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

FACTUM OF ERNST & YOUNG LLP
(Motion Seeking Leave to Appeal)

August 20, 2012

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FACTUM OF ERNST & YOUNG LLP

PART I - OVERVIEW

1. The moving party, Ernst & Young LLP ("**E&Y**") seeks leave to appeal the order of the Honourable Justice Morawetz dated July 27, 2012 (the "**Order**") declaring, *inter alia*, that the claims brought by E&Y against the Applicant, Sino-Forest Corporation ("**SFC**", the "**Company**" or the "**Applicant**") and its directors and officers, constitute "equity claims" as defined under section 2 of the *Companies Creditors Arrangement* Act, R.S.C. 1985, c. C-36 (the "**CCAA**").

2. There are serious and arguable grounds of appeal that are of real and significant interest to the parties, the insolvency practice generally and this proceeding. The appeal is *prima facie* meritorious and will not unduly delay the progress of the action:

(a) The Order has a direct and immediate consequence on E&Y's capacity to vote upon a restructuring plan of arrangement filed by SFC (see section 22.1 of the CCAA) and upon E&Y's right to be classified and paid as an unsecured creditor under such plan of arrangement (see section 6(8) of the CCAA);

(b) The legal issue at the core of this appeal is of great significance and importance to restructuring practice generally as it relates to the very definition of "equity claim" which was introduced into the CCAA (and the *Bankruptcy and Insolvency* Act, R.S.C. 1985, c. B-3 (the "**BIA**") in the context of the global reform of Canadian insolvency statutes which came into force in September 2009. The meaning and breadth of section 2(1)(e) of the CCAA has not yet been analyzed by this Court nor by any other Canadian appellate Court and is very likely to arise in

the context of numerous CCAA restructurings to come. Moreover, the pre-amendment jurisprudence on this very point is conflicting;

(c) The appeal is relevant and significant to the risk-shifting to third party auditors, who do not accept the same risks as shareholders of a corporation. The policy reasons behind the 2009 amendments to the CCAA do not support the interpretation that significant additional risk be borne by third party auditors; and

(d) The appeal will not unduly hinder the progress of SFC's CCAA proceedings.

PART II - THE FACTS

3. During the relevant periods, E&Y was retained as SFC's auditor.

Reference Description of Claim of E&Y, attached as Exhibit A (Schedule A2) to the Affidavit of Christina Shiels sworn June 21, 2012 ("Shiels Affidavit"), Motion Record of E&Y (Motion for Leave to Appeal), Tab 4AA2, at para. 1

4. On June 2, 2011, a short-seller, Muddy Waters LLC, issued a report which purported to reveal alleged fraud at the Company and cast various aspersions on the Company's advisors. In the wake of that report, Sino-Forest's share price plummeted and Muddy Waters profited handsomely from its short position.

Reference Pre-Filing Report of the Proposed Monitor, March 20, 2012, Motion Record of the Underwriters named in Class Action (Motion Seeking Leave to Appeal), Tab 6, para. 14

5. E&Y was served with a multitude of class action claims in numerous jurisdictions including Ontario and Quebec.

Reference Description of Claim of E&Y, attached as Exhibit A (Schedule A2) to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), Tab 4AA2, at paras. 11-14

6. The plaintiffs in the Ontario Class Action claim damages in the aggregate, and against all defendants, of $9.2 billion on behalf of resident and non-resident shareholders and noteholders. The causes of action alleged are both statutory, under the *Securities Act (Ontario)*, and at common law, in negligence and negligent misrepresentation. The central claim is that Sino-Forest and its advisors, including the auditors and underwriters, misrepresented that the Company's financial statements complied with generally accepted accounting principles. The claims against E&Y and the other third party defendants are that they failed in their gatekeeping function. Similar claims are advanced in the Quebec and U.S. actions, (together with the Ontario Class Action, the "Class Actions").

