific corporate statutes. Mr. Kent mentioned, in particular, the *Canada Business Corporations Act* and some provincial/territorial statutes, and shared his view that "[i]t becomes a lottery, depending on where the corporation is organized, whether there is a vehicle for dealing with some of these claims or there may not be. It is a hodgepodge system."

The Joint Task Force on Business Insolvency Law Reform shared with the Committee a proposal that all claims arising under or relating to an instrument that is in the form of equity are to be treated as equity claims. Consequently, "all [equity] claims against a debtor in an insolvency proceeding … including claims for payment of dividends, redemption or retraction or repurchase or shares, and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor … ." It also proposed that these claims could be extinguished, at the discretion of the Court, in connection with the approval of a reorganization plan.

In view of recent corporate scandals in North America, the Committee believes that the issue of equity claims must be addressed in insolvency legislation. In our view, the law must recognize the facts in insolvency proceedings: since holders of equity have necessarily accepted – through their acceptance of equity rather than debt – that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently, their claims should be afforded lower ranking than secured and unsecured creditors, and the law – in the interests of fairness and predictability – should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full. From this perspective, the Committee recommends that:

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

The *Bankruptcy and Insolvency Act* be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not participate in the proceeds of a restructuring or bankruptcy until other creditors of the debtor have been paid in full.

Tab 9

In re DE LAURENTIIS ENTERTAINMENT GROUP, INC., a Delaware corporation, and Affiliates, Debtors. The OFFICIAL COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS, Appellant, v. PAINEWEBBER INC., Appellee

No. CV 90-3663 WJR

UNITED STATES DISTRICT COURT FOR THE CENTRAL DISTRICT OF CALIFORNIA

124 B.R. 305; 1991 U.S. Dist. LEXIS 2173; 21 Bankr. Ct. Dec. 739; 91 Daily Journal DAR 2581

February 21, 1991, Decided
February 22, 1991, Filed

PRIOR HISTORY: [**1] Bankruptcy Case No. LA-88-17251-AA.

CASE SUMMARY:

PROCEDURAL POSTURE: Appellant creditors' committee sought review of the order of the United States Bankruptcy Court, which granted appellee creditor's Fed. R. Bankr. P. 3013 motion that the creditor's litigation expense claim against a Chapter 11 estate should not be subordinated, under the Bankruptcy Code, 11 U.S.C.S. § 510(b), to the claims of all other general unsecured creditors.

OVERVIEW: Appellee creditor defended actions by securities holders against it, in connection with the public offerings of the Chapter 11 debtor's stock, pursuant to a contract with the debtor that provided for the reimbursement of its attorney's fees. The debtor's Chapter 11 plan provided for the subordination of the creditor's claim to those of the general unsecured creditors. The creditor filed a motion, pursuant to Fed. R. Bankr. P. 3013, to have its claim for reimbursement of the fees classified with general unsecured claims. The trial court granted the motion and appellant creditors' committee sought review. The court held that the Bankruptcy Code, 11 U.S.C.S. § 510(b), provided for the subordination of claims for reimbursement or contribution, reimbursement by definition included indemnification, and indemnification naturally included recovery of attorneys' fees.

OUTCOME: The judgment that appellee creditor's claim for reimbursement of attorney's fees shared equal status with the claims of other unsecured creditors was reversed.

CORE TERMS: litigation expense, reimbursement, holder, attorneys' fees, subordinated, stock, unsecured creditors, indemnification, subordination, underwriter's, indemnity claims, rescission, unsecured claims, plain language, equityholder, policy considerations, subordinate, issuance, drafters, public offerings, pro rata share, citations omitted, demonstrably, shareholders, classified, construing, indemnity, asserting, purchaser, owed

LexisNexis(R) Headnotes

Bankruptcy Law > Practice & Proceedings > Appeals > Jurisdiction
Civil Procedure > Appeals > Appellate Jurisdiction > Interlocutory Orders
[HN1] 28 U.S.C.S. § 158(a) authorizes trial courts to hear appeals from final bankruptcy orders or from interlocutory bankruptcy orders if the trial court grants leave to appeal.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > De Novo Review
Civil Procedure > Appeals > Standards of Review > De Novo Review
[HN2] The issue raised by an appeal, whether a bankruptcy creditor's claim is subordinate to the claims of other general unsecured creditors, is a question of law entitled to de novo review.

Bankruptcy Law > Claims > Types > Unsecured Nonpriority Claims
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN3] The Bankruptcy Code, 11 U.S.C.S. § 510(b), provides that, for the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor, for damages arising from the purchase or sale of a security, or for contribution or reimbursement allowed under § 502 on account of such a claim, shall be subordinated to all claims or interests that are senior or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Governments > Legislation > Interpretation
[HN4] In construing the meaning of the Bankruptcy Code, 11 U.S.C.S. § 510(b), the court begins with the language of the statute itself. If the court finds the language of the statute plain, the inquiry should end. An exception to the plain meaning rule exists in rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters. In such a case, the intent of congress controls in construing the meaning of a statute. Accordingly, legislative history and policy arguments become relevant in discerning congressional intent.

Bankruptcy Law > Claims > Types > Unsecured Nonpriority Claims
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN5] The plain language of 11 U.S.C.S. § 510(b) includes claims for indemnification of litigation expenses. Nothing in the language of § 510(b) supports drawing a distinction between claims for reimbursement of litigation expenses from those of liability expenses incurred on account of a claim arising from rescission of a purchase or sale of a security of the debtor.

COUNSEL: Attorneys for Official Committee of Creditors Holding Unsecured Claims: Richard T. Peters, Perry L. Landsberg, Thomas H. Patterson, Sidley & Austin, Los Angeles, California.

Attorneys for Painewebber Incorporated: Phillip L. Bosl, Donald J. Schmid, Gibson, Dunn & Crutcher, Los Angeles, California.

Attorneys for Debtors: Joseph A. Eisenberg, Peter S. Fishman, Werner Disse, Levene & Eisenberg, Los Angeles, California.

JUDGES: William J. Rea, United States District Judge.

OPINION BY: REA

OPINION

[*306] MEMORANDUM DECISION AND ORDER

WILLIAM J. REA, United States District Judge.

The Court has reviewed and considered the moving and opposing papers, the record of the case, the arguments of counsel, the applicable authorities and good cause appearing therefore:

IT IS HEREBY ORDERED that PaineWebber Incorporated's litigation expense claim against the Debtor's Chapter 11 estate is subordinated under 11 U.S.C. § 510(b) to the claims of all other general unsecured creditors.

The issue presented on appeal is whether the Bankruptcy Court erred in finding that PaineWebber's litigation expense claim against a Chapter 11 estate should not be subordinated under 11 U.S.C. Section 510(b) to the claims of all other general unsecured **[**2]** creditors. The Court reverses the order granting PaineWebber's Bankruptcy Rule 3013 motion.

BACKGROUND

The Official Committee of Creditors Holding Unsecured Claims ("Committee") in the Chapter 11 case of De Laurentiis Entertainment Group, Inc. ("Debtor") has appealed a May 9, 1990 Order of the Bankruptcy Court ("Order"). The Order granted a motion brought by PaineWebber Incorporated ("PaineWebber") pursuant to Bankruptcy Rule 3013, and thus, determined that PaineWebber's claim for reimbursement of attorneys' fees incurred in the defense of actions brought by securities holders in connection with the public offerings of stock was entitled to be classified with general unsecured claims.

PaineWebber had entered into a series of underwriting agreements with the Debtor in connection with securities offerings. The underwriting agreements included promises by the debtor that it would reimburse PaineWebber for any reasonable litigation expenses it incurred should it be sued in connection with those offerings. PaineWebber was subsequently sued by securities holders on the theory that the prospectuses and registration statements filed **[*307]** in connection with the public offerings contained material **[**3]** misstatements of fact. PaineWebber claims to have incurred over $ 800,000 in attorneys' fees in defending these actions.

PaineWebber asserted a contract-based claim for these expenses against the Debtor within the time period allowed.

In March 1990, the Debtor filed its proposed plan of reorganization which subordinated PaineWebber's litigation expense claims pursuant to Bankruptcy Code § 510(b). As a result of the subordinated position, PaineWebber's claims would receive no distribution.

The Debtors' Plan classifies groups of creditors in separate classes and specifies the treatment of such classes of creditors. Class 8 is entitled "General Unsecured" claims. The Plan provides that Class 8 creditors receive a distribution on account of their claims equal to the pro rata share of a fund consisting of cash and reorganization securities.

Class 9 is entitled "Securities Claims" and consists of two sub-classes: (1) Class 9-A, containing claims for damages or rescission arising out of the sale of a security of the Debtor; and (2) Class 9-B, containing claims for reimbursement, contribution, or indemnity on account of a Class 9-A claim. The Plan, as modified by the Confirmation Order, provides **[**4]** that Class 9-A and 9-B creditors receive no distribution on account of their claims.

PaineWebber filed a motion pursuant to Bankruptcy Rule 3013 to have its litigation expense claim classified as a general unsecured claim, and thereby, entitle it to some pro rata share of the assets remaining in the estate. Both the Debtor and the Committee opposed PaineWebber's motion. Following briefing and oral argument, Bankruptcy Judge Ahart granted PaineWebber's motion and classified PaineWebber's litigation expense claim as a Class 8 General Unsecured claim.

The Committee and the Debtor filed notices of appeal from the Bankruptcy Court's May 9, 1990 Order. The Debtor has not pursued the appeal any further.

DISCUSSION

I. *JURISDICTION*

[HN1] 28 U.S.C. § 158(a) authorizes district courts to hear appeals from final bankruptcy orders or from interlocutory bankruptcy orders if the district court grants leave to appeal. The Court exercises its discretion in granting leave to appeal as a successful appeal avoids the need for further proceedings relating to PaineWebber's pro rata share as a Class 8 creditor under the plan for distribution.

II. *Standard of Review*

Both parties agree that [HN2] the **[**5]** issue raised by this appeal is a question of law entitled to de novo review. *Pizza of Hawaii v. Shakey's, Inc.,* 761 F.2d 1374, 1377 (9th Cir. 1985).

III. *Subordination under 11 U.S.C. § 510(b)*

The Committee's argument on appeal is that the plain language of Section 510(b) requires PaineWebber's claim to be subordinated to the level of the claims of the holders of securities. [HN3] Section 510(b) of the Bankruptcy Code provides as follows:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor, for damages arising from the purchase or sale of a security, or for contribution or reimbursement allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

The Committee argues that the Bankruptcy Court erred in holding that PaineWebber's claim is not a claim for reimbursement or contribution within the scope of Section 510(b).

A. ***Language of Section 510(b)***

[HN4] In construing **[**6]** the meaning of Section 510(b), the Court begins with the language **[*308]** of the statute itself. *United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989) (citations omitted). If the Court finds the language of the statute plain, the Court's inquiry should end. *Id.* An exception to the plain meaning rule exists in "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters." *Id.* (quoting *Griffin v. Oceanic Contractors, Inc.,* 458 U.S. 564, 73 L. Ed. 2d 973, 102 S. Ct. 3245 (1982)). In such a case, the intent of Congress controls in construing the meaning of a statute. Accordingly, legislative history and policy arguments become relevant in discerning congressional intent. *Id.*

The Committee argues that PaineWebber's claim for attorneys' fees pursuant to its indemnification agreement with the Debtor is a claim for reimbursement under Section 510(b). Reimbursement by definition includes indemnification, and indemnification naturally includes recovery of attorneys' fees. Hence, PaineWebber's claim qualifies as one for reimbursement under the plain language of Section 510(b).

PaineWebber argues that the language of Section 510(b) **[**7]** does not mandate subordination of litigation expense claims. First, PaineWebber states that Section 510(b) does not mention litigation expense claims or even attorneys' fees claims. Therefore, the language must be interpreted by ascertaining the intent of Congress. *In re Arizona Appetito's Stores, Inc.,* 893 F.2d 216, 219 (9th Cir. 1990). PaineWebber asserts that the 1984 Amendment language supports the litigation expense/liability claim distinction drawn by the court in *Christian Life Center Litigation Defense Comm. v. Silva,* 821 F.2d 1370 (9th Cir. 1987).

PaineWebber focuses on the use of the words "on account of" as revealing Congressional intent to subordinate only those reimbursement or contribution claims which would be passed on to equity holders asserting damage or rescission claims. If Congress had meant to include litigation expense claims, Congress would have used the words "associated with," "related to," "resulting from," or "arising out of" to designate those reimbursement claims that it intended to subordinate.

Rather, PaineWebber argues that "on account of" connotes the partial payment or satisfaction of a specific debt and cites to Black's Law Dictionary. As **[**8]** such, PaineWebber concludes that Congress used "on account of" to refer specifically to a debt owed to the equityholders. Litigation expenses are not such a debt, but rather, encompass the debts owed to attorneys, experts, and court costs. Black's defines "on account", without "of", as "in part payment; in partial satisfaction of an account." The Court declines to adopt the novel interpretation proposed by PaineWebber and interprets "on account of" consistent with its meaning in normal usage.

The Court concludes that [HN5] the plain language of Section 510(b) includes claims for indemnification of litigation expenses. Nothing in the language of Section 510(b) supports drawing a distinction between claims for reimbursement of litigation expenses from those of liability expenses incurred on account of a claim arising from rescission of a purchase or sale of a security of the debtor. Thus, PaineWebber has the burden of showing that subordination of an underwriter's claim for indemnification of attorneys' fees in this case is "demonstrably at odds with the intention of its drafters" and not within the intended scope of Section 510(b). *See United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026, **[**9]** (1989).

B. *Underlying Policy*

The purpose of Section 510(b) as originally enacted was to prevent equityholders from converting their interests into higher priority general unsecured creditors claims by asserting damages or rescission claims. *Christian Life Center Litigation Defense Comm. v. Silva,* 821 F.2d 1370, 1375 (9th Cir. 1987).

Section 510(b) was amended in 1984 by adding a provision for "claims for reimbursement or contribution allowed under section 502 on account of such a claim." Bankruptcy Amendments and Federal **[*309]** Judgeship Act of 1984, Pub. L. No. 98-353, § 451, 98 Stat. 333, 375. There is no legislative history surrounding the 1984 Amendment.

PaineWebber asserts that the policy underlying Section 510(b) supports its position that the 1984 amendment to Section 510(b) relating to claims for reimbursement applies only to claims for reimbursement of liability, and not litigation expenses. PaineWebber relies on *Christian Life Center Litigation Defense Comm. v. Silva,* 821 F.2d 1370 (9th Cir. 1987) as supporting the position that the Ninth Circuit has distinguished litigation liability claims from litigation expense claims.

In *Christian Life,* the court addressed **[**10]** whether Section 510(b), prior to the 1984 amendments, required the subordination of officers' indemnity claims for litigation costs. Certain officers of the debtor incurred legal expenses in defense of an action for rescission of the sale of unregistered securities under the California Corporations Code. The attorneys representing the defendant officers filed a claim for indemnification from the estate, asserting, in part, that section

317 of the California Corporations Code provided for such claims. The creditors' committee and certain of the investors argued that the claim for fees should be subordinated pursuant to Section 510(b). The court held that the indemnity claims for litigation costs did not fall within the scope of Section 510(b).

> The officers' indemnity claims are for litigation costs, not for reimbursement of liability owed to the holders of the securities. The argument that the security holder may circuitously elevate his claim to a general unsecured claim through indemnity is relevant only to indemnity of liability. The security holder recovers nothing from the officers when the latter are merely indemnified for defense costs. Thus section 510(b) -- at least prior **[**11]** to the 1984 amendments -- does not require subordination of indemnity claims for defense costs. The blanket order subordinating all indemnity claims to general unsecured claims, even those for defense costs, is not proper under that section.

Christian Life, 821 F.2d at 1376. PaineWebber emphasizes that the Ninth Circuit's statements and the rationale underlying those statements are still valid even after the 1984 amendment. The important point is that the reimbursement of litigation expenses are fundamentally different from claims for reimbursement of liability losses because only reimbursements of liability losses are passed on to equityholders.

In reaching its conclusion in *Christian Life,* the Court relied on three underlying policy considerations of Section 510(b). One, "failure to subordinate the interests of shareholders to those of unsecured creditors would defeat the reasonable expectations of both." 821 F.2d at 1375. Two, "general creditors rely on the equity cushion created by the investment of shareholders and expect priority in bankruptcy." *Id.* And three, "shareholders in turn bargain for potential profit in exchange for expected subordination of their interests **[**12]** in bankruptcy." *Id.* (citations omitted).

The Committee distinguishes its case from that of *Christian Life* in that the officers were not purchasers of the securities in *Christian Life.* In contrast, the present case involves underwriters who have purchased stock. The Committee's position is that PaineWebber is a purchaser of stock, and therefore, should be considered an equityholder. PaineWebber's position is that it is seeking indemnification pursuant to its contractual rights and that its role as an equityholder is merely incidental to its true role in the transaction.

Both parties have presented strong policy reasons to support their positions. As underwriters, PaineWebber does not fall within the scope of either a purely non-purchaser of stock or a purchaser of stock, but rather is a highbred. It is unclear how Congress intended underwriters to be treated under Section 510(b). It is PaineWebber, however, that bears that burden of showing how interpreting Section 510(b) consistent with the plain language of the statute would subvert Congressional intent. Since both parties have presented equally compelling rationale to support their positions, the Court cannot say that **[**13]** **[*310]** enforcing the plain language of Section 510(b) would "produce a result demonstrably at odds with the intention of its drafters." *United States v. Ron Pair Enterprises, Inc.,* 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989) (citations omitted).

The *Christian Life* court's rationale emphasized the fact that the security holders would not be indirectly benefited if the officers were indemnified for defense costs. An equally important policy consideration behind Section 510(b), emphasized by the Ninth Circuit in *In re Holiday Mart, Inc.,* 715 F.2d 430, 433 (1983), is that it would not be fair to shift the risk of unlawfulness in the issuance of securities from the stockholders to the creditors. In the case presented before the Court, there is no danger that the security holders will be indirectly benefited by subordinating the claims for litigation expenses. Nevertheless, the general unsecured creditors will bear some risk associated with the unlawful issuance of securities by allowing PaineWebber to receive reimbursement for its litigation expense claim on par with the general unsecured creditors. Given that the fair allocation of risk is one of the underlying policy considerations of Section 510(b), [1] underwriters **[**14]** are in a better position than the general unsecured creditors to evaluate the risks associated with the issuance of stock and take the appropriate steps to protect themselves.

1 *See* Slain and Kripke, *The Interface Between Securities Regulation and Bankruptcy -- Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors,* 48 N.Y.U. L. Rev. 261 (1973).

Additional policy considerations exist to support the Court's conclusion that a litigation liability versus expense distinction should not be read into the language of Section 510(b).

An attorneys' fees exception to Section 510(b) could swallow the rule because such an interpretation could extend to all attorneys' fee claims and not just those of the defendants. For example, in cases where plaintiffs' counsel is paid out of a fund created for a class of plaintiffs, counsel could argue that the attorneys' fees portion of recovery should not be subordinated under Section 510(b).

Additionally, the failure to subordinate attorneys' **[**15]** fees may eliminate an incentive to settle securities cases. The Committee highlights the fact that underwriters are not permitted to pass on their damage claims that result from litigation surrounding the issued securities. If PaineWebber settles the case by agreeing to pay some damages, its indemnity claim against the debtor is subordinated. However, under PaineWebber's theory, if PaineWebber continues to litigate, its litigation costs are subsidized by the unsecured creditors. Thus, PaineWebber's interpretation of the statute could act as a disincentive to settlement.

IV. ***Conclusion***

The Court finds that Section 510(b) governs PaineWebber's claim for litigation expenses. In construing the provisions of Section 510(b), the Court concludes that PaineWebber's claim for litigation expenses incurred in defending an action brought by securities holders in connection with the public offerings of stock is subordinated to the claims of the general unsecured creditors. The Court is not persuaded that the subordination of an underwriter's claim to indemnification for attorneys' fees would conflict with the intent of the drafters of Section 510(b). Accordingly, the Court finds the language **[**16]** of the statute controlling and reverses the Bankruptcy Court's order granting PaineWebber's Rule 3013 motion.

Tab 10

Case Name:
Nelson Financial Group Ltd. (Re)

**IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, C-36, as amended
AND IN THE MATTER OF a Plan of Compromise or Arrangement of Nelson Financial Group Ltd.**

[2010] O.J. No. 4903

2010 ONSC 6229

75 B.L.R. (4th) 302

71 C.B.R. (5th) 153

2010 CarswellOnt 8655

Court File No. 10-8630-00CL

Ontario Superior Court of Justice
Commercial List

S.E. Pepall J.

November 16, 2010.

(36 paras.)

Bankruptcy and insolvency law -- Companies' Creditors' Arrangement Act (CCAA) -- Compromises and arrangements -- Claims -- Priority -- Motion by the holders of promissory notes from the debtor company for an order that all claims and potential claims of the preferred shareholders against the company be classified as equity claims within the meaning of the Companies' Creditors Arrangement Act allowed -- Claims of preferred shareholders for unpaid dividends, redemption, compensatory damages and rescission fell within s. 2 of the Companies' Creditors Arrangement Act and were thus equity claims.

Motion by the holders of promissory notes from the debtor company for an order that all claims and potential claims of the preferred shareholders against the company be classified as equity claims within the meaning of the Companies' Creditors Arrangement Act. The company raised money from investors and then used those funds to extend credit to customers in vendor assisted financing programmes. It issued promissory notes or preference shares to the investors. The preferred shareholders were entered on the share register and received share certificates. They were treated as equity in the company's financial statements. The claims of the preferred shareholders against the company were for declared but unpaid dividends, unperformed requests for redemption, compensatory damages for negligent or fraudulent misrepresentation and payment of the amounts due upon the rescission or annulment of the purchase or subscription for preferred shares.