Reference Particularized Claim, attached as Exhibit A (Schedule A1) to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), Tab 4AA1, at para. 6

Fresh as Amended Statement of Claim in the Ontario Class Action, attached as Exhibit A to the Affidavit of Elizabeth Fimio, sworn June 8, 2012 ("Fimio Affidavit"); Originating Documents in Quebec Class Action, attached as Exhibit B to the Fimio Affidavit; and, Complaint in New York Class Action, attached as Exhibit C to the Fimio Affidavit, Motion Record of the Underwriters Named in Class Actions (Motion Seeking Leave to Appeal), Tabs 4A, 4B, 4D

7. On March 30, 2012, the CCAA Court granted the Initial Order, which stayed the proceedings. On April 13, 2012, the CCAA Court extended the Stay until June 1, 2012, and on May 31, 2012 extended the stay to September 28, 2012. On May 8, 2012, the CCAA Court ordered that the Stay extend to the third party defendants to the Ontario Class Action, including E&Y.

Reference Fourth Report of the Monitor, July 10, 2012, Motion Record of the Underwriters Named in Class Actions (Motion Seeking Leave to Appeal), Tab 8, para 1

Initial Order of Justice Morawetz, March 30, 2012, Motion Record of the Underwriters Named in Class Actions (Motion Seeking Leave to Appeal), Tab 10

8. On May 14, 2012, the CCAA Court issued an order (the "**Claims Procedure Order**") setting out the manner in which creditors' claims against SFC would be dealt with and addressed in the context of SFC's CCAA proceedings. The Claims Procedure Order was issued following the presentation by SFC of a motion in this regard which proceeded on an unopposed basis following extensive discussions amongst the stakeholders including, *inter alia*, SFC, E&Y, the Class Action plaintiffs and the other Class Action defendants.

9. Pursuant to the Claims Procedure Order:

(a) Proofs of Claim were directed to be filed with the Monitor by any party advancing a claim be filed by no later than June 20, 2012;

(b) the Monitor, in consultation with the Applicant and the directors and officers named in the Proof of Claim as applicable, shall review all Proofs of Claim and D&O Proofs of Claim;

(c) the Monitor may attempt to resolve any claims and may by notice in writing revise or disallow in whole or in part the amount and/or status of any Proof of Claim or D&O Proof of Claim;

(d) where a purported Proof of Claim or D&O Proof of Claim is revised or disallowed, the Monitor shall deliver to the Claimant a notice of revision or

disallowance attaching a form of Dispute Notice (as defined in the Claims Procedure Order);

(e) in respect of any Proof of Claim or D&O Proof of Claim that exceeds $1 million, the Monitor and the Applicant shall not accept, admit, settle, resolve, value (for any purpose), revise or reject such Proof of Claim or D&O Proof of Claim without order of the Court; and

(f) a Claimant who intends to dispute a notice of revision or disallowance shall file a dispute notice with the Monitor, and failing a resolution or settlement of such disputed claim, the Monitor shall seek direction from the Court on the correct process for the resolution of the dispute. Without limitation, this "includes any dispute arising as to whether a claim is or is not an 'equity claim' as defined in the CCAA".

10. In accordance with the Claims Procedure Order, E&Y filed with the Monitor a Proof of Claim against SFC and its subsidiaries and a Proof of Claim against the directors and officers of SFC and its subsidiaries on June 20, 2012.

E&Y's Proof of Claim against Sino-Forest Corporation

11. E&Y has contractual claims of indemnification against SFC and its subsidiaries for all relevant years, in respect of its annual audits as well as related to prospectuses and debt offerings. E&Y has statutory and common law claims of contribution and/or indemnity against SFC and its subsidiaries for all relevant years. As evidenced in the E&Y Proof of Claim, E&Y also has stand-alone claims for breach of contract and negligent and/or fraudulent misrepresentation against the Company and its directors and officers.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), at Tabs 4A

12. The relationship between E&Y on the one hand, and SFC, the SFC Subsidiaries and their respective directors and officers on the other, was at all material times at arm's length. E&Y contracted with SFC to provide it with auditing services upon terms established by a series of engagement letters (the "**Engagement Letters**") for 2007 through and including 2010, attached as Schedule C1 to the Proof of Claim against the Company.