HELD: Motion allowed. The preferred shareholders were shareholders of the company, not creditors. The substance of the arrangement between the preferred shareholders and the company was a relationship based on equity and not debt. The claims of the preferred shareholder in the present case did not constitute a claim provable for the purposes of the Companies' Creditors Arrangement Act. The language of s. 2 of the Act was clear and unambiguous and equity claims included a claim in respect of an equity interest and a claim for a dividend or similar payment and a claim for rescission. This encompassed the claims of all of the preferred shareholders.

Statutes, Regulations and Rules Cited:

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 2, s. 121(1)

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

Counsel:

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

J.H. Grout and S. Aggarwal, for the Monitor.

Pamela Foy, for the Ontario Securities Commission.

Frank Lamie, for Nelson Financial Group Ltd.

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

Michael Beardsley, Self Represented Respondent.

Clifford Holland, Self Represented Respondent.

Arnold Bolliger, Self Represented Respondent.

John McVey, Self Represented Respondent.

Joan Frederick, Self Represented Respondent.

Rakesh Sharma, Self Represented Respondent.

Larry Debono, Self Represented Respondent.

Keith McClear, Self Represented Respondent.

REASONS FOR DECISION

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

Background Facts

2 Nelson was incorporated pursuant to the *Business Corporations Act* of Ontario in September, 1990. Nelson raised money from investors and then used those funds to extend credit to customers in vendor assisted financing programmes. It raised money in two ways. It issued promissory notes bearing a rate of return of 12% per annum and also issued preference shares typically with an annual dividend of 10%.[1] The funds were then lent out at significantly higher rates of interest.

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

(a) Noteholders

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

(b) Preferred Shareholders

5 Nelson was authorized to issue two classes of common shares and 2,800,000 Series A preferred shares and 2,000,000 Series B preferred shares, each with a stated capital of $25.00. The president and sole director of Nelson, Marc Boutet, is the owner of all of the issued and outstanding common shares. By July 31, 2007, Nelson had issued to investors 176,675 Series A preferred shares for an

aggregate consideration of $4,416,925. During the subsequent fiscal year ended July 31, 2008, Nelson issued a further 172,545 Series A preferred shares and 27,080 Series B preferred shares. These shares were issued for an aggregate consideration of $4,672,383 net of share issue costs.

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

7 As of the *CCAA* filing date of March 23, 2010, Nelson had issued and outstanding 585,916.6 Series A and Series B preferred shares with an aggregate stated capital of $14,647,914. The preferred shares are held by approximately 82 people. As of the date of filing of these *CCAA* proceedings, there were approximately $53,632 of declared but unpaid dividends outstanding with respect to the preferred shares and $73,652.51 of accumulated dividends.

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

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

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

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

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

(c) Insolvency

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

(d) Ontario Securities Commission

13 On May 12, 2010, the Ontario Securities Commission ("OSC") issued a Notice of Hearing and Statement of Allegations alleging that Nelson and its affiliate, Nelson Investment Group Ltd., and various officers and directors of those corporations committed breaches of the *Ontario Securities Act* in the course of selling preferred shares. The allegations include non-compliance with the prospectus requirements, the sale of shares in reliance upon exemptions that were inapplicable, the sale of shares to persons who were not accredited investors, and fraudulent and negligent misrepresentations made in the course of the sale of shares. The OSC hearing has been scheduled for the end of February, 2011.

(e) Legal Opinion

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

(f) Development of Plan

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

Motion

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

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

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

19 Mr. Styles states that he and his company invested approximately $4.5 million in Nelson. He states that Mr. Boutet persuaded him to convert his promissory notes into preference shares by promising a 13.75% dividend rate, assuring him that the obligation of Nelson to repay would be treated the same or better than the promissory notes, and that they would have the same or a priority position to the promissory notes. He then received dividends at the 13.75% rate contrary to the 10% rate found in the company's articles. In addition, at the time of the conversion, Nelson was insolvent.

20 In brief, Mr. Styles submits that:

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

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

The Issue

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

The Law

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

Section 2 of the *CCAA* states:

> In this Act,
>
> "Claim" means any indebtedness, liability or obligation of any kind that would be a claim provable within the meaning of section 2 of the *Bankruptcy and Insolvency Act*;
>
> "Equity Claim" means a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
> (b) a return of capital,
> (c) a redemption or retraction obligation,
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (*a*) to (*d*);"
>
> "Equity Interest" means
>
> (a) in the case of a corporation other than an income trust, a share in the

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

Section 6(8) states:

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

Section 22.1 states:

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

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

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

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

25 Historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. As noted by Laskin J.A. in *Re Central Capital Corporation*[2], on the insolvency of a company, the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of shareholders in an insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of management.

26 This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*[3] In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.*[4] concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent. The Court stated that "the real party against which [the shareholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." *National Bank of Canada v. Merit Energy Ltd.*[5] and *Earthfirst Canada Inc.*[6] both treated claims relating to agreements that were collateral to equity claims as equity claims. These cases dealt with separate indemnification agreements and the issuance of flow through shares. The separate agreements and the ensuing claims were treated as part of one integrated transaction in respect of an equity interest. The case law has also recognized the complications and delay that would ensue if *CCAA* proceedings were mired in shareholder claims.

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

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

29 Guidance on the appropriate approach to the issue of characterization was provided by the Ontario Court of Appeal in *Re Central Capital Corporation*[7]. Central Capital was insolvent and sought protection pursuant to the provisions of the *CCAA*. The appellants held preferred shares of Central Capital. The shares each contained a right of retraction, that is, a right to require Central Capital to redeem the shares on a fixed date and for a fixed price. One shareholder exercised his right of retraction and the other shareholder did not but both filed proofs of claim in the *CCAA* proceedings. In considering whether the two shareholders had provable debt claims, Laskin J.A. considered the substance of the relationship between the company and the shareholders. If the governing instrument contained features of both debt and equity, that is, it was hybrid in character, the court must determine the substance of the relationship between the company and the holder of the certificate. The Court examined the parties' intentions.

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

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

(a) Investors were given the option of investing in promissory notes or preference shares and opted to invest in shares. Had they taken promissory notes, they obviously would have been creditors. The preference shares carried many attractions including income tax advantages.
(b) The investors had the right to receive dividends, a well recognized right of a shareholder.
(c) The preference share conditions provided that on a liquidation, dissolution or winding up, the preferred shareholders ranked ahead of common shareholders. As in *Central Capital*, it is implicit that they therefore would rank behind creditors.
(d) Although I acknowledge that the preferred shareholders did not receive copies of the financial statements, nonetheless, the shares were treated as equity in Nelson's financial statements and in its books and records.

32 The substance of the arrangement between the preferred shareholders and Nelson was a relationship based on equity and not debt. Having said that, as I observed in *I. Waxman & Sons.*[8], there is support in the case law for the proposition that equity may become debt. For instance, in that case, I held that a judgment obtained at the suit of a shareholder constituted debt. An analysis of the nature of the claims is therefore required. If the claims fall within the parameters of section 2 of the *CCAA*, clearly they are to be treated as equity claims and not as debt claims.

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

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

34 In my view, all of these claims fall within the ambit of section 2, are governed by sections 6(8) and 22.1 of the *CCAA,* and therefore do not constitute a claim provable for the purposes of the statute. The language of section 2 is clear and unambiguous and equity claims include "a claim that is in respect of an equity interest" and a claim for a dividend or similar payment and a claim for rescission. This encompasses the claims of all of the preferred shareholders including the Styles whose claim largely amounts to a request for rescission or is in respect of an equity interest. The case of *National Bank of Canada v. Merit Energy Ltd.*[9] is applicable in regard to the latter. In substance, the Styles' claim is for an equity obligation. At a minimum, it is a claim in respect of an equity interest as described in section 2 of the CCAA. Parliament's intention is clear and the types of claims advanced in this case by the preferred shareholders are captured by the language of the amended statute. While some, and most notably Professor Janis Sarra[10], advocated a statutory amendment that provided for some judicial flexibility in cases involving damages arising from egregious conduct on the part of a debtor corporation and its officers, Parliament opted not to include such a provision. Sections 6(8) and 22.1 allow for little if any flexibility. That said, they do provide for greater certainty in the appropriate treatment to be accorded equity claims.

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

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

S.E. PEPALL J.

cp/e/qlafr/qlvxw/qlana

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

2 (1996), 38 C.B.R. (3d) 1 (Ont. C.A.).

3 (2000), 15 C.B.R. (4th) 169.

4 (1978) 579 F. 2d 206 (2nd Cir. Ct. of App.).

5 [2001] A.J. No. 918, (2001), 2001 CarswellAlta 913, aff'd [2002] A.J. no. 6, 2002 CarswellAlta 23 (Alta C.A.).

6 [2009] A.J. No. 749, (2009) 2009 CarswellAlta 1069.

7 Supra, note 2.

8 [2008] O.J. No. 885, (2008), 2008 CarswellOnt 1245.

9 Supra, note 5.

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

Tab 11

Indexed as:

Resurgence Asset Management LLC v. Canadian Airlines Corp.

IN THE MATTER OF The Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended;
AND IN THE MATTER OF The Business Corporations Act (Alberta) S.A. 1981, c.B-15., as amended, Section 185
AND IN THE MATTER OF Canadian Airlines Corporation and Canadian Airlines International Ltd.
Between
Resurgence Asset Management LLC, applicant, and Canadian Airlines Corporation and Canadian Airlines International Ltd., respondents

[2000] A.J. No. 610

2000 ABCA 149

80 Alta. L.R. (3d) 213

2000 CarswellAlta 503

261 A.R. 120

19 C.B.R. (4th) 33

97 A.C.W.S. (3d) 844

Docket: 00-18816

Alberta Court of Appeal
Calgary, Alberta

Wittmann J.A.
(In Chambers)

Heard: May 18, 2000.
Judgment: filed May 29, 2000.

(47 paras.)

Application for leave to appeal the order of Paperny J. Dated the 12th day of May, 2000.

Counsel:

D. Haigh, Q.C. and D. Nishimura, for the applicant.

A.L. Friend, Q.C. and H.M. Kay, for the respondents.
S. Dunphy, for Air Canada.
A.J. McConnell, for Bank of Nova Scotia Trust Company of New York, Montreal Trust Co. of Canada.
P.T. McCarthy, Q.C., for Price Waterhouse Coopers.

[Quicklaw note: Errata were filed by the Court June 5, 2000. The corrections have been made to the text and the Errata are appended to this document.]

MEMORANDUM OF DECISION

WITTMANN J.A.:--

INTRODUCTION

1 This is an application for leave to appeal the decision of Paperny, J. made on May 12, 2000, pursuant to the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended (CCAA). The applicant, Resurgence Asset Management LLC (Resurgence), is an unsecured creditor by virtue of its holding 58.2 per cent of U.S. $100,000,000.00 unsecured notes issued by Canadian Airlines Corporation (CAC)

2 CAC and Canadian Airlines International Ltd. (CAIL) (collectively Canadian) commenced proceedings under the CCAA on March 24, 2000.

3 A proposed Plan of Compromise and Arrangement (the Plan) has been filed in this matter regarding CAC and CAIL, pursuant to the CCAA.

4 The decision of Paperny, J. May 12, 2000 (the Decision) ordered, among other things, that the classification of creditors not be fragmented to exclude Air Canada as a separate class from Resurgence in terms of the unsecured creditors; that Air Canada should be entitled to vote on the Plan pursuant to s. 6 of the CCAA at the creditors' meeting to be held May 26, 2000; that there be no separation of unsecured creditors of CAC from unsecured creditors of CAIL for voting purposes; and that votes in respect of claims assigned to Air Canada, be recorded and tabulated separately, for the purpose of consideration in the application for court approval of the Plan (the Fairness Hearing).

LEAVE TO APPEAL UNDER THE CCAA

5 The section of the CCAA governing appeals to this Court is as follows:

> 13. Except in the Yukon Territory, any person dissatisfied with an order or a decision made under this Act may appeal therefrom on obtaining leave of the judge appealed from or of the court or a judge of the court to which the appeal lies and on such terms as to security and in other respects as the judge or court directs.

6 The criterion to be applied in an application for leave to appeal pursuant to the CCAA is not in dispute. The general criterion is embodied in the concept that there must be serious and arguable grounds that are of real and significant interest to the parties: Re Multitech Warehouse District (1995), 32 Alta. L.R. (3d) 62 at 63 (C.A.); Luscar Ltd. v. Smoky River Coal Ltd., [1999] A.J. No. 185 at para. 22 (C.A.); Re Blue Range Resource Corporation, [1999] A.J. No. 975; Re Blue Range Resource Corporation, [2000] A.J. No. 4;Re Blue Range Resource Corporation, [2000] A.J. No. 31.

7 Subsumed in the general criterion are four applicable elements which originated in Power Consolidated (China) Pulp Inc. v. British Columbia Resources Investment Corp. (1988), 19 C.P.C. (3d) at 396 (B.C.C.A.), and were adopted in Med Finance Company S.A. v. Bank of Montreal (1993), 22 C.B.R. (3d) 279 (B.C.C.A.). McLachlin, J.A. (as she then was) set forth the elements in Power Consolidated as follows at p.397:

> (1) whether the point on appeal is of significance to the practice;
> (2) whether the point raised is of significance to the action itself;
> (3) whether the appeal is prima facie meritorious or, on the other hand, whether it is frivolous; and
> (4) whether the appeal will unduly hinder the progress of the action.

These elements have been considered and applied by this Court, and were not in dispute before me as proper elements of the applicable criterion.

FACTS

8 On or about October 19, 1999, Air Canada announced its intention to make a bid for CAC and to proceed to complete a merger subject to a restructuring of Canadian's debt. On or about November 5, 1999, following a ruling by the Quebec Superior Court, a competing offer by Airline Industry Revitalization Co. Inc. was withdrawn and Air Canada indicated that it would proceed with its offer for CAC.

9 On or about November 11, 1999, Air Canada caused the incorporation of 853350 Alberta Ltd. (853350), for the sole purpose of acquiring the majority of the shares of CAC. At the time of incorporation, Air Canada held 10 per cent of the shares of 853350. Paul Farrar, among others, holds the remaining 90 per cent of the shares of 853350.

10 On or about November 11, 1999, Air Canada, through 853350, offered to purchase the outstanding shares of CAC at a price of $2.00 per share for a total of $92,000,000.00 for all of the issued and outstanding voting and non-voting shares of CAC.

11 On or about January 4, 2000, Air Canada and 853350 acquired 82 per cent of CAC's outstanding common shares for approximately $75,000,000.00 plus the preferred shares of CAIL for a purchase price of $59,000,000.00. Air Canada then replaced the Board of Directors of CAC with its own nominees.

12 Substantially all of the aircraft making up the fleet of Canadian are held by Air Canada through lease arrangements with various lessors or other aircraft financial agencies. These arrangements were the result of negotiations with lessors, jointly conducted by Air Canada and Canadian.

13 In general, these arrangements include the following:

> (i) the leases have been renegotiated to reflect contemporary fair market value (or below) based on two independent desk top valuations; and
> (ii) the present value of the difference between the financial terms under the previous lease arrangements and the renegotiated fair market value terms was characterized as "unsecured deficiency," reflected in a Promissory Note payable to the lessor from Canadian and assigned by the lessor to Air Canada.

14 In the result, Air Canada has acquired or is in the process of acquiring all but eight of the deficiency claims of aircraft lessors or financiers listed in Schedule "B" to the Plan in the total amount of $253,506.944.00. Air Canada intends to vote those claims as an unsecured creditor under the Plan.

15 The executory contracts claims listed in Schedule "B" to the Plan total $110,677,000.00, of which $108,907,000.00 is the claim of Loyalty Management Group Canada Inc. (Loyalty), an entity with a long term contract with Canadian to purchase air miles. The claim is subject to an agreement of settlement between Loyalty, Canadian and Air Canada. Air Canada was assigned the Loyalty unsecured claim.

16 In the Plan, all unsecured creditors of both CAC and CAI are grouped in the same class for voting purposes.

17 Pursuant to the Plan, unsecured creditors will receive a payment of $0.12 on the dollar for each $1.00 of their claim unless the total amount of unsecured claims exceeds $800 million, in which case, they will receive less. Air Canada will fund this Pro Rata Cash Amount. As a result of the assignments of the deficiency amounts in favour of Air Canada, if the Plan is approved, Air Canada will notionally be paying a substantial proportion of the Pro Rata Cash Amount to itself.

18 The Plan further contemplates Air Canada becoming the 100 per cent owner of Canadian through 853350.

19 On April 7, 2000, an Order was granted by Paperny, J., directing that the Plan be filed by the Petitioners; establishing a claims dispute process; authorizing the calling of meetings for affected creditors to vote on the Plan to be held on May 26, 2000; authorizing the Petitioners to make application for an Order sanctioning the Plan on June 5, 2000; and providing other directions.

20 The April 7, 2000 Order established three classes of creditors: (a) the holders of Canadian Airlines Corporation 10 per cent Senior Secured Notes due 2005 (the Secured Noteholders); (b) the secured creditors of the Petitioners affected by the Plan (the Affected Secured Creditors); and (c) the unsecured creditors affected by the Plan (the Affected Unsecured Creditors).

21 On April 25, 2000, the Petitioners filed and served the Plan, in accordance with the Order of April 7, 2000. By Notice of Motion dated April 27, 2000, Resurgence brought an application, among other things, seeking "directions as to the classification and voting rights of the creditors . . . (and) the quantum of the deficiency claims' assigned to Air Canada." Resurgence sought to have Air Canada excluded from voting as an unsecured creditor unless segregated into a separate class. Resurgence also sought to have the holders of the unsecured notes vote as a separate class.

22 The result of the April 27, 2000 motion by Resurgence is the Decision.

THE DECISION

23 In the Decision, the supervising chambers judge referred to her order of April 14, 2000, wherein she approved transactions involving the re-negotiation of the aircraft leases. She referred to "about $200,000,000.00 worth of concessions for CAIL" as "concessions or deficiency claims" which were quantified and reflected in promissory notes which were assigned to Air Canada in exchange for its guarantee of the aircraft leases. The monitor approved of the method of quantifying the claims and Paperny, J. approved the transactions, reserving the issue of classification and voting to her May 12 Decision.

24 The Plan provides for one class of unsecured creditor. The unsecured class is composed of a number of types of unsecured claims including executory contracts (e.g. Air Canada from Loyalty) unsecured notes (e.g. Resurgence), aircraft leases (e.g. Air Canada from lessors), litigation claims, real estate leases and the deficiencies, if any, of the senior secured noteholders.

25 In seeking to have Air Canada vote the promissory notes in a separate class Resurgence argued several factors before Paperny, J., as set out at pp. 4-5 of the Decision as follows:

1. The Air Canada appointed board caused Canadian to enter into these CCAA proceedings under which Air Canada stands to gain substantial benefits in its own operations and in the merged operations and ownership contemplated after the compromise of debts under the plan.
2. Air Canada is providing the fund of money to be distributed to the Affected Unsecured Creditors and will, therefore, end up paying itself a portion of that money if it is included in the Affected Unsecured Creditors' class and permitted to vote.
3. Air Canada gave no real consideration in acquiring the deficiency claims and manufactured them only to secure a yes' vote.

26 She then recited the argument made by Air Canada and Canadian to the effect that the legal rights associated with Air Canada's unsecured claims are the same as those associated with the other affected unsecured claimants, and that the matters raised by Resurgence relating to classification are really matters of fairness more appropriately dealt with in a Fairness Hearing scheduled to be held June 5, 2000.

27 After observing that the CCAA offers no guidance with respect to the classification of claims, beyond identifying secured and unsecured categories and the possibility of classes within each category, and that the process has developed in case law, Paperny, J. embarked on a detailed analysis and consideration of the case law in this area including Norcen Energy Resources Ltd. v. Oakwood Petroleums Ltd. (1988), 72 C.B.R. (N.S.) 20 (Alta. Q.B.); Sovereign Life Assurance Co. v. Dodd, [1892] 2 Q.B. 573 (C.A.); Re Fairview Industries Ltd. (1991), 11 C.B.R. (3d) 71 (N.S.S.C.T.D.); Re Northland Properties (1989), 73 C.B.R. (N.S.) 195; Savage v. Amoco Acquisition Corp. (1988), 68 C.B.R. (N.S.) 154 (Alta. C.A.); Re Woodward's Ltd. (1993), 84 B.C.L.R. (2d) 206 (B.C.S.C.); Sklar-Peppler Furniture Corp. v. Bank of Nova Scotia (1991), 86 D.L.R. (4th) 621 at 626 (Ont. Gen. Div.); Re NsC Diesel Power Inc. (1990), 79 C.B.R. (N.S.) 1 (N.S.S.C.T.D.); Re Wellington Bldg. Corp., [1934] O.R. 653, 16 C.B.R. 48 (Ont. S.C.). Paperny, J. also referred to an oft-cited article "Reorganization under the Companies Creditors Arrangement Act" by S. E. Edwards (1947), 25 Can. Bar Rev. 587. She concluded her legal analysis at pp.12-13 by setting forth the principles she found to be applicable in assessing commonality of interest as an appropriate test for the classification of creditors:

1. Commonality of interest should be viewed on the basis of the non-fragmentation test, not on an identity of interest test;
2. The interests to be considered are the legal interests the creditor holds qua creditor in relationship to the debtor company, prior to and under the plan as well as on liquidation;
3. The commonality of these interests are to be viewed purposively, bearing in mind the object of the CCAA, namely to facilitate reorganizations if at all possible;
4. In placing a broad and purposive interpretation on the CCAA, the court should be careful to resist classification approaches which would potentially jeopardize potentially viable plans.
5. Absent bad faith, the motivations of the creditors to approve or disapprove are irrelevant.
6. The requirement of creditors being able to consult together means being able to assess their legal entitlement as creditors before or after the plan in a similar manner.