Reference Engagement Letters, attached at Exhibit A (Schedule C) to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), at Tab 4AC

13. Management of SFC and the SFC Subsidiaries was and is responsible for the preparation and fair presentation of SFC's consolidated financial statements, which SFC prepared and issued, and contracted with E&Y on behalf of SFC and the SFC Subsidiaries to audit. Management was responsible for the preparation of those consolidated financial statements in accordance with Canadian generally accepted accounting principles ("**GAAP**"), and for such internal controls as management determined were necessary to enable the preparation of consolidated financial statements that were free from material misstatement, whether due to fraud or error.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), at Tabs 4A, 4AA1, 4AA2

14. The Board of Directors of SFC approved the consolidated financial statements. The consolidated financial statements were accompanied in all cases by representations from management.

15. E&Y's responsibility was to express an opinion on those consolidated financial statements based on its audits conducted in accordance with Canadian generally accepted auditing standards ("**GAAS**").

16. E&Y had a direct professional relationship with SFC and with each of the SFC Subsidiaries.

17. E&Y as auditor of SFC did not have any relationship with the equity or debt holders of SFC in their capacity as security holders of SFC. E&Y was not a shareholder, other equity holder or a holder of funded debt of SFC or any SFC Subsidiary.

Reference Proof of Claim of E&Y, attached as Exhibit A to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), at Tab 4A

The Decision Below

18. By way of Notice of Motion dated June 8, 2012 (and seeking a hearing date of June 15, 2012), the Applicant brought a motion to have the anticipated claims of the plaintiffs in the class actions and the anticipated claims for contribution and indemnity of E&Y and other third parties declared "equity claims" under the CCAA. As stated above, the claims bar date under the Claims Procedure Order was June 20, 2012. The motion was brought in an evidentiary vacuum and notwithstanding the fact that the Claims Procedure Order expressly provided that the nature, quality or quantity of the claims against the Applicant would be determined in the context of the claims process. No such determination was (or has to date) been made.

19. SFC sought an order declaring that:

(a) any claims made against the Applicant in the context of the CCAA proceedings resulting from the ownership, purchase or sale of an equity interest in SFC, are "equity claims" as defined by section 2 of the CCAA, including, without limitation, the claims by or on behalf of current or former shareholders asserted in the proceedings as listed in Schedule "A" to the Order;

(b) any claims for indemnification made against SFC related to or arising from the Shareholder Claims are "equity claims" as defined by section 2 of the CCAA, including, without limitation, claims for indemnification made by or on behalf of any of the other defendants to the proceedings listed on Schedule "A" to the Order; and

(c) a direction that the order sought is without prejudice to SFC's right (but not the right of any other party) to apply for a similar order with respect to any claims (or indemnification claims) that are in respect of securities other than shares.

20. The Company and the Monitor specifically submitted that the Order sought would not apply to SFC's subsidiaries.

21. The motion was heard on June 26, 2012.

22. By way of endorsement and Order dated July 27, 2012, the Court below granted the Motion in part and concluded that:

(a) The Motion was not premature notwithstanding the terms of the Claims Procedure Order;

(b) The claims of SFC's shareholders against the Applicant are "equity claims" under section 2 of the CCAA;

(c) The most significant portion of the claims of E&Y against SFC as well as those of BDO and the Underwriters should be characterized as "equity claims" under section 2 of the CCAA, insofar as they are "being used to recover an equity investment" and relate to the claims brought by SFC's shareholders; and

(d) Defence costs incurred and to be incurred by E&Y in defending the class actions may not necessarily constitute equity claims insofar as they may not be "in respect of an equity claim" should the shareholders be ultimately unsuccessful in their class action proceedings brought against SFC.

PART III - THE PROPOSED ISSUES ON APPEAL

The proposed questions to be determined on appeal are:

(1) Were the Motion and the Order of the Court below premature?

(2) Did the Court below err in concluding that a significant portion of the claims of E&Y against SFC constitute "equity claims" under section 2(e) of the CCAA?

PART IV - LAW AND ARGUMENT

(A) Test for Leave to Appeal

23. In accordance with the provisions of the CCAA and the *Rules of Civil Procedure*, leave is required from this Court of Appeal before E&Y's appeal can be heard. The following factors are relevant to whether leave should be granted:

(a) The point on appeal is of significance to the practice;

(b) The point is of significance to the action;

(c) The appeal is *prima facie* meritorious and not frivolous; and

(d) The appeal will not unduly hinder the progress of the action.

Reference *Re Blue Range Resources*, 2000 ABQB 4 (CanLII), , E&Y Brief of Authorities, Tab 1

National Bank of Canada v. *Merit Energy Ltd.*, 2001 ABQB 583 (CanLII), E&Y Brief of Authorities, Tab 2

Re : Earthfirst Canada Inc., 2009 ABQB 316 (CanLII) (Ont. S.C.J.), E&Y Brief of Authorities, Tab 3

24. As set out below, the test is met.

(B) The Matter Has Significance to the Practice

25. The relevant provisions of the CCAA came into force in 2009 and have not been interpreted by any appellate court in Canada. As set out below, the pre-amendment jurisprudence is conflicting on the very matter at issue in the proposed appeal. The Court of Appeal's guidance on the interpretation of "equity claims" particularly as they relate to indemnity claims by third parties, such as E&Y as auditor, will be significant to insolvency practice generally.

26. More generally, the matter at issue is also relevant and significant to the risk-shifting to third party auditors, which results from the decision of the learned judge, an effect well outside the policy underlying the statutory amendments to, and the purpose of, the CCAA.

(C) The Matter Has Significance to the Action

27. The appeal is of profound significance to this proceeding. The CCAA provides that holders of equity claims cannot vote on a Plan of Arrangement, nor participate in any distribution to creditors until all other categories of creditors have been paid in full. Classifying E&Y's claim as an equity claim subordinates that claim to the claims of all creditors, both secured and unsecured. There is no expectation that holders of "equity claims" will recover anything in this CCAA process. The matter at issue in the appeal is of critical importance to E&Y and the other third party claimants.

(D) The Appeal is Meritorious and Not Frivolous

28. The proposed questions on appeal are meritorious and not frivolous.

(1) Were the Motion and the Order of the Court below premature?

29. As outlined above, on May 14, 2012, the CCAA Court granted the Claims Procedure Order on an unopposed basis.

30. E&Y and other creditors of SFC duly filed proofs of claim in the CCAA proceedings pursuant to the Claims Procedure Order, assuming that the nature of their rights resulting from such claims against SFC would be determined in accordance with the Claims Procedure Order.

31. However, prior to any determination of those proofs of claim, SFC, supported by the Monitor, effectively pre-empted the Claims Procedure Order and brought the Motion in order to pre-determine whether or not the claims of E&Y, BDO and the Underwriters constitute "equity claims" as defined under CCAA.

32. The Court below erred in concluding that the Motion was not presented prematurely and should have concluded that the nature of and rights resulting from the Shareholder Claims and Related Indemnity Claims must be addressed in the context of the Claims Procedure Order.

33. It is indeed important to bear in mind that the conclusion reached by the Court below as to the nature of such claims was made absent sufficient and adequate evidence in this regard.

(2) **Did the Court below err in concluding that a significant portion of the claims of E&Y against the Applicant constitute equity claims under section 2(e) of the CCAA?**

34. The Court below found that the Related Indemnity Claims constitute "equity claims" as defined under section 2 of the CCAA based upon the following rationale:

(a) "the Related Indemnity Claims are being used to recover an equity investment";

(b) "it would be totally inconsistent... to enable the auditors or the Underwriters, through a claim for indemnification to be treated as creditors when the underlying actions of the shareholders cannot achieve the same status". Such treatment "would potentially put the shareholders in a position to achieve creditor status through their claims against E&Y, BDO and the Underwriters"; and

(c) the plain language of section 2(1)(e) of the CCAA leads to the conclusion that the Related Indemnity Claims constitute a "contribution or indemnity" in respect of shareholder Claims which themselves constitute equity claims under section 2(1)(d) of the CCAA.

Reference Endorsement dated July 27, 2012 at paras. 79, 82-84 and 89-90, Motion Record of E&Y (Motion for Leave to Appeal), Tab 3

35. These conclusions reached by the Court below are erroneous: as is more fully detailed hereafter, it is evident under section 2 of the CCAA, that the claims of E&Y against SFC are not claims in respect of an equity interest: SFC's auditors do not hold equity in SFC and are not exercising a claim to "recover an equity investment".