THE STANDARD OF REVIEW AND LEAVE APPLICATIONS

28 The elements of the general criterion cannot be properly considered in a leave application without regard to the standard of review that this Court applies to appeals under the CCAA. If leave to appeal were to be granted, the applicable standard of review is succinctly set forth by Fruman, J.A. in UTI Energy Corp. v. Fracmaster Ltd. (2000), 244 A.R. 93 where she stated for the Court at p.95:

> . . . . this is a court of review. It is not our task to reconsider the merits of the various offers and decide which proposal might be best. The decisions made by the Chambers judge involve a good measure of discretion, and are owed considerable deference. Whether or not we agree, we will only interfere if we conclude that she acted unreasonably, erred in principle or made a manifest error.

In another recent CCAA case from this Court, Re Smoky River Coal Ltd. (1999) 237 A.R. 326, Hunt, J.A., speaking for the unanimous Court, extensively reviewed the history and purpose of the CCAA, and observed at p.341:

> The fact that an appeal lies only with leave of an appellate court (s. 13 CCAA) suggests that Parliament, mindful that CCAA cases often require quick decision-making, intended that most decisions be made by the supervising judge. This supports the view that those decisions should be interfered with only in clear cases.

29 The standard of review of this Court, in reviewing the CCAA decision of the supervising judge, is therefore one of correctness if there is an error of law. Otherwise, for an appellate court to interfere with the decision of the supervising judge, there must be a palpable and overriding error in the exercise of discretion or in findings of fact.

STATUTORY PROVISIONS

30 The CCAA includes provisions defining secured creditor, unsecured creditor, refers to classes of them, and provides for court approval of a plan of compromise or arrangement in the following sections:

> 2. INTERPRETATION . . . "secured creditor" means a holder of a mortgage, hypothec, pledge, charge, lien or privilege on or against, or any assignment, cession or transfer of, all or any property of a debtor company as security for indebtedness of the debtor company, or a holder of any bond of a debtor company secured by a mortgage, hypothec, pledge, charge, lien or privilege on or against, or any assignment, cession or transfer of, or a trust in respect of, all or any property of the debtor company, whether the holder or beneficiary is resident or domiciled within or outside Canada, and a trustee under any trust deed or other instrument securing any of those bonds shall be deemed to be a secured creditor for all purposes of this Act except for the purpose of voting at a creditors' meeting in respect of any of those bonds; . . .
> "Unsecured creditor" means any creditor of a company who is not a secured creditor, whether resident or domiciled within or outside Canada, and a trustee for the holders of any unsecured bonds issue under a trust deed or other instrument running in favour of the trustee shall be deemed to be an unsecured creditor for all purposes of this Act except for the purpose of voting at a creditors' meeting in respect of any of those bonds.
>
> COMPROMISES AND ARRANGEMENTS
> 4. Where a compromise or an arrangement is proposed

between a debtor company and its unsecured creditors or any class of them, the court may, on the application in a summary way of the company, of any such creditor or of the trustee in bankruptcy or liquidator of the company, order a meeting of the creditors or class of creditors, and, if the court so determines, of the shareholders of the company, to be summoned in such a manner as the court directs.

5. Where a compromise or an arrangement is proposed between a debtor company and its secured creditors or any class of them, the court may, on the application in a summary way of the company or of any such creditor or of the trustee in bankruptcy or liquidator of the company, order a meeting of the creditors or class of creditors, and, if the court so determines, of the shareholders of the company, to be summoned in such manner as the courts directs. . . . 6. Where a majority in number representing two-thirds in value of the creditors, or class of creditors, as the case may be, present and voting either in person or by proxy at the meeting or meetings thereof respectively held pursuant to sections 4 and 5, or either of those sections, agree to any compromise or arrangement either as proposed or as altered or modified at the meeting or meetings, the compromise or arrangement may be sanctioned by the court, and if so sanctioned is binding

(a) on all the creditors or the class of creditors, as the case may be, and on any trustee for any such class of creditors, whether secured or unsecured, as the case may be, and on the company; and
(b) in the case of a company that has made an authorized assignment or against which a receiving order has been made under the Bankruptcy and Insolvency Act or is in the course of being wound up under the Winding-up and Restructuring Act, on the trustee in bankruptcy or liquidator and contributories of the company.

CLASSES OF CREDITORS

31 It is apparent from a review of the foregoing sections that division into classes of creditors within the unsecured and secured categories may, in any given case, materially affect the outcome of the vote referenced in section 6. Compliance with section 6 triggers the ability of the court to approve or sanction the Plan and to bind the parties referenced in s. 6(a) and 6(b) of the CCAA. In argument before me, it was conceded by the applicant that Resurgence would not have the ability to ensure approval of the Plan by casting its vote if Air Canada were to be excised from the unsecured creditor category into a separate class. Conversely, counsel for Resurgence candidly admitted that Resurgence would effectively have a veto of the Plan if Air Canada were segregated into a separate class of unsecured creditor.

APPLICATION OF THE CRITERIA FOR LEAVE TO APPEAL

32 The four elements of the general criterion are set out in paragraph [7]. The first and second elements are satisfied in this case. The points raised on appeal are of significance to the action. If Resurgence succeeds, it obtains a veto. If it does not succeed, and it votes as a member of the unsecured creditors class with Air Canada, Air Canada can control the vote of the unsecured creditors.

33 In terms of the points on appeal being of significance to the practice, it may be that an appellate court's views in this province on the classification of unsecured creditors issue is desirable, there being no appellate authority from this Court on this issue. Although I have doubt as to the significance of this element of the general criterion in the context of the facts of this case, I am prepared for the purposes of this application to treat this element as having being satisfied.

34 The third element is whether the appeal is prima facie meritorious or, on the other hand, whether it is frivolous. In my view, the proper interpretation of this element is not a mutually exclusive application of an appeal being either meritorious or frivolous. Rather, the appeal must be prima facie meritorious; if it is not prima facie meritorious, this element is not satisfied.

35 I find that the appeal on the points raised from the Decision is not prima facie meritorious. In the plain ordinary meaning of the words of this element, on first impression, there must appear to be an error in principle of law or a palpable and overriding error of fact. Exercise of discretion by a supervising judge, so long as it is exercised judicially, is not a matter for interference by an appellate court, even if the appellate court were inclined to decide the matter another way. It is precisely this kind of a factor which breathes life into the modifier "prima facie" meritorious.

36 I have carefully reviewed all of the cases referred to by the supervising chambers judge and the principles she derived from them. In my view, she made no error in law.

37 In the exercise of her discretion, she decided neither to allow the applicant's motion to excise Air Canada from the unsecured creditors class nor to prohibit Air Canada from voting. She also declined, on the facts established before her, to separate creditors of CAC from creditors of CAIL for voting purposes. She did, however, order that Air Canada's vote be recorded and tabulated and indicated that this will be considered at the Fairness Hearing.

38 It was strenuously argued before me by the applicant, that deferring classification and voting issues to the Fairness Hearing was an error of law or principle in and of itself.

39 The argument was put in terms that if, on a proper classification of unsecured creditors, Air Canada was removed from the unsecured class, and Resurgence vetoed the Plan, the matter of a Fairness Hearing would never arise. While that may be true, it does not follow that there is any error in law in what the supervising judge did. She concluded that the separate tabulation of the votes will allow the voice of the unsecured creditors to be heard, while, at the same time, permit, rather than rule out the possibility, that the Plan might proceed. This approach is consistent with the purpose of the CCAA as articulated in many of the authorities in this country.

40 The supervising chambers judge also refused to exclude Air Canada from voting on the basis that the legal rights attached to the notes held by Air Canada were valid. Resurgence argued that because Air Canada had other interests in the outcome of the Plan, it should be excluded from voting as an unsegregated secured creditor. Paperny, J. held that this was an issue of fairness, as was the fact that Air Canada was really voting on its own reorganization. She did not err in principle. She expressly acknowledged the authorities that, on different facts, either allowed different classes or excluded a vote. See, for example, Re Woodward's Ltd. (1993), 84 B.C.L.R. (2d) 206 (B.C.S.C.); Re Northland Properties Ltd. (1988), 73 C.B.R. (N.S.) 166 (B.C.S.C.); Re NsC Diesel Power Inc. (1990), 79 C.B.R. (N.S.) 1 (N.S.S.C.T.D.).

41 The fourth element of the general criterion is whether the appeal will unduly hinder the progress of the action. In other words, will the delay involved in prosecuting, hearing and deciding the appeal be of such length so as to unduly impede the ultimate resolution of the matter by a vote or court sanction? The approach of the supervising judge to the issues raised by the applicant is that its concerns will be seriously addressed at the Fairness Hearing scheduled for June 5, 2000, pursuant to s. 6 of the CCAA, provided the creditors vote to adopt the Plan.

42 This element has at its root the purpose of the CCAA; the role of the supervising judge; the need for a timely and orderly resolution of the matter; and the effect on the interests of all parties pending a decision on appeal. The comments of McFarlane, J.A. in Re Pacific National Lease Holding Corp. (1992) 15 C.B.R. (3d) 265 (B.C.C.A.) are particularly apt where he stated as follows at p.272:

> Despite what I have said, there may be an arguable case for the petitioners to present to a panel of this Court on discreet questions of law. But I am of the view that this Court should exercise its powers sparingly when it is asked to intervene with respect to questions which arise under the C.C.A.A. The process of management which the Act has assigned to the trial Court is an ongoing one. In this case a number of orders have been made. Some, including the one under appeal, have not been settled or entered. Other applications are pending. The process contemplated by the Act is continuing.
>
> A colleague has suggested that a judge exercising a supervisory function under the C.C.A.A. is more like a judge hearing a trial, who makes orders in the course of that trial, than a chambers judge who makes interlocutory or proceedings for which he has no further responsibility.
>
> Also, we know that in a case where a judgment has not been entered, it may be open to a judge to reconsider his or her judgment, and alter its terms. In supervising a proceeding under the C.C.A.A. orders are made, and orders are varied as changing circumstances require. Orders depend upon a careful and delicate balancing of a variety of interests and of problems. In that context appellate proceedings may well upset the balance, and delay or frustrate the process under the C.C.A.A. I do not say that leave will never be granted in a C.C.A.A. proceeding. But the effect upon all parties concerned will be an important consideration in deciding whether leave ought to be granted.

43 In that case, it appears that McFarlane, J.A. was satisfied that the first three elements of the criteria had been met, i.e. that there "may be an arguable case for the petitioners to present to a panel of this court on discrete [sic] questions of law".

44 It was argued before me that an appeal would give rise to an uncertainly of process and a lack of confidence in it; that the creditors, or some of them, may be inclined to withdraw support for the Plan that would otherwise be forthcoming, but for the delay. None of the parties tendered affidavit evidence on this issue.

45 Nowhere in any of the authorities has the issue of onus in meeting the elements the general criterion been prominent. I am of the view that the onus is on the applicant. That onus would include the applicant producing at least some evidence on the fourth element to shift the onus to the respondents, even though it involves proving a negative, i.e. that there will not be any material adverse impact as the result of the delay occasioned by an appeal. That evidence is lacking in this case. It is lacking on both sides but the respondents do not have an initial onus in this regard. Therefore, I find that the fourth element has not been established by the applicant.

46 The last step in a proper analysis in the context of a leave application is to ascribe appropriate weight to each of the elements of the general criterion and decide over all whether the test has been met. In most cases, the last two elements will be more important, and ought to be ascribed more weight than the first two elements. The last two elements here have not been met while the first two arguably have.

In the result, I am satisfied that the applicant has not met the threshold for leave to appeal on the basis of the authorities, and I am therefore denying the application.

CONCLUSION

47 The application for leave to appeal the Decision is dismissed on the basis that there is no prima facie meritorious case and that the granting of leave would likely unduly hinder the progress of the action.

WITTMANN J.A.

* * * * *

ERRATA

Filed: June 5, 2000

Please replace front cover page of the above-mentioned judgment with the attached corrected page:

The change made was as follows:

> Above the words, "MEMORANDUM OF DECISION", in lines 18-21, the phrase reading:
>
> "APPLICATION FOR LEAVE TO APPEAL THE ORDER OF THE HONOURABLE MADAM JUSTICE M.S. PAPERNY DATED THE 18TH DAY OF MAY, 2000"
>
> have been changed to read:
>
> "APPLICATION FOR LEAVE TO APPEAL THE ORDER OF THE HONOURABLE MADAM JUSTICE M.S. PAPERNY DATED THE 12TH DAY OF MAY, 2000"

cp/i/qljpn/qlwag/qlvls

Tab 12

Case Name:

RJR-MacDonald Inc. v. Canada (Attorney General)

RJR-MacDonald Inc., Applicant;
v.
The Attorney General of Canada, Respondent, and
The Attorney General of Quebec, Mis-en-cause, and
The Heart and Stroke Foundation of Canada, Interveners on the
the Canadian Cancer Society, application for the Canadian
Council on Smoking and Health, and interlocutory relief
Physicians for a Smoke-Free Canada
And between
Imperial Tobacco Ltd., Applicant;
v.
The Attorney General of Canada, Respondent, and
The Attorney General of Quebec, Mis-en-cause, and
The Heart and Stroke Foundation of Canada, Interveners on the
the Canadian Cancer Society, application for the Canadian
Council on Smoking and Health, and interlocutory relief
Physicians for a Smoke-Free Canada

[1994] S.C.J. No. 17

[1994] A.C.S. no 17

[1994] 1 S.C.R. 311

[1994] 1 R.C.S. 311

111 D.L.R. (4th) 385

164 N.R. 1

J.E. 94-423

60 Q.A.C. 241

54 C.P.R. (3d) 114

1994 CanLII 117

46 A.C.W.S. (3d) 40

1994 CarswellQue 120

File Nos.: 23460, 23490.

Supreme Court of Canada

1993: October 4 / 1994: March 3.

Present: Lamer C.J. and La Forest, L'Heureux-Dubé, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.
APPLICATIONS FOR INTERLOCUTORY RELIEF

Practice -- Interlocutory motions to stay implementation of regulations pending final decision on appeals and to delay implementation if appeals dismissed -- Leave to appeal granted shortly after applications to stay heard -- Whether the applications for relief from compliance with regulations should be granted -- Tobacco Products Control Act, S.C. 1988, c. 20, ss. 3, 4 to 8, 9, 11 to 16, 17(f), 18. -- Tobacco Products Control Regulations, amendment, SOR/93-389 -- Canadian Charter of Rights and Freedoms, ss. 1, 2(b), 24(1) - - Rules of the Supreme Court of Canada, SOR/83-74, s. 27 -- Supreme Court Act, R.S.C., 1985, c. S-26, s. 65.1.

The Tobacco Products Control Act regulates the advertisement of tobacco products and the health warnings which must be placed upon those products. Both applicants successfully challenged the Act's constitutional validity in the Quebec Superior Court on the grounds that it was ultra vires Parliament and that it violates the right to freedom of expression in s. 2(b) of the Canadian Charter of Rights and Freedoms. The Court of Appeal ordered the suspension of enforcement until judgment was rendered on the Act's validity but declined to order a stay of the coming into effect of the Act until 60 days following a judgment validating the Act. The majority ultimately found the legislation constitutional.

The Tobacco Products Control Regulations, amendment, would cause the applicants to incur major expense in altering their packaging and these expenses would be irrecoverable should the legislation be found unconstitutional. Before a decision on applicants' leave applications to this Court in the main actions had been made, the applicants brought these motions for stay pursuant to s. 65.1 of the Supreme Court Act, or, in the event that leave was granted, pursuant to r. 27 of the Rules of the Supreme Court of Canada. In effect, the applicants sought to be released from any obligation to comply with the new packaging requirements until the disposition of the main actions. They also requested that the stays be granted for a period of 12 months from the dismissal of the leave applications or from a decision of this Court confirming the validity of Tobacco Products Control Act.

This Court heard applicants' motions on October 4 and granted leave to appeal the main action on October 14. At issue here was whether the applications for relief from compliance with the Tobacco Products Control Regulations, amendment should be granted. A preliminary question was raised as to this Court's jurisdiction to grant the relief requested by the applicants.

Held: The applications should be dismissed.

The powers of the Supreme Court of Canada to grant relief in this kind of proceeding are contained in s. 65.1 of the Supreme Court of Canada Act and r. 27 of the Rules of the Supreme Court of Canada.

The words "other relief" in r. 27 of the Supreme Court Rules are broad enough to permit the Court to defer enforcement of regulations that were not in existence when the appeal judgment was rendered. It can apply even though leave to appeal may not yet be granted. In interpreting the language of the rule, regard should be had to its purpose: to facilitate the "bringing of cases" before the Court "for the effectual execution and working of this Act". To achieve its purpose the rule can neither be limited to cases in which leave to appeal has already been granted nor be interpreted narrowly to apply only to an order stopping or arresting execution of the Court's process by a third party or freezing the judicial proceeding which is the subject matter of the judgment in appeal.

Section 65.1 of the Supreme Court Act was adopted not to limit the Court's powers under r. 27 but to enable a single judge to exercise the jurisdiction to grant stays in circumstances in which, before the amendment, a stay could be granted by the Court. It should be interpreted as conferring the same broad powers as are included in r. 27. The Court, pursuant to both s. 65.1 and r. 27, can not only grant a stay of execution and of proceedings in the traditional sense but also make any order that preserves matters between the parties in a state that will, as far as possible, prevent prejudice pending resolution by the Court of the controversy, so as to enable the Court to render a meaningful and effective judgment. The Court must be able to intervene not only against the direct dictates of the judgment but also against its effects. The Court therefore must have jurisdiction to enjoin conduct on the part of a party acting in reliance on the judgment which, if carried out, would tend to negate or diminish the effect of the judgment of this Court.

Jurisdiction to grant the relief requested by the applicants exists even if the applicants' requests for relief are for "suspension" of the regulation rather than "exemption" from it. To hold otherwise would be inconsistent with Manitoba (Attorney General) v. Metropolitan Stores (MTS) Ltd. which established that the distinction between "suspension" and "exemption" cases is made only after jurisdiction has been otherwise established. If jurisdiction under s. 65.1 of the Act and r. 27 were wanting, jurisdiction would be found in s. 24(1) of the Canadian Charter of Rights and Freedoms. A Charter remedy should not be defeated because of a deficiency in the ancillary procedural powers of the Court to preserve the rights of the parties pending a final resolution of constitutional rights.

The three-part American Cyanamid test (adopted in Canada in Manitoba (Attorney General) v. Metropolitan Stores (MTS) Ltd.) should be applied to applications for interlocutory injunctions and as well for stays in both private law and Charter cases.

At the first stage, an applicant for interlocutory relief in a Charter case must demonstrate a serious question to be tried. Whether the test has been satisfied should be determined by a motions judge on the basis of common sense and an extremely limited review of the case on the merits. The fact that an appellate court has granted leave in the main action is, of course, a relevant and weighty consideration, as is any judgment on the merits which has been rendered, although neither is necessarily conclusive of the matter. A motions court should only go beyond a preliminary investigation into the merits when the result of the interlocutory motion will in effect amount to a final determination of the action, or when the constitutionality of a challenged statute can be determined as a pure question of law. Instances of this sort will be exceedingly rare. Unless the case on the merits is frivolous or vexatious, or the constitutionality of the statute is a pure question of law, a judge on a motion for relief must, as a general rule, consider the second and third stages of the Metropolitan Stores test.

At the second stage the applicant is required to demonstrate that irreparable harm will result if the relief is not granted. 'Irreparable' refers to the nature of the harm rather than its magnitude. In Charter cases, even quantifiable financial loss relied upon by an applicant may be considered irreparable harm so long as it is unclear that such loss could be recovered at the time of a decision on the merits.

The third branch of the test, requiring an assessment of the balance of inconvenience to the parties, will normally determine the result in applications involving Charter rights. A consideration of the public interest must be taken into account in assessing the inconvenience which it is alleged will be suffered by both parties. These public interest considerations will carry less weight in exemption cases than in suspension cases. When the nature and declared purpose of legislation is to promote the public interest, a motions court should not be concerned whether the legislation has in fact this effect. It must be assumed to do so. In order to overcome the assumed benefit to the public interest arising from the continued application of the legislation, the applicant who relies on the public interest must demonstrate that the suspension of the legislation would itself provide a public benefit.

As a general rule, the same principles would apply when a government authority is the applicant in a motion for interlocutory relief. However, the issue of public interest, as an aspect of irreparable harm to the interests of the government, will be considered in the second stage. It will again be considered in the third stage when harm to the applicant is balanced with harm to the respondent including any harm to the public interest established by the latter.

Here, the application of these principles to the facts required that the applications for stay be dismissed.

The observation of the Quebec Court of Appeal that the case raised serious constitutional issues and this Court's decision to grant leave to appeal clearly indicated that these cases raise serious questions of law.

Although compliance with the regulations would require a significant expenditure and, in the event of their being found unconstitutional, reversion to the original packaging would require another significant outlay, monetary loss of this nature will not usually amount to irreparable harm in private law cases. However, where the government is the unsuccessful party in a constitutional claim, a plaintiff will face a much more difficult task in establishing constitutional liability and obtaining monetary redress. The expenditures which the new regulations require will therefore impose irreparable harm on the applicants if these motions are denied but the main actions are successful on appeal.