36. It is also evident that allowing E&Y to be treated as an unsecured creditor would not have the effect of granting shareholders of SFC the status of creditor in SFC's CCAA proceedings and, *ipso facto*, lead to a result inconsistent with the principles of CCAA. The claims of E&Y against SFC should thus be treated as general unsecured claims against SFC for all relevant purposes under CCAA.

(a) The substance of the relationship between E&Y and SFC

37. To determine whether the E&Y claim is an equity claim or not, consideration must be given to the substance of the relationship between E&Y and SFC, as Courts have done in this context.

> Guidance on the appropriate approach to the issue of characterization was provided by the Ontario Court of Appeal in Re Central Capital Corporation [7]. (...) 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.

Reference *Nelson Financial Group Ltd., supra,* at para. 29, E&Y Brief of Authorities, Tab 10

Central Capital Corp., (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at paras. 116, 119, 120, E&Y Brief of Authorities, Tab 4

Re Blue Range Resource Corporation, supra, at para. 26, E&Y Brief of Authorities, Tab 1

38. For this analysis, the "Engagement Letters" between E&Y and SFC are centrally important. The Engagement Letters stipulate that E&Y was retained as an independent service provider to be paid based upon a fixed or an hourly basis, and in any case entirely independently of SFC's revenues or financial performance.

39. E&Y's remuneration has never been dependent upon SFC's profits.

40. E&Y has never been a shareholder of SFC or of any SFC Subsidiary nor did it ever hold any equity of SFC or any SFC Subsidiary.

41. In its role as auditor of SFC, E&Y contracted to express an opinion on the consolidated financial statements of SFC and the SFC Subsidiaries. E&Y had a direct contractual and professional relationship with each of those entities.

42. Undoubtedly, the substance of the relationship between E&Y and SFC can in no way be considered one of equity.

(b) The law prior to the proclaiming in force the new CCAA provisions

43. Only since 2000 has Canadian jurisprudence begun filling the legislative void with respect to the treatment of claims brought by shareholders against a debtor company.

44. Prior to the 2009 legislative amendments, Canadian courts had held that:

(a) Claims by shareholders seeking to recover the loss of share value or other shareholder interest ought to be subordinated to unsecured claims, regardless of the legal basis of such claims;

Reference *Re Blue Range Resources, supra,* at para. 57, E&Y Brief of Authorities, Tab 1

National Bank of Canada v. Merit, supra, at para. 55, E&Y Brief of Authorities, Tab 2

(b) Claims by third parties, including auditors, seeking indemnification from the debtor company for litigation relating to its shares, were not subordinated and ranked equally with unsecured claims.

Reference *National Bank of Canada v. Merit, supra,* at paras. 72 and 80.

45. Pursuant to Canadian jurisprudence, claims by shareholders generally fell in two categories: (1) claims in tort for negligent or fraudulent misrepresentation, and (2) claims in contract pursuant to an indemnity agreement.

46. Prior to the 2009 amendments to the CCAA, Courts subordinated both these types of claims brought by shareholders of an insolvency company as a result of the very nature of a shareholder's ownership interest and the consequences that flow therefrom.

(i) Claims by Shareholders in Tort

47. In *Re Blue Range Resources*, the first decision on this matter by a Canadian court, the Alberta Court of Queen's Bench held that a claim by a shareholder for fraudulent misrepresentation made by the debtor company at the time of the issuance of shares was in substance a claim for a return of the shareholders' capital investment. As such, Romaine J. held that the shareholders' claim ought to be subordinated to unsecured claims.

Reference *Re Blue Range Resources, supra,* at paras. 25 and 57, E&Y Brief of Authorities, Tab 1

48. In the absence of any Canadian case law on this matter, Romaine J. based her decision on the following five policy reasons:

(a) Recovery by shareholders on a *pari passu* basis with creditors would contravene the fundamental corporate law principle that a claim in damages by a shareholder for a return of the amount paid for the shares should rank below creditors in an insolvency;

(b) The expectation of creditors who conduct business with corporations upon the assumption that they would be given priority over the shareholders should not be disturbed;

(c) The investment of shareholders is inherently a risky one compared to creditors' interest to receive payment;

(d) United States case law supported the subordination of shareholders' claims based on fraud in an insolvency context; and

(e) Recovery by shareholders on a *pari passu* basis with creditors would open the floodgates to tort claims by shareholders in the context of CCAA proceedings.

49. These policy reasons underline the amendments brought to the CCAA in 2009 which sought to codify the treatment of shareholder claims under pre-amendment case law.

50. An application of these policy reasons to this matter leads to the conclusion that E&Y's claim against the Company should not have been qualified as an equity claim by the Court below and should not be subordinated to creditor claims.

(ii) Claims by Shareholders Pursuant to Indemnity Agreements

51. Claims by shareholders pursuant to indemnity agreements with a debtor company, whereby the latter is obligated to indemnify shareholders, have also been subordinated in the context of CCAA proceedings.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 39, 51 to 55, E&Y Brief of Authorities, Tab 2

Re Earthfirst Canada Inc., supra, at para. 5, E&Y Brief of Authorities, Tab 3

52. In both *Merit Energy* and *Earth First Canada*, the debtor company had agreed that any expenses qualifying as exploration expenses for the purpose of *Income Tax Act* deductions would be for the benefit of their shareholders and undertook to indemnify them in the event the shareholders were unable to benefit from any such expenses.

53. Both the Alberta Court of Queen's Bench and the Ontario Superior Court respectively held that the claims of the shareholders holding flow-through shares of the debtor company (based on an indemnity agreement) were subordinated to the claims of unsecured creditors.

54. The Alberta Court of Queen's Bench and the Ontario Superior Court both stated that the essence of the relationship between the shareholders and the debtors company was one that concerns primarily a stock investment, regardless of whether their indemnity claims could have been individually characterized as a debt.

Reference *Nelson Financial Group Ltd., supra,* at para. 34, E&Y Brief of Authorities, Tab 10

Central Capital Corp., supra at paras. 116, 119, 120, E&Y Brief of Authorities, Tab 4

Re: Blue Range Resource Corporation, supra, at para. 26, E&Y Brief of Authorities, Tab 3

55. In only one case have the courts considered whether or not a claim by a third party based upon an indemnity agreement (as opposed to indemnity claims by flow-through shareholders) was subordinate to unsecured claims.

56. In *National Bank of Canada v. Merit Energy Ltd.* ("**Merit Energy**"), the Alberta Court of Queen's Bench refused to subordinate the claims of the auditor, underwriter and directors who sought to recover their losses based on an indemnity agreement. According to the Court, the subordination of the claims of such third parties would in no way further the well-sounded policy principles that grounded the decision of Romaine J. in *Re Blue Range Resources*, since:

a. The shareholders' claim against each of the directors, underwriters and auditors is distinct from the claims of the latter against the debtor company. As such, the shareholders are "strangers" to the claims of those third parties against the debtor company. Accordingly, the obligation of the debtor company to indemnify its directors, underwriters and auditors is not "in respect of" a shareholder's interest;

b. Underwriters, directors and auditors are creditors of the debtor company who do not assume the risk assumed by shareholders; and

c. Allowing the claims of underwriters, directors and auditors would not open the floodgates to claims by shareholders in CCAA proceedings, since such parties are not shareholders.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 62 to 72, 79 to 81, E&Y Brief of Authorities, Tab 2.

57. The Alberta Court also dismissed the argument upheld by the Court below in the present case that the recovery by third parties of indemnity claims on a *pari passu* basis with unsecured

claims would allow the shareholders to recover indirectly from those indemnified parties what they could not recover directly from the company.

Reference *National Bank of Canada v. Merit Energy Ltd., supra,* at paras. 69 to 72, E&Y Brief of Authorities, Tab 2

58. The Alberta Court stated that such an argument erroneously assumed that the success by the shareholders against the indemnified party was either contingent upon, or necessarily leading to, success by the indemnified parties against the debtor company. Such an assumption was not supported by the facts of that case, nor is it supported by the facts of the present case.

59. Surprisingly, the Court below makes no mention of the policy considerations which led the Alberta Court in *Merit Energy* to conclude that the claims of indemnified auditors against the company should not be subordinated nor treated like the claims of shareholders indemnified by the company (as was the case in *Blue Range Resources*).