Among the factors which must be considered in order to determine whether the granting or withholding of interlocutory relief would occasion greater inconvenience are the nature of the relief sought and of the harm which the parties contend they will suffer, the nature of the legislation which is under attack, and where the public interest lies. Although the required expenditure would impose economic hardship on the companies, the economic loss or inconvenience can be avoided by passing it on to purchasers of tobacco products. Further, the applications, since they were brought by two of the three companies controlling the Canadian tobacco industry, were in actual fact for a suspension of the legislation, rather than for an exemption from its operation. The public interest normally carries greater weight in favour of compliance with existing legislation. The weight given is in part a function of the nature of the legislation and in part a function of the purposes of the legislation under attack. The government passed these regulations with the intention of protecting public health and furthering the public good. When the government declares that it is passing legislation in order to protect and promote public health and it is shown that the restraints which it seeks to place upon an industry are of the same nature as those which in the past have had positive public benefits, it is not for a court on an interlocutory motion to assess the actual benefits which will result from the specific terms of the legislation. The applicants, rather, must offset these public interest considerations by demonstrating a more compelling public interest in suspending the application of the legislation. The only possible public interest in the continued application of the current packaging requirements, however, was that the price of cigarettes for smokers would not increase. Any such increase would not be excessive and cannot carry much weight when balanced against the undeniable importance of the public interest in health and in the prevention of the widespread and serious medical problems directly attributable to smoking.

Cases Cited

Applied: Manitoba (Attorney General) v. Metropolitan Stores (MTS) Ltd., [1987] 1 S.C.R. 110; considered: Labatt Breweries of Canada Ltd. v. Attorney General of Canada, [1980] 1 S.C.R. 594; American Cyanamid Co. v. Ethicon Ltd., [1975] A.C. 396; referred to: R. v. Crown Zellerbach Canada Ltd., [1988] 1 S.C.R. 401; Keable v. Attorney General (Can.), [1978] 2 S.C.R. 135; Battle Creek Toasted Corn Flake Co. v. Kellogg Toasted Corn Flake Co. (1924), 55 O.L.R. 127; Laboratoire Pentagone Ltée v. Parke, Davis & Co., [1968] S.C.R. 269; Adrian Messenger Services v. The Jockey

Club Ltd. (No. 2) (1972), 2 O.R. 619; Bear Island Foundation v. Ontario (1989), 70 O.R. (2d) 574; N.W.L. Ltd. v. Woods, [1979] 1 W.L.R. 1294; Trieger v. Canadian Broadcasting Corp. (1988), 54 D.L.R. (4th) 143; Tremblay v. Daigle, [1989] 2 S.C.R. 530; Dialadex Communications Inc. v. Crammond (1987), 34 D.L.R. (4th) 392; R.L. Crain Inc. v. Hendry (1988), 48 D.L.R. (4th) 228; MacMillan Bloedel Ltd. v. Mullin, [1985] 3 W.W.R. 577; Hubbard v. Pitt, [1976] Q.B. 142; Mills v. The Queen, [1986] 1 S.C.R. 863; Nelles v. Ontario, [1989] 2 S.C.R. 170; Ainsley Financial Corp. v. Ontario Securities Commission (1993), 14 O.R. (3d) 280; Morgentaler v. Ackroyd (1983), 150 D.L.R. (3d) 59; Attorney General of Canada v. Fishing Vessel Owners' Association of B.C., [1985] 1 F.C. 791; Esquimalt Anglers' Association v. Canada (Minister of Fisheries and Oceans) (1988), 21 F.T.R. 304; Island Telephone Co., Re (1987), 67 Nfld. & P.E.I.R. 158; Black v. Law Society of Alberta (1983), 144 D.L.R. (3d) 439; Vancouver General Hospital v. Stoffman (1985), 23 D.L.R. (4th) 146; Rio Hotel Ltd. v. Commission des licences et permis d'alcool, [1986] 2 S.C.R. ix; Ontario Jockey Club v. Smith (1922), 22 O.W.N. 373; R. v. Oakes, [1986] 1 S.C.R. 103.

Statutes and Regulations Cited

Canadian Charter of Rights and Freedoms, ss. 1, 2(b), 24(1).
Code of Civil Procedure of Québec, art. 523.
Constitution Act, 1867, s. 91.
Fisheries Act, R.S.C. 1970 c. F-14.
Rules of the Supreme Court of Canada, 1888, General Order No. 85(17).
Rules of the Supreme Court of Canada, SOR/83-74, s. 27.
Supreme Court Act, R.S.C., 1985, c. S-26, ss. 65.1 [ad. S.C. 1990, c. 8, s. 40], 97(1)(a).
Tobacco Products Control Act, R.S.C., 1985, c. 14 (4th Supp.), S.C. 1988, c. 20, ss. 3, 4 to 8, 9, 11 to 16, 17(f), 18.
Tobacco Products Control Regulations, amendment, SOR/93-389.

Authors Cited

Canada. Minister of National Health and Welfare. Regulatory Impact Analysis Statement. (Statement following Tobacco Products Control Regulations, amendment, SOR/93-389.) In Canada Gazette, Part II, Vol. 127, No. 16, p. 3284.
Cassels, Jamie. "An Inconvenient Balance: The Injunction as a Charter Remedy". In Jeffrey Berryman, ed. Remedies: Issues and Perspectives. Scarborough, Ont.: Carswell, 1991, 271.
Sharpe, Robert J. Injunctions and Specific Performance, 2nd ed. Aurora, Ont.: Canada Law Book, 1992 (loose-leaf).

APPLICATIONS for interlocutory relief ancillary to constitutional challenge of enabling legislation following judgment of the Quebec Court of Appeal, [1993] R.J.Q. 375, 53 Q.A.C. 79, 102 D.L.R. (4th) 289, 48 C.P.R. (3d) 417, allowing an appeal from a judgment of Chabot J., [1991] R.J.Q. 2260, 82 D.L.R. (4th) 449, 37 C.P.R. (3d) 193, granting the application. Applications dismissed.

Colin K. Irving, for the applicant RJR-MacDonald Inc.
Simon V. Potter, for the applicant Imperial Tobacco Inc.
Claude Joyal and Yves Leboeuf, for the respondent.
W. Ian C. Binnie, Q.C., and Colin Baxter, for the Heart and Stroke Foundation of Canada, the Canadian Cancer Society, the Canadian Council on Smoking and Health, and Physicians for a Smoke-Free Canada.

Solicitors for the applicant RJR-MacDonald Inc.: Mackenzie, Gervais, Montreal.
Solicitors for the applicant Imperial Tobacco Inc.: Ogilvy, Renault, Montreal.

Solicitors for the respondent: Côté & Ouellet, Montreal.
Solicitors for the interveners on the application for interlocutory relief Heart and Stroke Foundation of Canada, the Canadian Cancer Society, the Canadian Council on Smoking and Health, and Physicians for a Smoke-Free Canada: McCarthy, Tétrault, Toronto.

The judgment of the Court on the applications for interlocutory relief was delivered by

SOPINKA AND CORY JJ.:--

I. Factual Background

1 These applications for relief from compliance with certain Tobacco Products Control Regulations, amendment, SOR/93-389 as interlocutory relief are ancillary to a larger challenge to regulatory legislation which will soon be heard by this Court.

2 The Tobacco Products Control Act, R.S.C., 1985, c. 14 (4th Supp.), S.C. 1988, c. 20, came into force on January 1, 1989. The purpose of the Act is to regulate the advertisement of tobacco products and the health warnings which must be placed upon tobacco products.

3 The first part of the Tobacco Products Control Act, particularly ss. 4 to 8, prohibits the advertisement of tobacco products and any other form of activity designed to encourage their sale. Section 9 regulates the labelling of tobacco products, and provides that health messages must be carried on all tobacco packages in accordance with the regulations passed pursuant to the Act.

4 Sections 11 to 16 of the Act deal with enforcement and provide for the designation of tobacco product inspectors who are granted search and seizure powers. Section 17 authorizes the Governor in Council to make regulations under the Act. Section 17(f) authorizes the Governor in Council to adopt regulations prescribing "the content, position, configuration, size and prominence" of the mandatory health messages. Section 18(1)(b) of the Act indicates that infringements may be prosecuted by indictment, and upon conviction provides for a penalty by way of a fine not to exceed $100,000, imprisonment for up to one year, or both.

5 Each of the applicants challenged the constitutional validity of the Tobacco Products Control Act on the grounds that it is ultra vires the Parliament of Canada and invalid as it violates s. 2(b) of the Canadian Charter of Rights and Freedoms. The two cases were heard together and decided on common evidence.

6 On July 26, 1991, Chabot J. of the Quebec Superior Court granted the applicants' motions, [1991] R.J.Q. 2260, 82 D.L.R. (4th) 449, finding that the Act was ultra vires the Parliament of Canada and that it contravened the Charter. The respondent appealed to the Quebec Court of Appeal. Before the Court of Appeal rendered judgment, the applicants applied to this court for interlocutory relief in the form of an order that they would not have to comply with certain provisions of the Act for a period of 60 days following judgment in the Court of Appeal.

7 Up to that point, the applicants had complied with all provisions in the Tobacco Products Control Act. However, under the Act, the complete prohibition on all point of sale advertising was not due to come into force until December 31, 1992. The applicants estimated that it would take them approximately 60 days to dismantle all of their advertising displays in stores. They argued that, with the benefit of a Superior Court judgment declaring the Act unconstitutional, they should not be required to take any steps to dismantle their displays until such time as the Court of Appeal might eventually hold the legislation to be valid. On the motion the Court of Appeal held that the penalties for non-compliance with the ban on point of sale advertising could not be enforced against the applicants until such time as the Court of Appeal had released its decision on the merits. The court refused, however, to stay the enforcement of the provisions for a period of 60 days following a judgment validating the Act.

8 On January 15, 1993, the Court of Appeal for Quebec, [1993] R.J.Q. 375, 102 D.L.R. (4th) 289, allowed the respondent's appeal, Brossard J.A. dissenting in part. The Court unanimously held that the Act was not ultra vires the government of Canada. The Court of Appeal accepted that the Act infringed s. 2(b) of the Charter but found, Brossard J.A. dissenting on this aspect, that it was justified under s. 1 of the Charter. Brossard J.A. agreed with the majority with respect to the requirement of unattributed package warnings (that is to say the warning was not to be attributed to the Federal Government) but found that the ban on advertising was not justified under s. 1 of the Charter. The applicants filed an application for leave to appeal the judgment of the Quebec Court of Appeal to this Court.

9 On August 11, 1993, the Governor in Council published amendments to the regulations dated July 21, 1993, under the Act: Tobacco Products Control Regulations, amendment, SOR/93-389. The amendments stipulate that larger, more prominent health warnings must be placed on all tobacco products packets, and that these warnings can no longer be attributed to Health and Welfare Canada. The packaging changes must be in effect within one year.

10 According to affidavits filed in support of the applicant's motion, compliance with the new regulations would require the tobacco industry to redesign all of its packaging and to purchase thousands of rotograve cylinders and embossing dies. These changes would take close to a year to effect, at a cost to the industry of about $30,000,000.

11 Before a decision on their leave applications in the main actions had been made, the applicants brought these motions for a stay pursuant to s. 65.1 of the Supreme Court Act, R.S.C., 1985, c. S-26 (ad. by S.C. 1990, c. 8, s. 40) or, in the event that leave was granted, pursuant to r. 27 of the Rules of the Supreme Court of Canada, SOR/83-74. The applicants seek to stay "the judgment of the Quebec Court of Appeal delivered on January 15, 1993", but "only insofar as that judgment validates sections 3, 4, 5, 6, 7 and 10 of [the new regulations]". In effect, the applicants ask to be released from any obligation to comply with the new packaging requirements until the disposition of the main actions. The applicants further request that the stays be granted for a period of 12 months from the dismissal of the leave applications or from a decision of this Court confirming the validity of Tobacco Products Control Act.

12 The applicants contend that the stays requested are necessary to prevent their being required to incur considerable irrecoverable expenses as a result of the new regulations even though this Court may eventually find the enabling legislation to be constitutionally invalid.

13 The applicants' motions were heard by this Court on October 4. Leave to appeal the main actions was granted on October 14.

II. Relevant Statutory Provisions

Tobacco Products Control Act, R.S.C., 1985, c. 14 (4th Supp.), S.C. 1988, c. 20, s. 3:

> 3. The purpose of this Act is to provide a legislative response to a national public health problem of substantial and pressing concern and, in particular,
>
> (a) to protect the health of Canadians in the light of conclusive evidence implicating tobacco use in the incidence of numerous debilitating and fatal

diseases;

(b) to protect young persons and others, to the extent that is reasonable in a free and democratic society, from inducements to use tobacco products and consequent dependence on them; and

(c) to enhance public awareness of the hazards of tobacco use by ensuring the effective communication of pertinent information to consumers of tobacco products.

Supreme Court Act, R.S.C., 1985, c. S-26, s. 65.1 (ad. S.C. 1990, c. 8, s. 40):

> 65.1 The Court or a judge may, on the request of a party who has filed a notice of application for leave to appeal, order that proceedings be stayed with respect to the judgment from which leave to appeal is being sought, on such terms as to the Court or the judge seem just.

Rules of the Supreme Court of Canada, SOR/83-74, s. 27:

> 27. Any party against whom judgment has been given, or an order made, by the Court or any other court, may apply to the Court for a stay of execution or other relief against such a judgment or order, and the Court may give such relief upon such terms as may be just.

III. Courts Below

14 In order to place the applications for the stay in context it is necessary to review briefly the decisions of the courts below.

Superior Court, [1991] R.J.Q. 2260, 82 D.L.R. (4th) 449

15 Chabot J. concluded that the dominant characteristic of the Tobacco Products Control Act was the control of tobacco advertising and that the protection of public health was only an incidental objective of the Act. Chabot J. characterized the Tobacco Products Control Act as a law regulating advertising of a particular product, a matter within provincial legislative competence.

16 Chabot J. found that, with respect to s. 2(b) of the Charter, the activity prohibited by the Act was a protected activity, and that the notices required by the Regulations violated that Charter guarantee. He further held that the evidence demonstrated that the objective of reducing the level of consumption of tobacco products was of sufficient importance to warrant legislation restricting freedom of expression, and that the legislative objectives identified by Parliament to reduce tobacco use were a pressing and substantial concern in a free and democratic society.

17 However, in his view, the Act did not minimally impair freedom of expression, as it did not restrict itself to protecting young people from inducements to smoke, or limit itself to lifestyle advertising. Chabot J. found that the evidence submitted by the respondent in support of its contention that advertising bans decrease consumption was unreliable and without probative value because it failed to demonstrate that any ban of tobacco advertising would be likely to bring about a reduction of tobacco consumption. Therefore, the respondent had not demonstrated that an advertising ban restricted freedom of expression as little as possible. Chabot J. further concluded that the evidence of a rational connection between the ban of Canadian advertising and the objective of reducing overall consumption of tobacco was deficient, if not non-existent. He held that the Act was a form of censorship and social engineering which was incompatible with a free and democratic society and could not be justified.

Court of Appeal (on the application for a stay)

18 In deciding whether or not to exercise its broad power under art. 523 of the Code of Civil Procedure of Québec to "make any order necessary to safeguard the rights of the parties", the Court of Appeal made the following observation on the nature of the relief requested:

> But what is at issue here (if the Act is found to be constitutionally valid) is the suspension of the legal effect of part of the Act and the legal duty to comply with it for 60 days, and the suspension, as well, of the power of the appropriate public authorities to enforce the Act. To suspend or delay the effect or the enforcement of a valid act of the legislature, particularly one purporting to relate to the protection of public health or safety is a serious matter. The courts should not lightly limit or delay the implementation or enforcement of valid legislation where the legislature has brought that legislation into effect. To do so would be to intrude into the legislative and the executive spheres. [Emphasis in original.]

The Court made a partial grant of the relief sought as follows:

> Since the letters of the Department of Health and Welfare and appellants' contestation both suggest the possibility that the applicants may be prosecuted under Sec. 5 after December 31, 1992 whether or not judgment has been rendered on these appeals by that date, it seems reasonable to order the suspension of enforcement under Sec. 5 of the Act until judgment has been rendered by this Court on the present appeals. There is, after all, a serious issue as to the validity of the Act, and it would be unfairly onerous to require the applicants to incur substantial expense in dismantling these point of sale displays until we have resolved that issue.
>
> We see no basis, however, for ordering a stay of the coming into effect of the Act for 60 days following our judgment on the appeals.
>
> ...
>
> Indeed, given the public interest aspect of the Act, which purports to be concerned with the protection of public health, if the Act were found to be valid, there is excellent reason why its effect and enforcement should not be suspended (A.G. of Manitoba v. Metropolitan Stores (MTS) Ltd. [1987] 1 S.C.R. 110, 127, 135). [Emphasis in original.]

Court of Appeal (on the validity of the legislation), [1993] R.J.Q. 375, 102 D.L.R. (4th) 289

1. LeBel J.A. (for the majority)

19 LeBel J.A. characterized the Tobacco Products Control Act as legislation relating to public health. He also found that it was valid as legislation enacted for the peace, order and good government of Canada.

20 LeBel J.A. applied the criteria set out in R. v. Crown Zellerbach Canada Ltd., [1988] 1 S.C.R. 401, and concluded that the Act satisfied the "national concern" test and could properly rest on a purely theoretical, unproven link between tobacco advertising and the overall consumption of tobacco.

21 LeBel J.A. agreed with Brossard J.A. that the Act infringed freedom of expression pursuant to s. 2

(b) of the Charter but found that it was justified under s. 1 of the Charter. LeBel J.A. concluded that Chabot J. erred in his findings of fact in failing to recognize that the rational connection and minimal impairment branches of the Oakes test have been attenuated by later decisions of the Supreme Court of Canada. He found that the s. 1 test was satisfied since there was a possibility that prohibiting tobacco advertising might lead to a reduction in tobacco consumption, based on the mere existence of a [Translation] "body of opinion" favourable to the adoption of a ban. Further he found that the Act appeared to be consistent with minimal impairment as it did not prohibit consumption, did not prohibit foreign advertising and did not preclude the possibility of obtaining information about tobacco products.

2. Brossard J.A. (dissenting in part)

22 Brossard J.A. agreed with LeBel J.A. that the Tobacco Products Control Act should be characterized as public health legislation and that the Act satisfied the "national concern" branch of the peace, order and good government power.

23 However, he did not think that the violation of s. 2(b) of the Charter could be justified. He reviewed the evidence and found that it did not demonstrate the existence of a connection or even the possibility of a connection between an advertising ban and the use of tobacco. It was his opinion that it must be shown on a balance of probabilities that it was at least possible that the goals sought would be achieved. He also disagreed that the Act met the minimal impairment requirement since in his view the Act's objectives could be met by restricting advertising without the need for a total prohibition.

IV. Jurisdiction

24 A preliminary question was raised as to this Court's jurisdiction to grant the relief requested by the applicants. Both the Attorney General of Canada and the interveners on the stay (several health organizations, i.e., the Heart and Stroke Foundation of Canada, the Canadian Cancer Society, the Canadian Council on Smoking and Health, and Physicians for a Smoke-Free Canada) argued that this Court lacks jurisdiction to order a stay of execution or of the proceedings which would relieve the applicants of the obligation of complying with the new regulations. Several arguments were advanced in support of this position.

25 First, the Attorney General argued that neither the old nor the new regulations dealing with the health messages were in issue before the lower courts and, as such, the applicants' requests for a stay truly cloaks requests to have this Court exercise an original jurisdiction over the matter. Second, he contended that the judgment of the Quebec Court of Appeal is not subject to execution given that it only declared that the Act was intra vires s. 91 of the Constitution Act, 1867 and justified under s. 1 of the Charter. Because the lower court decision amounts to a declaration, there is, therefore, no "proceeding" that can be stayed. Finally, the Attorney General characterized the applicants' requests as being requests for a suspension by anticipation of the 12-month delay in which the new regulations will become effective so that the applicants can continue to sell tobacco products for an extended period in packages containing the health warnings required by the present regulations. He claimed that this Court has no jurisdiction to suspend the operation of the new regulations.

26 The interveners supported and elaborated on these submissions. They also submitted that r. 27 could not apply because leave to appeal had not been granted. In any event, they argued that the words "or other relief" are not broad enough to permit this Court to defer enforcement of regulations that were not even in existence at the time the appeal judgment was rendered.

27 The powers of the Supreme Court of Canada to grant relief in this kind of proceeding are contained in s. 65.1 of the Supreme Court Act and r. 27 of the Rules of the Supreme Court of Canada.

Supreme Court Act

> 65.1 The Court or a judge may, on the request of a party who has filed a notice of application for leave to appeal, order that proceedings be stayed with respect to the judgment from which leave to appeal is being sought, on such terms as to the Court or the judge seem just.

Rules of the Supreme Court of Canada

> 27. Any party against whom judgment has been given, or an order made, by the Court or any other court, may apply to the Court for a stay of execution or other relief against such a judgment or order, and the Court may give such relief upon such terms as may be just.

28 Rule 27 and its predecessor have existed in substantially the same form since at least 1888 (see Rules of the Supreme Court of Canada, 1888, General Order No. 85(17)). Its broad language reflects the language of s. 97 of the Act whence the Court derives its rule-making power. Subsection (1)(a) of that section provides that the rules may be enacted:

> 97. ... (a) for regulating the procedure of and in the Court and the bringing of cases before it from courts appealed from or otherwise, and for the effectual execution and working of this Act and the attainment of the intention and objects thereof;

Although the point is now academic, leave to appeal having been granted, we would not read into the rule the limitations suggested by the interveners. Neither the words of the rule nor s. 97 contain such limitations. In our opinion, in interpreting the language of the rule, regard should be had to its purpose, which is best expressed in the terms of the empowering section: to facilitate the "bringing of cases" before the Court "for the effectual execution and working of this Act". To achieve its purpose the rule can neither be limited to cases in which leave to appeal has already been granted nor be interpreted narrowly to apply only to an order stopping or arresting execution of the Court's process by a third party or freezing the judicial proceeding which is the subject matter of the judgment in appeal. Examples of the former, traditionally described as stays of execution, are contained in the subsections of s. 65 of the Act which have been held to be limited to preventing the intervention of a third party such as a sheriff but not the enforcement of an order directed to a party. See Keable v. Attorney General (Can.), [1978] 2 S.C.R. 135. The stopping or freezing of all proceedings is traditionally referred to as a stay of proceedings. See Battle Creek Toasted Corn Flake Co. v. Kellogg Toasted Corn Flake Co. (1924), 55 O.L.R. 127 (C.A.). Such relief can be granted pursuant to this Court's powers in r. 27 or s. 65.1 of the Act.

29 Moreover, we cannot agree that the adoption of s. 65.1 in 1992 (S.C. 1990, c. 8, s. 40) was intended to limit the Court's powers under r. 27. The purpose of that amendment was to enable a single judge to exercise the jurisdiction to grant stays in circumstances in which, before the amendment, a stay could be granted by the Court. Section 65.1 should, therefore, be interpreted to confer the same broad powers that are included in r. 27.

30 In light of the foregoing and bearing in mind in particular the language of s. 97 of the Act we cannot agree with the first two points raised by the Attorney General that this Court is unable to grant a stay as requested by the applicants. We are of the view that the Court is empowered, pursuant to both s. 65.1 and r. 27, not only to grant a stay of execution and of proceedings in the traditional sense, but also to make any order that preserves matters between the parties in a state that will prevent prejudice as far as possible pending resolution by the Court of the controversy, so as to enable the Court to render a meaningful and effective judgment. The Court must be able to intervene not only against the direct dictates of the judgment but also against its effects. This means that the Court must have jurisdiction to enjoin conduct on the part of a party in reliance on the judgment which, if carried out, would tend to negate or diminish the effect of the judgment of this Court. In this case, the new regulations constitute conduct under a law that has been declared constitutional by the lower courts.

31 This, in our opinion, is the view taken by this Court in Labatt Breweries of Canada Ltd. v. Attorney General of Canada, [1980] 1 S.C.R. 594. The appellant Labatt, in circumstances similar to those in this case, sought to suspend enforcement of regulations which were attacked by it in an action for a declaration that the regulations were inapplicable to Labatt's product. The Federal Court of Appeal reversed a lower court finding in favour of Labatt. Labatt applied for a stay pending an appeal to this Court. Although the parties had apparently agreed to the terms of an order suspending further proceedings, Laskin C.J. dealt with the issue of jurisdiction, an issue that apparently was contested notwithstanding the agreement. The Chief Justice, speaking for the Court, determined that the Court was empowered to make an order suspending the enforcement of the impugned regulation by the Department of Consumer and Corporate Affairs. At page 600, Laskin C.J. responded as follows to arguments advanced on the traditional approach to the power to grant a stay:

> It was contended that the Rule relates to judgments or orders of this Court and not to judgments or orders of the Court appealed from. Its formulation appears to me to be inconsistent with such a limitation. Nor do I think that the position of the respondent that there is no judgment against the appellant to be stayed is a tenable one. Even if it be so, there is certainly an order against the appellant. Moreover, I do not think that the words of Rule 126, authorizing this Court to grant relief against an adverse order, should be read so narrowly as to invite only intervention directly against the order and not against its effect while an appeal against it is pending in this Court. I am of the opinion, therefore, that the appellant is entitled to apply for interlocutory relief against the operation of the order dismissing its declaratory action, and that this Court may grant relief on such terms as may be just. [Emphasis added.]

32 While the above passage appears to answer the submission of the respondents on this motion that Labatt was distinguishable because the Court acted on a consent order, the matter was put beyond doubt by the following additional statement of Laskin C.J. at p. 601:

> Although I am of the opinion that Rule 126 applies to support the making of an order of the kind here agreed to by counsel for the parties, I would not wish it to be taken that this Court is otherwise without power to prevent proceedings pending before it from being aborted by unilateral action by one of the parties pending final determination of an appeal.

Indeed, an examination of the factums filed by the parties to the motion in Labatt reveals that while it was agreed that the dispute would be resolved by an application for a declaration, it was not agreed that pending resolution of the dispute the enforcement of the regulations would be stayed.

33 In our view, this Court has jurisdiction to grant the relief requested by the applicants. This is the case even if the applicants' requests for relief are for "suspension" of the regulation rather than "exemption" from it. To hold otherwise would be inconsistent with this Court's finding in Manitoba (Attorney General) v. Metropolitan Stores (MTS) Ltd., [1987] 1 S.C.R. 110. In that case, the distinction between "suspension" and "exemption" cases is made only after jurisdiction has been otherwise established and the public interest is being weighed against the interests of the applicant seeking the stay of proceedings. While "suspension" is a power that, as is stressed below, must be exercised sparingly, this is achieved by applying the criteria in Metropolitan Stores strictly and not by a restrictive interpretation of this Court's jurisdiction. Therefore, the final argument of the Attorney General on the issue of jurisdiction also fails.

34 Finally, if jurisdiction under s. 65.1 of the Act and r. 27 were wanting, we would be prepared to find jurisdiction in s. 24(1) of the Charter. A Charter remedy should not be defeated due to a deficiency in the ancillary procedural powers of the Court to preserve the rights of the parties pending a final resolution of constitutional rights.

V. Grounds for Stay of Proceedings

35 The applicants rely upon the following grounds:

1. The challenged Tobacco Products Control Regulations, amendment were promulgated pursuant to ss. 9 and 17 of the Tobacco Products Control Act, S.C. 1988, c. 20.
2. The applicants have applied to this Court for leave to appeal a judgment of the Quebec Court of Appeal dated January 15, 1993. The Court of Appeal overturned a decision of the Quebec Superior Court declaring certain sections of the Act to be beyond the powers of the Parliament of Canada and an unjustifiable violation of the Canadian Charter of Rights and Freedoms.
3. The effect of the new regulations is such that the applicants will be obliged to incur substantial unrecoverable expenses in carrying out a complete redesign of all its packaging before this Court will have ruled on the constitutional validity of the enabling legislation and, if this Court restores the judgment of the Superior Court, will incur the same expenses a second time should they wish to restore their packages to the present design.
4. The tests for granting of a stay are met in this case:

   (i) There is a serious constitutional issue to be determined.
   (ii) Compliance with the new regulations will cause irreparable harm.
   (iii) The balance of convenience, taking into account the public interest, favours retaining the status quo until this court has disposed of the legal issues.

VI. Analysis

36 The primary issue to be decided on these motions is whether the applicants should be granted the interlocutory relief they seek. The applicants are only entitled to this relief if they can satisfy the test laid down in Manitoba (Attorney General) v. Metropolitan Stores (MTS) Ltd., supra. If not, the applicants will have to comply with the new regulations, at least until such time as a decision is rendered in the main actions.

A. Interlocutory Injunctions, Stays of Proceedings and the Charter

37 The applicants ask this Court to delay the legal effect of regulations which have already been enacted and to prevent public authorities from enforcing them. They further seek to be protected from enforcement of the regulations for a 12-month period even if the enabling legislation is eventually found to be constitutionally valid. The relief sought is significant and its effects far reaching. A careful balancing process must be undertaken.

38 On one hand, courts must be sensitive to and cautious of making rulings which deprive legislation enacted by elected officials of its effect.

39 On the other hand, the Charter charges the courts with the responsibility of safeguarding fundamental rights. For the courts to insist rigidly that all legislation be enforced to the letter until the moment that it is struck down as unconstitutional might in some instances be to condone the most blatant violation of Charter rights. Such a practice would undermine the spirit and purpose of the Charter and might encourage a government to prolong unduly final resolution of the dispute.

40 Are there, then, special considerations or tests which must be applied by the courts when Charter violations are alleged and the interim relief which is sought involves the execution and enforceability of legislation?

41 Generally, the same principles should be applied by a court whether the remedy sought is an injunction or a stay. In Metropolitan Stores, at p. 127, Beetz J. expressed the position in these words:

> A stay of proceedings and an interlocutory injunction are remedies of the same nature. In the absence of a different test prescribed by statute, they have sufficient characteristics in common to be governed by the same rules and the courts have rightly tended to apply to the granting of interlocutory stay the principles which they follow with respect to interlocutory injunctions.

42 We would add only that here the applicants are requesting both interlocutory (pending disposition of the appeal) and interim (for a period of one year following such disposition) relief. We will use the broader term "interlocutory relief" to describe the hybrid nature of the relief sought. The same principles apply to both forms of relief.

43 Metropolitan Stores adopted a three-stage test for courts to apply when considering an application for either a stay or an interlocutory injunction. First, a preliminary assessment must be made of the merits of the case to ensure that there is a serious question to be tried. Secondly, it must be determined whether the applicant would suffer irreparable harm if the application were refused. Finally, an assessment must be made as to which of the parties would suffer greater harm from the granting or refusal of the remedy pending a decision on the merits. It may be helpful to consider each aspect of the test and then apply it to the facts presented in these cases.

B. The Strength of the Plaintiff's Case

44 Prior to the decision of the House of Lords in American Cyanamid Co. v. Ethicon Ltd., [1975] A.C. 396, an applicant for interlocutory relief was required to demonstrate a "strong prima facie case" on the merits in order to satisfy the first test. In American Cyanamid, however, Lord Diplock stated that an applicant need no longer demonstrate a strong prima facie case. Rather it would suffice if he or she could satisfy the court that "the claim is not frivolous or vexatious; in other words, that there is a serious question to be tried". The American Cyanamid standard is now generally accepted by the Canadian courts, subject to the occasional reversion to a stricter standard: see Robert J. Sharpe, Injunctions and Specific Performance (2nd ed. 1992), at pp. 2-13 to 2-20.

45 In Metropolitan Stores, Beetz J. advanced several reasons why the American Cyanamid test rather than any more stringent review of the merits is appropriate in Charter cases. These included the difficulties involved in deciding complex factual and legal issues based upon the limited evidence available in an interlocutory proceeding, the impracticality of undertaking a s. 1 analysis at that stage, and the risk that a tentative determination on the merits would be made in the absence of complete pleadings or prior to the notification of any Attorneys General.

46 The respondent here raised the possibility that the current status of the main action required the applicants to demonstrate something more than "a serious question to be tried." The respondent relied upon the following dicta of this Court in Laboratoire Pentagone Ltée v. Parke, Davis & Co., [1968] S.C.R. 269, at p. 272:

> The burden upon the appellant is much greater than it would be if the injunction were interlocutory. In such a case the Court must consider the balance of convenience as between the parties, because the matter has not yet come to trial. In the present case we are being asked to suspend the operation of a judgment of the Court of Appeal, delivered after full consideration of the merits. It is not sufficient to justify such an order being made to urge that the impact of the injunction upon the appellant would be greater than the impact of its suspension upon the respondent.

To the same effect were the comments of Kelly J.A. in Adrian Messenger Services v. The Jockey Club Ltd. (No. 2) (1972), 2 O.R. 619 (C.A.), at p. 620:

> Unlike the situation prevailing before trial, where the competing allegations of the parties are unresolved, on an application for an interim injunction pending an appeal from the dismissal of the action the defendant has a judgment of the Court in its favour. Even conceding the ever-present possibility of the reversal of that judgment on appeal, it will in my view be in a comparatively rare case that the Court will interfere to confer upon a plaintiff, even on an interim basis, the very right to which the trial Court has held he is not entitled.

And, most recently, of Philp J. in Bear Island Foundation v. Ontario (1989), 70 O.R. (2d) 574 (H.C.), at p. 576:

> While I accept that the issue of title to these lands is a serious issue, it has been resolved by trial and by appeal. The reason for the Supreme Court of Canada granting leave is unknown and will not be known until they hear the appeal and render judgment. There is not before me at this time, therefore, a serious or substantial issue to be tried. It has already been tried and appealed. No attempt to stop harvesting was made by the present plaintiffs before trial, nor before the appeal before the Court of Appeal of Ontario. The issue is no longer an issue at trial.

47 According to the respondent, such statements suggest that once a decision has been rendered on the merits at trial, either the burden upon an applicant for interlocutory relief increases, or the applicant can no longer obtain such relief. While it might be possible to distinguish the above authorities on the basis that in the present case the trial judge agreed with the applicant's position, it is not necessary to do so. Whether or not these statements reflect the state of the law in private applications for interlocutory relief, which may well be open to question, they have no application in Charter cases.

48 The Charter protects fundamental rights and freedoms. The importance of the interests which, the applicants allege, have been adversely affected require every court faced with an alleged Charter violation to review the matter carefully. This is so even when other courts have concluded that no Charter breach has occurred. Furthermore, the complex nature of most constitutional rights means that a motions court will rarely have the time to engage in the requisite extensive analysis of the merits of the applicant's claim. This is true of any application for interlocutory relief whether or not a trial has been conducted. It follows that we are in complete agreement with the conclusion of Beetz J. in Metropolitan Stores, at p. 128, that "the American Cyanamid 'serious question' formulation is sufficient in a constitutional case where, as indicated below in these reasons, the public interest is taken into consideration in the balance of convenience."

49 What then are the indicators of "a serious question to be tried"? There are no specific requirements which must be met in order to satisfy this test. The threshold is a low one. The judge on the application must make a preliminary assessment of the merits of the case. The decision of a lower court judge on the merits of the Charter claim is a relevant but not necessarily conclusive indication that the issues raised in an appeal are serious: see Metropolitan Stores, supra, at p. 150. Similarly, a decision by an appellate court to grant leave on the merits indicates that serious questions are raised, but a refusal of leave in a case which raises the same issues cannot automatically be taken as an indication of the lack of strength of the merits.

50 Once satisfied that the application is neither vexatious nor frivolous, the motions judge should proceed to consider the second and third tests, even if of the opinion that the plaintiff is unlikely to succeed at trial. A prolonged examination of the merits is generally neither necessary nor desirable.

51 Two exceptions apply to the general rule that a judge should not engage in an extensive review of the merits. The first arises when the result of the interlocutory motion will in effect amount to a final determination of the action. This will be the case either when the right which the applicant seeks to protect can only be exercised immediately or not at all, or when the result of the application will impose such hardship on one party as to remove any potential benefit from proceeding to trial. Indeed Lord Diplock modified the American Cyanamid principle in such a situation in N.W.L. Ltd. v. Woods, [1979] 1 W.L.R. 1294, at p. 1307:

> Where, however, the grant or refusal of the interlocutory injunction will have the practical effect of putting an end to the action because the harm that will have been already caused to the losing party by its grant or its refusal is complete and of a kind for which money cannot constitute any worthwhile recompense, the degree of likelihood that the plaintiff would have succeeded in establishing his right to an injunction if the action had gone to trial is a factor to be brought into the balance by the judge in weighing the risks that injustice may result from his deciding the application one way rather than the other.

Cases in which the applicant seeks to restrain picketing may well fall within the scope of this exception. Several cases indicate that this exception is already applied to some extent in Canada.

52 In Trieger v. Canadian Broadcasting Corp. (1988), 54 D.L.R. (4th) 143 (Ont. H.C.), the leader of the Green Party applied for an interlocutory mandatory injunction allowing him to participate in a party leaders' debate to be televised within a few days of the hearing. The applicant's only real interest was in being permitted to participate in the debate, not in any subsequent declaration of his rights. Campbell J.

refused the application, stating at p. 152:

> This is not the sort of relief that should be granted on an interlocutory application of this kind. The legal issues involved are complex and I am not satisfied that the applicant has demonstrated there is a serious issue to be tried in the sense of a case with enough legal merit to justify the extraordinary intervention of this court in making the order sought without any trial at all. [Emphasis added.]

53 In Tremblay v. Daigle, [1989] 2 S.C.R. 530, the appellant Daigle was appealing an interlocutory injunction granted by the Quebec Superior Court enjoining her from having an abortion. In view of the advanced state of the appellant's pregnancy, this Court went beyond the issue of whether or not the interlocutory injunction should be discharged and immediately rendered a decision on the merits of the case.

54 The circumstances in which this exception will apply are rare. When it does, a more extensive review of the merits of the case must be undertaken. Then when the second and third stages of the test are considered and applied the anticipated result on the merits should be borne in mind.

55 The second exception to the American Cyanamid prohibition on an extensive review of the merits arises when the question of constitutionality presents itself as a simple question of law alone. This was recognized by Beetz J. in Metropolitan Stores, at p. 133:

> There may be rare cases where the question of constitutionality will present itself as a simple question of law alone which can be finally settled by a motion judge. A theoretical example which comes to mind is one where Parliament or a legislature would purport to pass a law imposing the beliefs of a state religion. Such a law would violate s. 2(a) of the Canadian Charter of Rights and Freedoms, could not possibly be saved under s. 1 of the Charter and might perhaps be struck down right away; see Attorney General of Quebec v. Quebec Association of Protestant School Boards, [1984] 2 S.C.R. 66, at p. 88. It is trite to say that these cases are exceptional.

A judge faced with an application which falls within the extremely narrow confines of this second exception need not consider the second or third tests since the existence of irreparable harm or the location of the balance of convenience are irrelevant inasmuch as the constitutional issue is finally determined and a stay is unnecessary.

56 The suggestion has been made in the private law context that a third exception to the American Cyanamid "serious question to be tried" standard should be recognized in cases where the factual record is largely settled prior to the application being made. Thus in Dialadex Communications Inc. v. Crammond (1987), 34 D.L.R. (4th) 392 (Ont. H.C.), at p. 396, it was held that:

> Where the facts are not substantially in dispute, the plaintiffs must be able to establish a strong prima facie case and must show that they will suffer irreparable harm if the injunction is not granted. If there are facts in dispute, a lesser standard must be met. In that case, the plaintiffs must show that their case is not a frivolous one and there is a substantial question to be tried, and that, on the balance of convenience, an injunction should be granted.

To the extent that this exception exists at all, it should not be applied in Charter cases. Even if the facts upon which the Charter breach is alleged are not in dispute, all of the evidence upon which the s. 1 issue must be decided may not be before the motions court. Furthermore, at this stage an appellate court will not normally have the time to consider even a complete factual record properly. It follows that a motions court should not attempt to undertake the careful analysis required for a consideration of s. 1 in an interlocutory proceeding.

C. Irreparable Harm

57 Beetz J. determined in Metropolitan Stores, at p. 128, that "[t]he second test consists in deciding whether the litigant who seeks the interlocutory injunction would, unless the injunction is granted, suffer irreparable harm". The harm which might be suffered by the respondent, should the relief sought be granted, has been considered by some courts at this stage. We are of the opinion that this is more appropriately dealt with in the third part of the analysis. Any alleged harm to the public interest should also be considered at that stage.

58 At this stage the only issue to be decided is whether a refusal to grant relief could so adversely affect the applicants' own interests that the harm could not be remedied if the eventual decision on the merits does not accord with the result of the interlocutory application.

59 "Irreparable" refers to the nature of the harm suffered rather than its magnitude. It is harm which either cannot be quantified in monetary terms or which cannot be cured, usually because one party cannot collect damages from the other. Examples of the former include instances where one party will be put out of business by the court's decision (R.L. Crain Inc. v. Hendry (1988), 48 D.L.R. (4th) 228 (Sask. Q.B.)); where one party will suffer permanent market loss or irrevocable damage to its business reputation (American Cyanamid, supra); or where a permanent loss of natural resources will be the result when a challenged activity is not enjoined (MacMillan Bloedel Ltd. v. Mullin, [1985] 3 W.W.R. 577 (B.C.C.A.)). The fact that one party may be impecunious does not automatically determine the application in favour of the other party who will not ultimately be able to collect damages, although it may be a relevant consideration (Hubbard v. Pitt, [1976] Q.B. 142 (C.A.)).

60 The assessment of irreparable harm in interlocutory applications involving Charter rights is a task which will often be more difficult than a comparable assessment in a private law application. One reason for this is that the notion of irreparable harm is closely tied to the remedy of damages, but damages are not the primary remedy in Charter cases.

61 This Court has on several occasions accepted the principle that damages may be awarded for a breach of Charter rights: (see, for example, Mills v. The Queen, [1986] 1 S.C.R. 863, at pp. 883, 886, 943 and 971; Nelles v. Ontario, [1989] 2 S.C.R. 170, at p. 196). However, no body of jurisprudence has yet developed in respect of the principles which might govern the award of damages under s. 24(1) of the Charter. In light of the uncertain state of the law regarding the award of damages for a Charter breach, it will in most cases be impossible for a judge on an interlocutory application to determine whether adequate compensation could ever be obtained at trial. Therefore, until the law in this area has developed further, it is appropriate to assume that the financial damage which will be suffered by an applicant following a refusal of relief, even though capable of quantification, constitutes irreparable harm.