60. The plain language used at section 2(1)(e) of the CCAA ("indemnity in respect of an equity interest") fully supports an interpretation which essentially codifies and is consistent with the *rationale* and result of the *Merit Energy* decision: section 2(1)(e) should only apply where the indemnity is in favour of a shareholder, not where it is in favour of an independent third party.

61. In *Return on Innovations v. Gandi Innovations*, the only Canadian decision rendered after the coming into force of the 2009 legislative reform that dealt with the notion of equity claims, the Ontario Superior Court approached the issue differently. That case is distinguishable:

(a) the decision was not based on the amended CCAA (which governs the present case); and

(b) the decision deals only with the indemnification claims of directors, not third parties such as underwriters.

Reference *Return on Innovations* v. *Gandi Innovations*, 2011 ONSC 5018 (CanLII) ("*Return on Innovations*") at para. 55, E&Y Brief of Authorities, Tab 5

62. Accordingly, the Ontario Court of Appeal confirmed that the decision *Return on Innovations* should not be read as a direct judicial precedent on the interpretation of the term "equity claims" within the meaning of s. 2 of the amended CCAA.

Reference *Return on Innovations,* 2012 ONCA 10 (CanLII) (C.A.), at para. 12, E&Y Brief of Authorities, Tab 5

63. Should this Court hold that *Return on Innovations* is applicable on these facts, respectfully submit that the Ontario Superior Court erroneously concluded that the indemnity claims of directors against the debtor company should be subordinated to the ordinary creditors.

64. The Court arrived at this conclusion based upon an erroneous premise, i.e. that the jurisprudence prior to 2009 (that directors' claims were to be subordinated to unsecured creditors) was codified within the definition of the term "equity claim" at s. 2(1)(e) of the CCAA.

> [55] This definition of equity claims 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. (…)
>
> (emphasis added)

65. The Superior Court decision in *Return on Innovations* is not a reliable precedent for the interpretation of the term "equity claim" at s. 2 of the CCAA, as was stated by the Ontario Court

of Appeal. Moreover, the premise underlying it is, respectfully, mistaken. For these reasons, this decision ought to be distinguished upon the facts from the present case.

(c) The Policy Reasons at the Root of the Historical Subordination of Equity Claims and the Legislative Purpose behind the 2009 Amendments to the CCAA

66. According to each of the Senate Committee on Banking, Trade and Commerce, and the Joint Task Force on Business and Insolvency Law Reform of 2002, the legislative purpose underlying the new CCAA provisions on equity claims were the following:

(a) In the interest of predictability, to enshrine in statutory law the rule that shareholders may not recover, in priority to creditors, amounts in relation to claims in damages against the debtor company; and

(b) In the interest of facilitating and encouraging restructuring proceedings in Canada, to align Canadian statutory law with U.S. law.

Reference Senate Committee on Banking, Trade and Commerce, Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, Nov. 2003, at pp. 158 and 159, E&Y Brief of Authorities, Tab 8

67. In the United States, the subordination of equity claims is set out at 10 (b) of Title 11 of the *United States Code* (the "U.S. Bankruptcy Code"), a provision which bears striking similarities to the definition of the term "equity claim" as well as to sections 6(8) and 22.1 of the CCAA:

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

> represented by such security, except that if such security is common stock, such claim has the same priority as common stock.
>
> (emphasis added)

68. No party was able to submit to the Court below decision in the United States where an auditor's claim was subordinated to the ordinary creditors' claims and it thus appears that no reported U.S. case comes to such conclusion.

69. Recovery by E&Y against SFC can in no way benefit the Plaintiffs' claim against SFC.

(d) The provisions of the CCAA

70. The specific provisions of the CCAA dealing with "equity claims" were introduced in 2007 by Bill C-12 and proclaimed in force in September of 2009 as part of a broad reform of Canadian insolvency legislation.

Reference Bill C-12, *An Act to Amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Act* and chapter 47 of the Statutes of Canada, s. 105 (the "Act"), Schedule B.

71. The CCAA now defines an equity claim as a claim that is "in respect of an equity interest" and contains a non-exhaustive ("among others") list of examples of such equity claims.