D. The Balance of Inconvenience and Public Interest Considerations

62 The third test to be applied in an application for interlocutory relief was described by Beetz J. in Metropolitan Stores at p. 129 as: "a determination of which of the two parties will suffer the greater harm from the granting or refusal of an interlocutory injunction, pending a decision on the merits". In light of the relatively low threshold of the first test and the difficulties in applying the test of irreparable harm in Charter cases, many interlocutory proceedings will be determined at this stage.

63 The factors which must be considered in assessing the "balance of inconvenience" are numerous and will vary in each individual case. In American Cyanamid, Lord Diplock cautioned, at p. 408, that:

> [i]t would be unwise to attempt even to list all the various matters which may need to be taken into consideration in deciding where the balance lies, let alone to suggest the relative weight to be attached to them. These will vary from case to case.

He added, at p. 409, that "there may be many other special factors to be taken into consideration in the particular circumstances of individual cases."

64 The decision in Metropolitan Stores, at p. 149, made clear that in all constitutional cases the public interest is a 'special factor' which must be considered in assessing where the balance of convenience lies and which must be "given the weight it should carry." This was the approach properly followed by Blair J. of the General Division of the Ontario Court in Ainsley Financial Corp. v. Ontario Securities Commission (1993), 14 O.R. (3d) 280, at pp. 303-4:

> Interlocutory injunctions involving a challenge to the constitutional validity of legislation or to the authority of a law enforcement agency stand on a different footing than ordinary cases involving claims for such relief as between private litigants. The interests of the public, which the agency is created to protect, must be taken into account and weighed in the balance, along with the interests of the private litigants.

1. The Public Interest

65 Some general guidelines as to the methods to be used in assessing the balance of inconvenience were elaborated by Beetz J. in Metropolitan Stores. A few additional points may be made. It is the "polycentric" nature of the Charter which requires a consideration of the public interest in determining the balance of convenience: see Jamie Cassels, "An Inconvenient Balance: The Injunction as a Charter Remedy", in J. Berryman, ed., Remedies: Issues and Perspectives, 1991, 271, at pp. 301-5. However, the government does not have a monopoly on the public interest. As Cassels points out at p. 303:

> While it is of utmost importance to consider the public interest in the balance of convenience, the public interest in Charter litigation is not unequivocal or asymmetrical in the way suggested in Metropolitan Stores. The Attorney General is not the exclusive representative of a monolithic "public" in Charter disputes, nor does the applicant always represent only an individualized claim. Most often, the applicant can also claim to represent one vision of the "public interest". Similarly, the public interest may not always gravitate in favour of enforcement of existing legislation.

66 It is, we think, appropriate that it be open to both parties in an interlocutory Charter proceeding to rely upon considerations of the public interest. Each party is entitled to make the court aware of the damage it might suffer prior to a decision on the merits. In addition, either the applicant or the respondent may tip the scales of convenience in its favour by demonstrating to the court a compelling public interest in the granting or refusal of the relief sought. "Public interest" includes both the concerns of society generally and the particular interests of identifiable groups.

67 We would therefore reject an approach which excludes consideration of any harm not directly suffered by a party to the application. Such was the position taken by the trial judge in Morgentaler v. Ackroyd (1983), 150 D.L.R. (3d) 59 (Ont. H.C.), per Linden J., at p. 66.

> The applicants rested their argument mainly on the irreparable loss to their

> potential women patients, who would be unable to secure abortions if the clinic is not allowed to perform them. Even if it were established that these women would suffer irreparable harm, such evidence would not indicate any irreparable harm to these applicants, which would warrant this court issuing an injunction at their behest. [Emphasis in original.]

68 When a private applicant alleges that the public interest is at risk that harm must be demonstrated. This is since private applicants are normally presumed to be pursuing their own interests rather than those of the public at large. In considering the balance of convenience and the public interest, it does not assist an applicant to claim that a given government authority does not represent the public interest. Rather, the applicant must convince the court of the public interest benefits which will flow from the granting of the relief sought.

69 Courts have addressed the issue of the harm to the public interest which can be relied upon by a public authority in different ways. On the one hand is the view expressed by the Federal Court of Appeal in Attorney General of Canada v. Fishing Vessel Owners' Association of B.C., [1985] 1 F.C. 791, which overturned the trial judge's issuance of an injunction restraining Fisheries Officers from implementing a fishing plan adopted under the Fisheries Act, R.S.C. 1970, c. F-14, for several reasons, including, at p. 795:

> (b) the Judge assumed that the grant of the injunction would not cause any damage to the appellants. This was wrong. When a public authority is prevented from exercising its statutory powers, it can be said, in a case like the present one, that the public interest, of which that authority is the guardian, suffers irreparable harm.

This dictum received the guarded approval of Beetz J. in Metropolitan Stores at p. 139. It was applied by the Trial Division of the Federal Court in Esquimalt Anglers' Association v. Canada (Minister of Fisheries and Oceans) (1988), 21 F.T.R. 304.

70 A contrary view was expressed by McQuaid J.A. of the P.E.I. Court of Appeal in Island Telephone Co. Re, (1987), 67 Nfld. & P.E.I.R. 158, who, in granting a stay of an order of the Public Utilities Commission pending appeal, stated at p. 164:

> I can see no circumstances whatsoever under which the Commission itself could be inconvenienced by a stay pending appeal. As a regulatory body, it has no vested interest, as such, in the outcome of the appeal. In fact, it is not inconceivable that it should welcome any appeal which goes especially to its jurisdiction, for thereby it is provided with clear guidelines for the future, in situations where doubt may have therefore existed. The public interest is equally well served, in the same sense, by any appeal. . . .

71 In our view, the concept of inconvenience should be widely construed in Charter cases. In the case of a public authority, the onus of demonstrating irreparable harm to the public interest is less than that of a private applicant. This is partly a function of the nature of the public authority and partly a function of the action sought to be enjoined. The test will nearly always be satisfied simply upon proof that the authority is charged with the duty of promoting or protecting the public interest and upon some indication that the impugned legislation, regulation, or activity was undertaken pursuant to that responsibility. Once these minimal requirements have been met, the court should in most cases assume that irreparable harm to the public interest would result from the restraint of that action.

72 A court should not, as a general rule, attempt to ascertain whether actual harm would result from the restraint sought. To do so would in effect require judicial inquiry into whether the government is governing well, since it implies the possibility that the government action does not have the effect of promoting the public interest and that the restraint of the action would therefore not harm the public interest. The Charter does not give the courts a licence to evaluate the effectiveness of government action, but only to restrain it where it encroaches upon fundamental rights.

73 Consideration of the public interest may also be influenced by other factors. In Metropolitan Stores, it was observed that public interest considerations will weigh more heavily in a "suspension" case than in an "exemption" case. The reason for this is that the public interest is much less likely to be detrimentally affected when a discrete and limited number of applicants are exempted from the application of certain provisions of a law than when the application of certain provisions of a law than when the application of the law is suspended entirely. See Black v. Law Society of Alberta (1983), 144 D.L.R. (3d) 439; Vancouver General Hospital v. Stoffman (1985), 23 D.L.R. (4th) 146; Rio Hotel Ltd. v. Commission des licences et permis d'alcool, [1986] 2 S.C.R. ix.

74 Similarly, even in suspension cases, a court may be able to provide some relief if it can sufficiently limit the scope of the applicant's request for relief so that the general public interest in the continued application of the law is not affected. Thus in Ontario Jockey Club v. Smith (1922), 22 O.W.N. 373 (H.C.), the court restrained the enforcement of an impugned taxation statute against the applicant but ordered him to pay an amount equivalent to the tax into court pending the disposition of the main action.

2. The Status Quo

75 In the course of discussing the balance of convenience in American Cyanamid, Lord Diplock stated at p. 408 that when everything else is equal, "it is a counsel of prudence to ... preserve the status quo." This approach would seem to be of limited value in private law cases, and, although there may be exceptions, as a general rule it has no merit as such in the face of the alleged violation of fundamental rights. One of the functions of the Charter is to provide individuals with a tool to challenge the existing order of things or status quo. The issues have to be balanced in the manner described in these reasons.

E. Summary

76 It may be helpful at this stage to review the factors to be considered on an application for interlocutory relief in a Charter case.

77 As indicated in Metropolitan Stores, the three-part American Cyanamid test should be applied to applications for interlocutory injunctions and as well for stays in both private law and Charter cases.

78 At the first stage, an applicant for interlocutory relief in a Charter case must demonstrate a serious question to be tried. Whether the test has been satisfied should be determined by a motions judge on the basis of common sense and an extremely limited review of the case on the merits. The fact that an appellate court has granted leave in the main action is, of course, a relevant and weighty consideration, as is any judgment on the merits which has been rendered, although neither is necessarily conclusive of the matter. A motions court should only go beyond a preliminary investigation of the merits when the result of the interlocutory motion will in effect amount to a final determination of the action, or when the constitutionality of a challenged statute can be determined as a pure question of law. Instances of this sort will be exceedingly rare. Unless the case on the merits is frivolous or vexatious, or the constitutionality of the statute is a pure question of law, a judge on a motion for relief must, as a general rule, consider the second and third stages of the Metropolitan Stores test.

79 At the second stage the applicant must convince the court that it will suffer irreparable harm if the relief is not granted. 'Irreparable' refers to the nature of the harm rather than its magnitude. In Charter cases, even quantifiable financial loss relied upon by an applicant may be considered irreparable harm so long as it is unclear that such loss could be recovered at the time of a decision on the merits.

80 The third branch of the test, requiring an assessment of the balance of inconvenience, will often determine the result in applications involving Charter rights. In addition to the damage each party alleges it will suffer, the interest of the public must be taken into account. The effect a decision on the application will have upon the public interest may be relied upon by either party. These public interest considerations will carry less weight in exemption cases than in suspension cases. When the nature and declared purpose of legislation is to promote the public interest, a motions court should not be concerned whether the legislation actually has such an effect. It must be assumed to do so. In order to overcome the assumed benefit to the public interest arising from the continued application of the legislation, the applicant who relies on the public interest must demonstrate that the suspension of the legislation would itself provide a public benefit.

81 We would add to this brief summary that, as a general rule, the same principles would apply when a government authority is the applicant in a motion for interlocutory relief. However, the issue of public interest, as an aspect of irreparable harm to the interests of the government, will be considered in the second stage. It will again be considered in the third stage when harm to the applicant is balanced with harm to the respondent including any harm to the public interest established by the latter.

VII. Application of the Principles to these Cases

A. A Serious Question to be Tried

82 The applicants contend that these cases raise several serious issues to be tried. Among these is the question of the application of the rational connection and the minimal impairment tests in order to justify the infringement upon freedom of expression occasioned by a blanket ban on tobacco advertising. On this issue, Chabot J. of the Quebec Superior Court and Brossard J.A. in dissent in the Court of Appeal held that the government had not satisfied these tests and that the ban could not be justified under s. 1 of the Charter. The majority of the Court of Appeal held that the ban was justified. The conflict in the reasons arises from different interpretations of the extent to which recent jurisprudence has relaxed the onus fixed upon the state in R. v. Oakes, [1986] 1 S.C.R. 103, to justify its action in public welfare initiatives. This Court has granted leave to hear the appeals on the merits. When faced with separate motions for interlocutory relief pertaining to these cases, the Quebec Court of Appeal stated that "[w] hatever the outcome of these appeals, they clearly raise serious constitutional issues." This observation of the Quebec Court of Appeal and the decision to grant leaves to appeal clearly indicate that these cases raise serious questions of law.

B. Irreparable Harm

83 The applicants allege that if they are not granted interlocutory relief they will be forced to spend very large sums of money immediately in order to comply with the regulations. In the event that their appeals are allowed by this Court, the applicants contend that they will not be able either to recover their costs from the government or to revert to their current packaging practices without again incurring the same expense.

84 Monetary loss of this nature will not usually amount to irreparable harm in private law cases. Where the government is the unsuccessful party in a constitutional claim, however, a plaintiff will face a much more difficult task in establishing constitutional liability and obtaining monetary redress. The expenditures which the new regulations require will therefore impose irreparable harm on the applicants if these motions are denied but the main actions are successful on appeal.

C. Balance of Inconvenience

85 Among the factors which must be considered in order to determine whether the granting or withholding of interlocutory relief would occasion greater inconvenience are the nature of the relief sought and of the harm which the parties contend they will suffer, the nature of the legislation which is under attack, and where the public interest lies.

86 The losses which the applicants would suffer should relief be denied are strictly financial in nature. The required expenditure is significant and would undoubtedly impose considerable economic hardship on the two companies. Nonetheless, as pointed out by the respondent, the applicants are large and very successful corporations, each with annual earnings well in excess of $50,000,000. They have a greater capacity to absorb any loss than would many smaller enterprises. Secondarily, assuming that the demand for cigarettes is not solely a function of price, the companies may also be able to pass on some of their losses to their customers in the form of price increases. Therefore, although the harm suffered may be irreparable, it will not affect the long-term viability of the applicants.

87 Second, the applicants are two companies who seek to be exempted from compliance with the latest regulations published under the Tobacco Products Control Act. On the face of the matter, this case appears to be an "exemption case" as that phrase was used by Beetz J. in Metropolitan Stores. However, since there are only three tobacco producing companies operating in Canada, the application really is in the nature of a "suspension case". The applicants admitted in argument that they were in effect seeking to suspend the application of the new regulations to all tobacco producing companies in Canada for a period of one year following the judgment of this Court on the merits. The result of these motions will therefore affect the whole of the Canadian tobacco producing industry. Further, the impugned provisions are broad in nature. Thus it is appropriate to classify these applications as suspension cases and therefore ones in which "the public interest normally carries greater weight in favour of compliance with existing legislation".

88 The weight accorded to public interest concerns is partly a function of the nature of legislation generally, and partly a function of the purposes of the specific piece of legislation under attack. As Beetz J. explained, at p. 135, in Metropolitan Stores:

> Whether or not they are ultimately held to be constitutional, the laws which litigants seek to suspend or from which they seek to be exempted by way of interlocutory injunctive relief have been enacted by democratically-elected legislatures and are generally passed for the common good, for instance: ... the protection of public health ... . It seems axiomatic that the granting of interlocutory injunctive relief in most suspension cases and, up to a point, as will be seen later, in quite a few exemption cases, is susceptible temporarily to frustrate the pursuit of the common good. [Emphasis added.]

89 The regulations under attack were adopted pursuant to s. 3 of the Tobacco Products Control Act which states:

> 3. The purpose of this Act is to provide a legislative response to a national public health problem of substantial and pressing concern and, in particular,
>
> (a) to protect the health of Canadians in the light of conclusive evidence implicating tobacco use in the incidence of numerous debilitating and fatal diseases;
>
> (b) to protect young persons and others, to the extent that is reasonable in a free and democratic society, from inducements to use tobacco products and

consequent dependence on them; and

(c) to enhance public awareness of the hazards of tobacco use by ensuring the effective communication of pertinent information to consumers of tobacco products.

90 The Regulatory Impact Analysis Statement, in the Canada Gazette, Part II, Vol. 127, No. 16, p. 3284, at p. 3285, which accompanied the regulations stated:

> The increased number and revised format of the health messages reflect the strong consensus of the public health community that the serious health hazards of using these products be more fully and effectively communicated to consumers. Support for these changes has been manifested by hundreds of letters and a number of submissions by public health groups highly critical of the initial regulatory requirements under this legislation as well as a number of Departmental studies indicating their need.

91 These are clear indications that the government passed the regulations with the intention of protecting public health and thereby furthering the public good. Further, both parties agree that past studies have shown that health warnings on tobacco product packages do have some effects in terms of increasing public awareness of the dangers of smoking and in reducing the overall incidence of smoking in our society. The applicants, however, argued strenuously that the government has not shown and cannot show that the specific requirements imposed by the impugned regulations have any positive public benefits. We do not think that such an argument assists the applicants at this interlocutory stage.

92 When the government declares that it is passing legislation in order to protect and promote public health and it is shown that the restraints which it seeks to place upon an industry are of the same nature as those which in the past have had positive public benefits, it is not for a court on an interlocutory motion to assess the actual benefits which will result from the specific terms of the legislation. That is particularly so in this case, where this very matter is one of the main issues to be resolved in the appeal. Rather, it is for the applicants to offset these public interest considerations by demonstrating a more compelling public interest in suspending the application of the legislation.

93 The applicants in these cases made no attempt to argue any public interest in the continued application of current packaging requirements rather than the new requirements. The only possible public interest is that of smokers' not having the price of a package of cigarettes increase. Such an increase is not likely to be excessive and is purely economic in nature. Therefore, any public interest in maintaining the current price of tobacco products cannot carry much weight. This is particularly so when it is balanced against the undeniable importance of the public interest in health and in the prevention of the widespread and serious medical problems directly attributable to smoking.

94 The balance of inconvenience weighs strongly in favour of the respondent and is not offset by the irreparable harm that the applicants may suffer if relief is denied. The public interest in health is of such compelling importance that the applications for a stay must be dismissed with costs to the successful party on the appeal.

Tab 13

Case Name:
Kane v. University of British Columbia

Julius Kane, Appellant; and
Board of Governors of the University of British Columbia, Respondent.

[1980] S.C.J. No. 32

[1980] A.C.S. no 32

[1980] 1 S.C.R. 1105

[1980] 1 R.C.S. 1105

110 D.L.R. (3d) 311

31 N.R. 214

[1980] 3 W.W.R. 125

J.E. 80-181

18 B.C.L.R. 124

1980 CanLII 10

2 A.C.W.S. (2d) 117

Supreme Court of Canada

1979: October 25, 26 / 1980: March 3.

Present: Martland, Ritchie, Pigeon, Dickson, Beetz, Estey and McIntyre JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR BRITISH COLUMBIA

Colleges and universities -- University president ordering suspension of faculty member -- Appeal to Board of Governors -- Appellant's withdrawal following conclusion of hearing by Board -- Further facts given to Board by president in absence of appellant -- Breach of natural justice -- Failure to observe rule expressed in maxim audi alteram partem.

Two deans of faculties at the University of British Columbia recommended that the appointment of the appellant (K), a professor at the University, be terminated for cause, the chief complaint being that he had made improper use of the university computer facilities for personal purposes. Following a meeting called by the President of the University, at which K and his counsel were present, the deans recommended that, instead of terminating K's appointment, he should be suspended without salary for three months, and be required to make financial restitution to the University. The deans were influenced by the argument that the irregular procedures followed by K were the result of a misunderstanding rather than a deliberate attempt to deceive, and that administrative officers of the University may have been lax in discharging their duties to such a degree as to mislead K as to the proper procedures to be followed.

The President of the University acted according to the deans' recommendation. He suspended K for three months, without salary, pursuant to s. 58(1) of the Universities Act, 1974 (B.C.), c. 100, and directed him to provide a full accounting and restitution of all sums due the University.

K appealed to the Board of Governors of the University, pursuant to s. 58(3). K did not question the fact that he had used the university computer for his own purposes, but felt that he should not be suspended for doing so. The President attended the meeting as a member of the Board. Section 61 of the Universities Act provides that the President is a member of the Board "and shall attend its regular meetings."

K and his counsel were heard by the Board. K answered questions directed to him by members of the Board. During the hearing, the President of the University responded to questions directed to him by Board members, but did not ask questions of K or his counsel.

At the conclusion of the hearing, the chairman requested K and his counsel to leave so that the Board might deliberate. Following an adjournment for dinner, the Board deliberated, the University President being present throughout. The President did not participate in the discussions. Nor did he vote upon the resolution. He did, however, answer questions directed to him by Board members. The Board approved the three-month suspension of K, without salary, and the order for a full accounting and restitution of all sums due to the University for the use of the computer for private and commercial affairs.

K petitioned the Supreme Court of British Columbia for an order that the Board resolution be quashed, pursuant to the Judicial Review Procedure Act, 1976 (B.C.), c. 25. The petition was dismissed. A majority of the British Columbia Court of Appeal dismissed an appeal from the trial judgment. K appealed from the judgment of the Court of Appeal to this Court.

Held (Ritchie J. dissenting): The appeal should be allowed.

Per Martland, Pigeon, Dickson, Beetz, Estey and McIntyre JJ.: The submission which was based upon the fact that the President testified or gave evidence during the postprandial session in the absence of K and that this amounted to a breach of the principles of natural justice and a failure to observe the rule expressed in the maxim audi alteram partem was accepted. Applying the following principles, the appeal must be allowed.

1. It is the duty of the courts to attribute a large measure of autonomy of decision to a tribunal, such as a Board of Governors of a University, sitting in appeal, pursuant to legislative mandate.

2. As a constituent of the autonomy it enjoys, the tribunal must observe natural justice. To abrogate the rules of natural justice, express language or necessary implication must be found in the statutory instrument.

3. A high standard of justice is required when the right to continue in one's profession or employment is at stake. A disciplinary suspension can have grave and permanent consequences upon a professional career.

4. The tribunal must listen fairly to both sides giving the parties to the controversy a fair opportunity for correcting or contradicting any relevant statement prejudicial to their views.

5. Unless expressly or by necessary implication empowered to act ex parte, an appellate authority must not hold private interviews with witnesses or, a fortiori, hear evidence in the absence of a party whose conduct is impugned and under scrutiny.

6. The Court will not inquire whether the evidence did work to the prejudice of one of the parties; it is sufficient if it might have done so.

The Board was under an obligation to postpone further consideration of the matter until such time as K might be present and hear the additional facts adduced; at the very least the Board should have made K aware of those facts and afforded him a real and effective opportunity to correct or meet any adverse statement made. In the event, the Board followed neither course. The Board heard the further facts, deliberated, and ruled against K. In doing so, it made a fundamental error. The danger against which the Courts must be on guard is the possibility that further information could have been put before the Board for its consideration which affected the disposition of the appeal.

Per Ritchie J., dissenting: K knew from the outset exactly what it was that he was charged with, and he had an opportunity to present his case and to examine the witnesses against him. It could not be suggested that the President decided to wait until K was absent before providing the members of the Board with facts prejudicial to K, what the allegations really were and the reasons why the penalty was reduced from termination to suspension. If this had been the case there would indeed have been a grave breach of good faith on the part of the President and other Board members and a denial to the appellant of the fundamental right to be heard in his own defence in breach of the elementary principles of natural justice.

The statement contained in a letter from a member of the Board to the counsel for the University to the effect that the President provided the Board with necessary facts without in any way discussing the merits of the appeal, was too slender a thread upon which to support an accusation of such gravity against men of presumed integrity acting under a statutory authority.

Cases Cited

[Local Government Board v. Arlidge, [1915] A.C. 120; Ridge v. Baldwin, [1962] 1 All E.R. 834; Russell v. Duke of Norfolk, [1949] 1 All E.R. 109; Abbott v. Sullivan, [1952] 1 K.B. 189; Board of Education v. Rice, [1911] A.C. 179; Kanda v. Government of the Federation of Malaya, [1962] A.C. 322; Errington v. Ministry of Health, [1935] 1 K.B. 249; Re Brook and Delcomyn (1864), 16 C.B.R. (N.S.) 403; Re an Arbitration between Gregson and Armstrong (1894), 70 L.T. 1106; R. v. Deputy Industrial Injuries Commissioner, Ex p. Jones, [1962] 2 Q.B. 677; Pfizer Co. Ltd. v. Deputy Minister of National Revenue for Customs and Excise, [1977] 1 S.C.R. 456; Jeffs v. New Zealand Dairy Production and Marketing Bd., [1967] 1 A.C. 551; R. v. Architects' Registration Tribunal, Ex p. Jaggar (1945), 61 T.L.R. 445, referred to.]

APPEAL from a judgment of the Court of Appeal for British Columbia [(1979), 11 B.C.L.R. 318], dismissing an appeal from the dismissal of a petition under the Judicial Review Procedure Act, 1976 (B.C.), c. 25. Appeal allowed, Ritchie J. dissenting.

David Roberts, for the appellant.
G.S. Cumming, Q.C., and M.A. Cummings, for the respondent.

Solicitors for the appellant: Macrae, Montgomery, Spring & Cunningham, Vancouver.
Solicitors for the respondent: Cumming, Richards, Underhill, Fraser, Skillings, Vancouver.

The judgment of Martland, Pigeon, Dickson, Beetz, Estey and McIntyre JJ. was delivered by

DICKSON J.:-- Julius Kane holds tenured appointment as a professor at the University of British Columbia. On February 21, 1977, the Dean of the Faculty of Graduate Studies and the Dean of the Faculty of Science recommended that Dr. Kane's appointment be terminated for cause. It was alleged he had made improper use of University Computer facilities for personal purposes. It was further alleged that he had improperly used his National Research Council grant to support private work and to purchase hardware items not related to the purposes of the grant.

Following a meeting called by the President of the University, Dr. Douglas T. Kenny, at which Dr. Kane and his counsel were present, the Deans recommended that, instead of terminating Dr. Kane's appointment, he should be suspended without salary for three months, and be required to make financial restitution to the University. The Deans were influenced by the argument that the irregular procedures followed by Dr. Kane were the result of a misunderstanding rather than a deliberate attempt to deceive, and that administrative officers of the University may have been lax in discharging their duties to such a degree as to mislead Dr. Kane as to the proper procedures to be followed.

The President of the University acted according to the Deans' recommendation. He suspended Dr. Kane for three months, without salary, pursuant to s. 58(1) of the Universities Act, 1974 (B.C.), c. 100, and directed him to provide a full accounting and restitution of all sums due the University. Section 58 of the Act reads:

> 58. (1) The president has power to suspend any member of the teaching and administrative staffs and any officer or employee of the university.
>
> (2) Upon the exercise of the power, he shall forthwith report his action to the board with a statement of his reasons.
>
> (3) A person who is suspended under this section has a right of appeal to the board.

Dr. Kane appealed to the Board of Governors of the University, pursuant to s. 58(3). The appeal came before a regular meeting of the Board of Governors. Dr. Kane did not question the fact that be had used the university computer for his own purposes, but felt that he should not be suspended for doing so. The President attended the meeting as a member of the Board. Section 61 of the Universities Act provides that the President is a member of the Board "and shall attend its regular meetings."

Dr. Kane and his counsel were heard by the Board. Dr. Kane answered questions directed to him by members of the Board. During the hearing, the President of the University responded to questions directed to him by Board members, but did not ask questions of Dr. Kane or his counsel.

At the conclusion of the hearing, the Chairman requested Dr. Kane and his counsel to leave so that the Board might deliberate. Following an adjournment for dinner, the Board deliberated, the University President being present throughout. According to the findings of the Chambers judge, "Dr. Kenny did not participate in the discussions. Nor did he vote upon the resolution. He did, however, answer questions directed to him by Board members." The Board approved the three-month suspension of Dr. Kane, without salary, and the order for a full accounting and restitution of all sums due to the University for the use of the computer for private and commercial affairs.

Dr. Kane petitioned the Supreme Court of British Columbia for an order that the Board resolution be quashed, pursuant to the Judicial Review Procedure Act, 1976 (B.C.), c. 25.

The main thrust of the case advanced on behalf of Dr. Kane was that no man could be a judge in his own cause, and although no actual bias on the part of the President was alleged, his presence during the deliberations of the Board violated the principles of natural justice. The judge rejected this submission, being of opinion that the judgment of this Court in Law Society of Upper Canada v. French [[1975] 2 S.C.R. 767], determined the application. The judge considered that the President was in no sense an accuser or prosecutor, and the Legislature, in directing the President to attend regular Board meetings, had implicitly accepted the duplication which followed through the President making the decision to suspend and then sitting on the Board of Governors on appeal from that decision. Reference was also made by the judge to King v. University of Saskatchewan [[1969] S.C.R. 678], and to Ringrose v. College of Physicians and Surgeons of Alberta [[1977] 1 S.C.R. 814].

A majority (McFarlane and Aikins, JJ.A., Lambert J.A. dissenting) of the British Columbia Court of Appeal agreed with the Chambers judge and dismissed an appeal brought to that Court by Dr. Kane. The Court rejected the argument based upon the dual position of the University President as originator of the suspension and member of the tribunal sitting in appeal. Rejected also was a second submission, apparently not advanced expressly in the Court of first instance, impugning the presence and conduct of the University President during the deliberations of the Board, after Dr. Kane and his counsel had withdrawn. This argument rested upon the fact that the President testified or gave evidence during the postprandial session in the absence of Dr. Kane. It is contended that this amounted to a breach of the principles of natural justice and a failure to observe the rule expressed in the maxim audi alteram partem. It is to that argument that I now turn because, in my view, it is one to which the University can give no compelling answer. If this ground of appeal succeeds, as I think it must, it is unnecessary to address the argument resting upon the dual role of the President, the maxim nemo judex in causa sua, and the ramifications of the King, French and Ringrose decisions.

The evidence as to what occurred following the dinner adjournment is scant. Paragraph 7 of Dr. Kane's petition reads:

> 7. During the consideration by the Board of Governors of the said appeal leading to the said Resolution, the President, Douglas T. Kenny, was present and took part in the consideration and the discussion of the merits of the said appeal.

Dr. Kane's affidavit in support of his petition reads in part:

> 6. I am informed by the said Roberts [David Roberts, counsel for Doctor Kane] and verily believe that he was informed by a member of the Board of Governors, Mr. George Morfitt, that following the hearing of my appeal pursuant to Section 58 of the Universities Act and when the Board of Governors was considering my appeal following the hearing, the President of the University of British Columbia, Douglas T. Kenny, from whose decision the said appeal was brought, was present and took part in the discussion leading to the said Resolution.

An affidavit was filed in which Mr. Morfitt, a member of the Board of Governors, swore that during the meeting after dinner President Kenny did not participate in the discussions with regard to the petitioner. In clarification of Mr. Morfitt's affidavit, Mr. George S. Cumming, counsel for the

University, wrote to counsel for Dr. Kane as follows:

> I refer you to our telephone conversation of December 14th in which you sought some clarification of the affidavit sworn by Mr. George Morfitt.
>
> Mr. Morfitt has advised me as follows:
>
> > "I note that Item 7 on page 2 of the Petition Facts states that President Kenny 'was present and took part in the consideration and discussion of the minutes [should read "merits"] of the said appeal'. While the President did provide the Board with the necessary facts relating to the Kane suspension it can be asserted that the President was at all times most careful not to take part in the consideration and the discussion of the merits of the appeal. A similar comment could be made in respect of the statement made in Item 6 of the Affidavit."
> >
> > I think it would be appropriate if this were filed with the Court on the hearing of the Petition. We can thereby avoid the necessity of any cross-examination upon affidavits.

The critical words are "... the President did provide the Board with the necessary facts relating to the Kane suspension ... " There was no cross-examination upon affidavits. The clarification which the letter sought to achieve is less than entire but this much is clear: the Board was furnished with "the necessary facts" relating to the suspension, in the absence of Dr. Kane and his counsel. In those circumstances, I do not see how the resolution of the Board can stand.

The following propositions, in my view, govern the outcome of this appeal:

1. It is the duty of the courts to attribute a large measure of autonomy of decision to a tribunal, such as a Board of Governors of a University, sitting in appeal, pursuant to legislative mandate. The Board need not assume the trappings of a court. There is no lis inter partes, no prosecutor and no accused. The Board is free, within reason, to determine its own procedures, which will vary with the nature of the inquiry and the circumstances of the case. Members of the Board are drawn from all constituencies of the community. They normally serve without remuneration in the discharge of what is frequently an arduous and thankless form of public service. Few, if any, of the members of the Board will be legally trained. It would be wrong, therefore, to ask of them, in the discharge of their quasi-judicial duties, the high standard of technical performance which one may properly expect of a court. They are not fettered by the strict evidential and other rules applicable to proceedings before courts of law. It is sufficient that the case has been heard in a judicial spirit and in accordance with the principles of substantial justice: per Lord Parmoor in Local Government Board v. Arlidge [[1915] A.C. 120], at p. 140. Let me make it clear that in this appeal nothing has been said which in any way impugns the integrity or bona fides of any member of the Board of Governors of the University of British Columbia.

2. As a constituent of the autonomy it enjoys, the tribunal must observe natural justice which, as Harman L.J. said, [Ridge v. Baldwin [[1962] 1 All E.R. 834 (C.A.)], at p. 850] is only "fair play in action". In any particular case, the requirements of natural justice will depend on "the circumstances of the case, the nature of the inquiry, the rules under which the tribunal is acting, the subject-matter which is being dealt with, and so forth": per Tucker L.J. in Russell v. Duke of Norfolk [[1949] 1 All E.R. 109], at p. 118. To abrogate the rules of natural justice, express language or necessary implication must be found in the statutory instrument.

3. A high standard of justice is required when the right to continue in one's profession or

employment is at stake. Abbott v. Sullivan [[1952] 1 K.B. 189], at p. 198; Russell v. Duke of Norfolk. supra, at p. 119. A disciplinary suspension can have grave and permanent consequences upon a professional career.

4. The tribunal must listen fairly to both sides, giving the parties to the controversy a fair opportunity "for correcting or contradicting any relevant statement prejudicial to their views". Board of Education v. Rice [[1911] A.C. 179 (H.L.)], at p. 182; Local Government Board v. Arlidge. supra, at pp. 133 and 141.

5. It is a cardinal principle of our law that, unless expressly or by necessary implication, empowered to act ex parte, an appellante authority must not hold private interviews with witnesses (de Smith, Judicial Review of Administrative Action (3rd. ed.) 179) or, a fortiori, hear evidence in the absence of a party whose conduct is impugned and under scrutiny. Such party must, in the words of Lord Denning in Kanda v. Government of the Federation of Malaya [[1962] A.C. 322], at p. 337, "... know the case which is made against him. He must know what evidence has been given and what statements have been made affecting him: and then he must be given a fair opportunity to correct or contradict them. ... Whoever is to adjudicate must not hear evidence or receive representations from one side behind the back of the other." In Errington v. Ministry of Health [[1935] 1 K.B. 249], Greer L.J. held that a quasi-judicial officer must exercise powers in accordance with the rules of natural justice, and must not hear one side in the absence of the other:

> If ... he takes into consideration evidence which might have been, but was not, given at the public inquiry, but was given ex parte without the owners having any opportunity whatsoever to deal with that evidence, then it seems to me that the confirming Order was not within the powers of the Act. (p. 268)

The principle was summarized in the headnote in these words:

> If the Minister holds a private inquiry to which the owners are not invited or takes into consideration ex parte statements with which the owners have had no opportunity of dealing he is not acting in accordance with correct principle of justice....

In the early case of Re Brook and Delcomyn [(1864), 16 C.B.R. (N.S.) 403], Erle C.J. came to the conclusion that the law had been violated when an arbitrator brought before the umpire evidence which had never been communicated to the other arbitrator and which, consequently, one of the parties never had an opportunity of meeting by contradictory evidence. Erle C.J. referred to this as "not a point of form" but a matter of substance, and "one of the last and deepest importance". A similar case is Re an Arbitration between Gregson and Armstrong [(1894), 70 L.T. 106], in which an award was set aside at the instance of a landlord when, all of the evidence on both sides having been heard, the arbitrators on a subsequent day, before making their award, held a meeting on the farm at which the outgoing tenant was present, but not the landlord. In a much later case, R. v. Deputy Industrial Injuries Commissioner, Ex p. Jones [[1962] 2 Q.B. 677], the tribunal received evidence which was both fresh and highly prejudicial to the applicant's position. The case at bar cannot be put so strongly, but the principle to be applied is the same. Lord Parker C.J., in granting the order for certiorari, stated that a tribunal is not entitled to continue privately to obtain evidence between the end of a hearing and the reaching of decision "without notifying the parties thereafter of the advice or information received, so as to give the parties an opportunity of having a further hearing if need be, or, at any rate, commenting on the information and making their submissions thereon" (p. 686).

A recent decision of this Court which has relevance for this appeal is Pfizer Company Limited v. Deputy Minister of National Revenue for Customs and Excise [[1977] 1 S.C.R. 456], in which Pigeon J., speaking for the Court, said at p. 463:

> While the Board is authorized by statute to obtain information otherwise than under sanction of an oath or affirmation ... this does not authorize it to depart from the rules of natural justice. It is clearly contrary to those rules to rely on information obtained after the hearing was completed without disclosing it to the parties and giving them an opportunity to meet it.

Pfizer is not a case in which a tribunal heard one party in the absence of the other. It establishes, however, the principle that each party to a hearing is entitled to be informed of, and to make representations, with respect to evidence which affected the disposition of the case. See also R. v. Birmingham City Justices, Ex p. Chris Foreign Foods (Wholesalers) Ltd. [[1970] 1 W.L.R. 1428]; R. v. Barnsley Metropolitan Borough Council, Ex p. Hook [[1976] 3 All E.R. 452]; R. v. Justices of Bodmin, Ex p. McEwen [[1947] 1 K.B. 321].

6. The court will not inquire whether the evidence did work to the prejudice of one of the parties; it is sufficient if it might have done so. Kanda v. Government of the Federation of Malaya, supra, at p. 337. In the case at bar, the Court cannot conclude that there was no possibility of prejudice as we have no knowledge of what evidence was, in fact, given by President Kenny following the dinner adjournment. See Jeffs v. New Zealand Dairy Production and Marketing Board [[1967] 1 A.C. 551 (P.C.)], at p. 567. We are not here concerned with proof of actual prejudice, but rather with the possibility or the likelihood of prejudice in the eyes of reasonable persons.

Applying the foregoing principles, I think this appeal must succeed. The Board was aware of the possibly anomalous position of the President during the after dinner deliberations. The Chairman, vigilant in ensuring that Dr. Kane receive a fair hearing, advised the meeting that the President should not participate in discussion, nor vote. There can be no criticism of this direction. The vigilance, unfortunately, was not carried to its full length for, despite the care with which the appeal was conducted, the Board, as appears to be the case, found that it needed additional, "necessary" facts before reaching a decision, and the President furnished those facts. It is quite immaterial whether the facts were furnished by the President or, for example, another professor at the University. It cannot improve matters that the informant was the University President.

The Board was under an obligation to postpone further consideration of the matter until such time as Dr. Kane might be present and hear the additional facts adduced; at the very least the Board should have made Dr. Kane aware of those facts and afforded him a real and effective opportunity to correct or meet any adverse statement made. In the event, the Board followed neither course. The Board heard the further facts, deliberated, and ruled against Dr. Kane. In so doing, it made a fundamental error. The danger against which the Courts must be on guard is the possibility that further information could have been put before the Board for its consideration which affected the disposition of the appeal. See R. v. Architects' Registration Tribunal, Ex p. Jaggar [(1945), 61 T.L.R. 445], at p. 447.

I would allow the appeal, set aside the judgment of the Court of Appeal, and quash the resolution passed on July 5, 1977, by the Board of Governors of the University of British Columbia relative to the appellant, with costs to the appellant in all Courts.

The following are the reasons delivered by

RITCHIE J. (dissenting):-- This is an appeal from a judgment of the Court of Appeal of British Columbia dismissing an appeal from a judgment rendered at trial by Mr. Justice Macdonald whereby he dismissed the petition of the present appellant brought pursuant to the Judicial Review Procedure Act. 1976 (B.C.), c. 25, seeking to quash a resolution passed by the respondent Board of Governors on July 5, 1977, approving the suspension of the appellant from his employment as a professor at the University of British Columbia for the three months May to July 1977, inclusive.

I have had the advantage of reading the reasons for judgment prepared for delivery by Mr. Justice Dickson in this case, but as I am unable to agree with the conclusion at which he arrives on the very slender record before us, I find it necessary to express my views separately.

The judgment rendered at trial by Mr. Justice Macdonald is now conveniently reported in 82 D.L.R. (3d) at p. 494 and the reasons for judgment of the Court of Appeal of British Columbia are also now reported in 11 B.C.L.R. 318; both of these reports contain a full review of the circumstances giving rise to this appeal.

The petitioner, Julius Kane, is a professor at the University of British Columbia with tenure of appointment but it was recommended by the Deans of the Faculty of Graduate Studies and of the Faculty of Science that his employment with the University be terminated for cause, the chief complaint being that he had made improper use of the university computer facilities for personal purposes.

Professor Kane at no time disputed the allegation that he had made use of the University computer in the manner complained of, but he complained of the penalty sought to be imposed by way of termination of his services, and following a meeting which was called by the President of the University, Dr. Douglas T. Kenny, at which Kane and his counsel were present, the Deans changed their recommendation to that of suspension without salary for three months and a requirement of financial restitution to the University by Kane. President Kenny complied with this latter recommendation and issued an order in conformity with it pursuant to s. 58(1) of the Universities Act. 1974 (B.C.), c. 100 (hereinafter called the Act). Section 58 of that Act reads:

> 58. (1) The president has power to suspend any member of the teaching and administrative staffs and any officer or employee of the university.
>
> (2) Upon the exercise of the power, he shall forthwith report his action to the board with a statement of his reasons.
>
> (3) A person who is suspended under this section has a right of appeal to the board.

Professor Kane exercised the right of appeal to which he was entitled under s. 58(3) and in due course the appeal came on for hearing before a regular meeting of ten members of the Board of Governors which included the Chairman (The Honourable T. A. Dohm, Q.C.) and the President whose presence was required by s. 61 of the Act. This meeting of the Board was also attended by the Dean of Science, the Dean of Geology and the Dean of Graduate Studies together with three other faculty members. Professor Kane together with his counsel and the counsel for the Board were also present. There is no report in the record of the proceedings at this meeting of the Board of Governors but I am prepared to adopt the account contained in the judgment of the learned trial judge at 82 D.L.R. (3d) at p. 497:

> The appeal came before the board of governors at a regular meeting on July 5th. It was one of many items on the agenda. Among the members of the board present was Dr. Kenny. When the appeal came on for hearing other persons joined the meeting, including the petitioner and his counsel, Mr. Roberts. The board heard from both Mr. Roberts and Dr. Kane. Dr. Kane was questioned by board members on points he had brought forward. During the hearing president Kenny did not ask

> questions of the petitioner or Mr. Roberts. He did answer questions directed to him by other members of the board and may have responded to statements made by Dr. Kane or Mr. Roberts. At the conclusion of the hearing the chairman requested Mr. Roberts and his client to leave so that the board could deliberate. The other non-members who attended for the hearing of the appeal also left. The board's deliberations upon the appeal commenced after adjournment for dinner. Dr. Kenny did not participate in the discussions. Nor did he vote upon the resolution. He did, however, answer questions directed to him by board members.

Accepting as I do this version of the proceedings, it appears to me to be plain that at the initial meeting of the Board the appellant was given full opportunity to answer all allegations against him and to present his version of the case. This opportunity was offered to him in the presence of a group of persons who as governors must be taken to have had the welfare of the University at heart, and whose chairman, the Honourable Mr. Dohm, was a former judge of the Supreme Court of British Columbia. Evidence was given by both the appellant and President Kenny and Dean Larkin, who as Dean of Graduate Studies had been one of those responsible for recommending that the appellant's employment with the University should be terminated, and I would think it to be a fair inference that all relevant facts having to do with the plight of the appellant would have been canvassed by either one or more of these witnesses at that time. It is to be remembered that the Board was acting pursuant to statutory authority and there is no suggestion anywhere in the record that the proceedings which took place at the initial hearing were not fairly and properly conducted giving due weight to the position of the appellant and the results flowing from his suspension from office.

However, the main complaint of the appellant relates to the fact that after the hearing had terminated the Chairman, President and other members of the Board adjourned for dinner and, in the absence of the appellant and his counsel, reconvened to continue their meeting which had been concerned with a number of issues in addition to the appellant's appeal and which culminated in so far as the appellant was concerned with the passage of the resolution ordering his suspension. By para. 7 of his petition the appellant complained that:

> During the consideration by the Board of Governors of the said appeal leading to the said Resolution, the President, Douglas T. Kenny, was present and took part in the consideration and the discussion of the merits of the said appeal.

The affidavit filed by the appellant in support of his petition contained the following paragraph:

> I am informed by the said Roberts and verily believe that he was informed by a member of the Board of Governors, Mr. George Morfitt, that following the hearing of my appeal pursuant to Section 58 of the Universities Act and when the Board of Governors was considering my appeal following the hearing, the President of the University of British Columbia, Douglas T. Kenny, from whose decision the said appeal was brought, was present and took part in the discussion leading to the said Resolution.

This affidavit was dated August 8, 1977, but it is C noteworthy that an affidavit was filed by Mr. Morfitt on September 6th of the same year in which he stated as follows after having described the Board meeting:

> 11. Mr. Roberts and the petitioner left the hearing. The hearing was adjourned
> 12. Following dinner the meeting of the Board was called to order.
> 13. President Kenny did not participate in the discussions with regard to the

petitioner.

This latter affidavit constitutes the only sworn evidence coming from any member of the Board who was present at the after dinner meeting and if it stood alone there can be no doubt that it would support the contention that nothing adverse was said about the appellant at that meeting. There was, however, a letter written by the solicitor for the University to Dr. Kane's counsel in which he quotes from Mr. Morfitt in part as follows:

> While the President did provide the Board with the necessary facts relating to the Kane suspension it can be asserted that the President was at all times most careful not to take part in the consideration and the discussion of the merits of the appeal.

The words which I have italicized are treated by the appellant as being potentially prejudicial to him in that they might be taken to mean that the President stated some necessary facts relating to the Kane suspension which could be construed adversely to him and he had no opportunity to answer. This submission is supported by reference to the case of Kanda v. Government of the Federation of Malaya [[1962] A.C. 322], in which the report of an inquiry containing a most damaging indictment against Inspector Kanda as an unscrupulous scoundrel was made available to the adjudicating officer before he sat to inquire into the charge while it was withheld from Kanda. It was in these circumstances that Lord Denning said at p. 337:

> It follows, of course, that the judge or whoever has to adjudicate must not hear evidence or receive representations from behind the back of the other. The court will not inquire whether the evidence or representations did work to his prejudice. Sufficient that they might do so. The court will not go into the likelihood of prejudice. The risk of it is enough.

The facts of the Kanda case are obviously vastly different from those with which we are here concerned. In the present case Kane knew from the outset exactly what it was that he was charged with and as I have explained, he had an opportunity to present his case and to examine the witnesses against him, and it cannot in my view be suggested that the President decided to wait until Kane was absent before providing the members of the Board with facts prejudicial to Kane, what the allegations really were and the reasons why the penalty was reduced from termination to suspension. If this had been the case there would indeed have been a grave breach of good faith on the part of the President and other Board members and a denial to the appellant of the fundamental right to be heard in his own defence in breach of the elementary principles of natural justice.

In my view the statement contained in Mr. Morfitt's letter to the effect that the President provided the Board with necessary facts without in any way discussing the merits of the appeal, is too slender a thread upon which to support an accusation of such gravity against men of presumed integrity acting under a statutory authority. I say this having in mind particularly the reasons for judgment of Mr. Justice Pennell in Re Schabas and Caput of the University of Toronto [(1974), 52 D.L.R. (3d) 495], which is referred to by Macdonald, J.A., in the present case at 11 B.C.L.R. 326 and where he said:

> Subject to evidence of actual bias, I am of the opinion that the Court should be reluctant to say that a presumption of bias can arise in so far as it relates to the personnel of a quasi-judicial body where the composition of the tribunal is specifically authorized by the Legislature: ... It is to be assumed that a body of men entrusted by the Legislature with large powers affecting the rights of others will act with good faith.

The Latin maxim "omnia praesumuntur rite acta esse ..." has been interpreted as meaning that where acts are of an official nature or require the concurrence of official persons a presumption arises in favour of their due execution. The maxim is an old one but not I think dead in the administration of our law, and in my view it expresses a principle applicable to the present circumstances. In Halsbury's Laws of England, 3rd ed., vol. 10, at p. 457 it is said:

> The presumption omnia rite esse acta (for example, that a man who has acted in a public capacity was duly appointed and has properly discharged his official duties) is common to criminal and civil proceedings.

For all these reasons, as well as for those contained in the reasons for judgment of Mr. Justice McFarlane and in the cases decided in this Court to which he has made reference, I would dismiss this appeal with costs.

Appeal allowed with costs, RITCHIE J. dissenting.

Tab 14

Indexed as:
Apotex Fermentation Inc. v. Novopharm Ltd.

Between
Apotex Fermentation Inc. and Apotex Inc., (Plaintiffs) Appellants, and
Novopharm Ltd., Albert D. Friesen, Jagroop Dahiya, Leslie Dan, Sydney Smith, Rafik Henein, KrKa P.O., (Defendants) Respondents

[1994] M.J. No. 357

[1994] 7 W.W.R. 420

95 Man.R. (2d) 241

29 C.P.C. (3d) 48

56 C.P.R. (3d) 20

48 A.C.W.S. (3d) 1231

Suit No. AI 94-30-01691

Manitoba Court of Appeal

Huband, Philp and Kroft JJ.A.

Heard: May 27, 1994.
Judgment: June 13, 1994.

(14 pp.)

Master and servant -- Duties of servant -- Duty of confidentiality, interference by employer -- Injunctions -- Practice -- Appeals.

Appeal from a judgment granting a motion to vacate an interim injunction in an action for damages for breach of covenant of non-disclosure of secret and confidential information. The appellant argued that while the risk of irreparable harm was a necessary element it was to be considered and determined along with the other elements required for injunctive relief.

HELD: Appeal allowed with costs.

QL Update: 940928
d/sdd

D.C.H. McCaffrey, Q.C., G.P.S. Riley and J.A. Myers, for the Appellants.
E.W. Olson, Q.C. and L.C. Mitchell, for the Respondent Dahiya.
D.T. Stockwood, Q.C., and R.S. Literovich, for the remaining Respondents.

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1 **HUBAND J.A.**:-- The plaintiff companies (Apotex) and the defendant Novopharm Ltd. (Novopharm) are in the same business; the development, manufacture and sale of generic drugs. The material which forms part of the record before us indicates that the process of obtaining approval is a long and arduous one, but if a drug is developed, and is blessed with approval by the federal government, the rewards can be very significant.

2 The individual defendants other than Jagroop Dahiya (Dr. Dahiya) are part of the Novopharm management team.

3 Dr. Dahiya was employed as a scientist by Apotex. Commencing in June of 1988 be entered into an employment contract containing a covenant that be would not disclose any secret or confidential information during or subsequent to his employment with Apotex. He entered into further contracts with Apotex in December of 1989 and February of 1991. The latter agreement, containing the same negative covenant as the first agreement, was in effect when Dr. Dahiya ended his employment at Apotex. Soon thereafter be joined Novopharm.

4 Apotex claims in its statement of claim that Dr. Dahiya breached his covenant of non-disclosure of secret and confidential information. All of the defendants deny the breach.

5 On August 12, 1993 Apotex applied for and obtained an interim injunction and an Anton Piller order on an ex parte basis. In early September a flurry of affidavits had been filed and Oliphant A.C.J.Q.B. heard a contested motion by the plaintiffs to convert the ex parte injunction into an interim injunction pending trial. On September 9, 1993 Oliphant A.C.J.Q.B. granted the order, the effect of which was to restrain Dr. Dahiya and Novopharm from any further research and development work with respect to certain drugs which Dr. Dahiya had been working on while employed by Apotex. In his reasons for decision be concluded that the plaintiffs had established a strong prig facie case, that the balance of convenience favoured them, and that they would suffer irreparable harm if the order was not granted. No appeal was taken from that order.

6 The expectation was that the trial would take place in January of 1994. But as the January date approached, it became evident that the case could not proceed on such an early date. The parties have agreed to, and the court can accommodate, a trial in September of 1994.

7 Given the delay in the scheduled trial, all of the defendants, save for Dr. Dahiya, brought a motion before Oliphant A.C.J.Q.B. seeking a variation of his order of September 9, 1993, and in particular seeking the right to proceed with work on two drugs called Lovastatin and Cyclosporin. The interim injunction would remain in effect with respect to Dr. Dahiya.

8 The court granted the motion. In the course of his reasons for decision Oliphant A.C.J.Q.B. referred to and relied upon the reasons for decision of Twaddle J.A. in Pereira v. Smith, [1993] 8 W.W.R. 607

Man.C.A.) as support for his conclusion that proof of irreparable harm proof that damages will not be an adequate remedy) is a condition precedent to the granting of or maintenance of an injunction. The defendant Novopharm was able to satisfy Oliphant A.C.J.Q.B. that, with certain safeguards in place, no irreparable barm was likely. Oliphant A.C.J.Q.B. noted that it takes several years of dealings with the federal bureaucracy before a new drug comes onto the market, - long after the intended trial in September of this year.

9 Having decided that no irreparable harm prior to trial was likely, Oliphant A.C.J.Q.B. concluded that it was not necessary to go further and consider either balance of convenience or the strength of the plaintiffs' case.

10 Apotex now appeals contending that while the risk of irreparable harm is a necessary element, it is normally to be considered and determined along with the other elements which are required to sustain injunctive relief, namely, the balance of convenience and the potential merits of the case. Apotex argues that the learned motions judge misinterpreted the reasons of Twaddle J.A. in Pereira v. Smith, and that the entire matter must now be referred back to him for further consideration.

11 We agree with the submission by counsel for Apotex that this Court was not intending any dramatic alteration in the law as a result of the decision in Pereira v. Smith.

12 The Pereira case was one where, as Twaddle J.A. remarked, "damages would clearly be an inadequate remedy for the plaintiff." Thus he was able to deal with that element first, as a condition precedent, and then move on to a consideration of the other factors. Where there is some doubt or argument whether damages will prove an adequate remedy, it was not intended that a determination of that issue should be severed and determined separately from a consideration of the other factors.

13 I have no doubt that there will be cases in the future where it will be self-evident, without reference either to the merits of the case or the balance of convenience, that damages either are or are not an adequate remedy, and it will make sense to deal with that issue first. Where, as in Pereira v. Smith, it is obvious that there will be irreparable harm, the court can then concentrate on the remaining elements. Where it is obvious that damages are an adequate remedy, it will be unnecessary to continue the inquiry.

14 Similarly, there will be cases where on the face of it the merits of the plaintiff's case are so wanting that the judge at the outset of the hearing will have no difficulty rejecting an application for injunction on that ground alone. Ordinarily, however, the three requirements which are usually necessary to support injunctive relief are to be considered, not as separate hurdles but as interrelated considerations. The approach which will normally be taken by the court in considering an interlocutory injunction is well set forth in R.J. Sharpe, Injunctions and Specific Performance (2nd ed. 1992) at pp. 2-32-34:

> The terms "Irreparable harm", "status quo" and balance of convenience" do not have a precise meaning. They are more properly seen as guides which take colour and definition in the circumstances of each case. More importantly, they ought not to be seen as separate, water-tight categories. These factors relate to each other, and strength on one part of the test ought to be permitted to compensate for weakness on another. It is not clear that the Cyanamid [[1975] A.C. 396] approach allows for this and the decision suggests a misleadingly mechanical approach. The Manitoba Court of Appeal has quite properly held that "it is not necessary ... to follow the consecutive steps set out in the American judgment in an inflexible way; nor is it necessary to treat the relative strength of each party's case only as a last step in the process."
>
> The checklist of factors which the courts have developed - relative strength of

> the case, irreparable harm and balance of convenience - should not be employed as a series of independent hurdles. They should be seen in the nature of evidence relevant to the central issue of assessing the relative risks of harm to the parties from granting or withholding interlocutory relief.

15 Counsel for Novopharm acknowledged that the decision in Pereira v. Smith was not an attempt to make a fundamental change in the law. Rather, he argued that there are cases, this being one of them, where the approach taken by Oliphant A.C.J.Q.B. is both justified and desirable. When it is determined that damages are a sufficient remedy, there is no point in a lengthy examination of the merits of the case and the balance of convenience which will only result in the parties incurring unnecessary costs.

16 That may be so in some cases, but I do not think that consideration of the other factors should be avoided in the present case. Apotex seeks to enforce a restrictive covenant. The reasonableness of it has not been contested. These are the kinds of cases where irreparable harm is assumed. In Miller v. Toews, [1991] 2 W.W.R. 604, this Court upheld an interlocutory injunction restraining the defendants from operating a business in contravention of a covenant given to a purchaser on the sale of a previous business. Among other cases, Twaddle J.A. referred to the judgment of Megarry J. in Hampstead & Suburban Properties Ltd. v. Diomedus, [1969] 1 Ch. 248, [1968] 3 All E.R. 545 at 550, who wrote in these terms:

> Where there is a plain and uncontested breach of a clear covenant not to do a particular thing, and the covenantor promptly begins to do what he has promised not to do, then in the absence of special circumstances it seems to me that the sooner he is compelled to keep his promise the better ... I see no reason for allowing a covenantor who stands in clear breach of an express prohibition to have a holiday from the enforcement of his obligation until the trial. It may be that there is no direct authority on this point; certainly none has been cited. If so, it is high time that there be such authority; and now there is.

17 In the Miller v. Toews decision itself Twaddle J.A. went on to state at pp. 607-8:

> ... when a negative covenant of this kind is reasonable on its face, the person who gave it will have a heavy burden to show that his escape from the bargain will not cause irreparable harm to the covenantee and that the balance of convenience so substantially favours him (the person who gave the covenant) that it would be unjust to restrain his activities until the trial.

18 As has been noted, the injunction has remained in effect with respect to Dr. Dahiya. It would be a strange result indeed if Dr. Dahiya was restrained by an injunction, but those to whom he may have already passed on confidential information in breach of a covenant are free to use that information pending a trial.

19 Given the existence of the restrictive covenant, I am of the view that the issue of irreparable harm is not as clear as it appeared to the learned motions judge, even taking into account the dilatorious government approval process. The inquiry on the motion to vary the interim injunction ended prematurely without a full vetting of all factors.

20 The argument for Novopharm was not that damages would be an adequate remedy if a wrong has been committed causing injury to Apotex. Rather, the argument was that no injury is likely to occur prior to trial. However, with valuable confidential information in the possession of and being used by Novopharm's employees, it becomes highly questionable whether injury can be prevented during the period leading to trial. The restrictive covenant resolves the issue in favour of Apotex. If injury did occur, the quantification of damages would be extremely difficult.

21 I would allow the appeal with costs. The interim injunction is reinstated pending trial or until a further consideration of the application to vary is again brought before the learned motions judge.

22 There is another aspect of this case which requires comment.

23 Part of the record before this Court consists of a transcript of hearing before Oliphant A.C.J.Q.B..

24 At the outset, the learned judge indicates that there are some housekeeping matters to be addressed:

> The Court: The number one: Is the door locked?
>
> The Clerk: Yes, it is, My Lord.

25 Thus assured, the hearing proceeded for four days. Presumably the door was locked for that duration.

26 The order ultimately granted was not attacked by the appellant Apotex as invalid by reason of the closed court room. Apotex was not in a position to raise the argument since, we are now told, earlier proceedings had been handled in precisely the same way. This particular file has not been open to any public scrutiny, and is not listed in the Court of Queen's Bench computer listing.

27 This Court has deep concerns about these practices even if the parties do not, and so the matter was raised by the Court itself.

28 The starting point must be the statement of Lord Halsbury in the decision of the House of Lords in Scott v. Scott, [1913] A.C. 417 at 440, "I am of opinion that every Court of justice is open to every subject of the King."

29 That specific statement was subsequently endorsed and expanded upon by Lord Blanesburgh in the reasons for decision of the Privy Council on appeal from the Supreme Court of Alberta in McPherson v. McPherson, [1936] A.C. 177. The McPherson case considered the validity of a divorce decree which was granted after a hearing in a judges' library where the word "private" was affixed to the door. The Privy Council concluded that the decree which was granted was voidable by reason of the private nature of the hearing (at p. 200):

> ... there was no actual exclusion of the public, although there was no actual public attendance. No such exclusion was intended nor, possibly, even desired. The learned judge would probably have been gratified by the presence of a small audience. But, even although it emerges in the last analysis that their actual exclusion resulted only from that word "private" on the outer door, the learned judge on this occasion, albeit unconsciously, was, their Lordships think, denying his Court to the public in breach of their right to be present, a right thus expressed by Lord Halsbury in Scott v. Scott: "Every Court of justice is open to every subject of the King."
>
> To this rule, there are, it need hardly be stated, certain strictly defined exceptions. Applications properly made in chambers, and infant cases, may be particularized. But publicity is the authentic hall-mark of judicial as distinct from administrative

> procedure, and it can be safely hazarded that the trial of a divorce suit, a suit not entertained by the old Ecclesiastical Courts at all, is not within any exception.
>
> The actual presence of the public is never of course necessary. Where Courts are held in remote parts of the Province, as they frequently must be, there may be no members of the public available to attend. But even so, the Court must be open to any who may present themselves for admission. The remoteness of the possibility of any public attendance must never by judicial action be reduced to the certainty that there will be none.

30 Both the McPherson case and the Scott case make it clear that there are exceptions to the general rule that the courts must be open to all.

31 This is all consistent with the provisions of secs. 76 and 77 of The Court of Queen's Bench Act, which calls for open public hearings and open court files, but allows exceptions where there is a "possibility of serious harm or injustice" were the hearing to be open to the public.

32 Not surprisingly, one of the exceptions which has developed (and there are few of them) relates to trade or manufacturing secrets. In his reasons for judgment in Scott v. Scott, Earl Loreburn made this observation (at p. 445):

> It has been held that when the subject-matter of the action would be destroyed by a hearing in open Court, as in a case of some secret process of manufacture, the doors may be closed. I think this may be justified upon wider ground. Farwell L.J. aptly cites Lord Eldon as saying, in a case of quite a different kind, that he dispensed with the presence of some of the parties "in order to do all that can be done for the purposes of justice rather than hold that no justice shall subsist among persons who may have entered into these contracts." An aggrieved person, entitled to protection against one ma who has stolen his secret, would not ask for it on the terms that the secret was to be communicated to all the world. There would be in effect a denial of justice.

33 The present case involves secret formula, and I can well appreciate that the parties will not wish to share their secrets with the outside world.

34 But steps can be taken to protect the parties from the loss of confidential information without necessarily closing the court room, or the court records, entirely to public access. The stating point should be that the court room is open and public access denied only to the extent necessary to ensure the protection of the secret information. In the hearing which took place before this Court, no part of the record contained secret formulas, and argument could and did take place in open court without concern.

35 Moreover, the onus is upon the party or parties to satisfy the court that the closure of the court room, and/or the court records, to public access in whole or in part is justified as an exception to the general rule. In his reasons in the Scott case, the Earl of Halsbury states that a hearing open to the public must be insisted upon (at p. 442):

> ... and that to justify an order for hearing in camera it must be shewn that the paramount object of securing that justice is done would really be rendered doubt of attainment.

36 In the instant case there is nothing on the record indicating that either party was put to the test of justifying a hearing behind locked doors on the motion to vary the prior order of the court. It would seem that no justification existed.

37 Where a party does request an in camera hearing, and it falls within a traditional exception to the rule of an open court room, the court should impose as few restrictions as possible on public access, while still preserving the ability to do justice in the case before it. So, it may be practical to keep secure certain documents or certain affidavits, or parts of them. The court room might be closed while certain witnesses testify within a sensitive area. The approach should be to minimize, as much as possible, the exclusion of the public.

38 Having raised its concerns, counsel for the parties were invited to consider the matter and return with their own proposals as to how the trial or other pretrial proceedings might be conducted. We are pleased to have received a joint brief containing a list of recommendations which the parties agree should be applied to their case. We are glad to endorse those recommendations, which are attached as Appendix A to these reasons, except that the fifth recommendation should not apply to documents which contain no confidential material.

Appendix A

1. The proceedings should be listed in the computer registry.
2. When the parties are in court for a hearing, the fact that there is a proceeding should be posted on the bulletin boards at the Law Courts Building.
3. Subject to the remaining recommendations, the court room should be open to the public.
4. The pleadings (statement of claim, amended statement of claim, statements of defence, reply and motions) ought to be available to the public.
5. Affidavits filed for the various motions, exhibits, answers to undertakings and expert reports should continue to be sealed to protect the confidential information contained therein.
6. During the course of future motions and the trial, the parties may request the presiding Justice to conduct a part of the motion or trial in camera, if required, to preserve the confidential nature of the secret processes that are at issue.
7. The parties may also request that the court order a publication ban in relation to certain evidence to protect the proprietary information and trade secrets of the parties.
8. The parties may also request that the court be cautious in the wording of its reasons for decision to prevent public disclosure of secret processes.

HUBBAND J.A.
PHILP J.A.
KROFT J.A.

IN THE MATTER OF THE *COMPANIES CREDITORS' ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION

Court File No. CV-12-9667-00-CL

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