72. There is no guidance in the jurisprudence as to the interpretation of these new statutory provisions. Accordingly, it is necessary to consider the provisions against the present facts, to assess and then apply the legislative purposes underlying the new CCAA provisions to equity claims and to review the relevant case law from the period prior to the enactment of the amendments of 2009.

(e) Classification of E&Y's Claim as an Equity Claim is Contrary to the Plain Language of the CCAA

(a) Section 2(1)(e) of the CCAA refers, *inter alia*, to "indemnity or contribution claims" in respect of claims against the debtor company

73. The plain language of "equity claim" in section 2 of the CCAA is clear and unambiguous and must be the starting point of any analysis as to the scope of such definition.

Reference *Nelson Financial Group Ltd., supra*, at para. 34, E&Y Brief of Authorities, Tab 10

74. A plain reading of the general definition of the terms "equity claim" leads to the conclusion that the claims of E&Y against SFC are clearly not made "in respect of an equity interest".

75. Moreover, it is essential to note that the term "equity claim" is defined at s. 2(1)(e) of the CCAA with reference to the term "claim", which is itself defined by reference to the term "claim provable within the meaning of the *Bankruptcy and Insolvency Act*" (the "BIA").

76. It is well established by section 121 of the BIA that a provable claim in bankruptcy is a claim which can be asserted against the bankrupt, not against a third party:

> 121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt (...) shall be deemed to be claims provable in proceedings under this Act.

Reference *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, Schedule B.

77. Accordingly, the term "claim" at s. 2(1)(e) of the CCAA, which identifies those indemnity or contribution claims that may be characterized as "equity claims", refers to claims against the debtor company.

78. This interpretation accords with case law preceding the 2009 Amendments.

Reference *National Bank of Canada v. Merit Energy Ltd.*, 2001 ABQB 583 (CanLII) at paras. 39, 51 to 55, E&Y Brief of Authorities, Tab *2*

In Re Earthfirst Canada Inc., 2009 ABQB 316 (CanLII) at para. 5, E&Y Brief of Authorities, Tab 3

79. The plain language of section 2(1)(e) of the CCAA is a codification of the result and rationale in the *Merit Energy* decision dictates a conclusion that is diametrically opposed to the conclusion reached by the Court below: E&Y's claims against SFC do not arise from an indemnity to compensate a loss arising from a claim against SFC and do not result from an indemnity "in respect of a claim" against SFC.

80. The actual and contingent losses in respect of which E&Y is asserting a claim against SFC, namely E&Y's potential liability under the Class Actions, does not arise from a "claim" against SFC. It arises instead from a different and distinct claim brought by the Class Action Plaintiffs against E&Y. The success of the claim by the shareholders against E&Y is not dependent on E&Y's ability to claim contribution and indemnity from the Company.

(f) The Classification of E&Y's Claim as an Equity Claim does not Further the Policy Reasons Justifying the Historical Subordination of Equity Claims and the Legislative Purpose Behind the 2009 Amendments

81. While "equity investors bear the risk relating to the integrity and character of management" and "tie their investment to the fortune of the corporation", the same is not true for E&Y.

> [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, on the insolvency of a company, the claims of creditors have always ranked ahead of shareholders for the return of 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 the shareholders in insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of management. (emphasis added)

Reference *Nelson Financial Group, supra,* at para. 25, E&Y Brief of Authorities, Tab 10

82. An auditor is in a fundamentally different position than a shareholder, namely that of a professional service provider who entered into a contract with the debtor company based upon the expectation of receiving a pre-established payment, independently of the company's financial performance.

83. The policy reasons related to the assumption of risk, business expectations, and the corporate law ranking between creditors and shareholders would be in no way furthered by the characterization of E&Y's claim as an equity claim.

(g) In the alternative, E&Y's claim is not in substance an indemnity claim

84. A significant component of E&Y's claim is not an indemnity claim at all, but rather a claim for breach of contract and fraudulent and negligent misrepresentation.

Reference Proof of Claim of E&Y, attached as Exhibit A (Schedule A2) to the Shiels Affidavit, Motion Record of E&Y (Motion for Leave to Appeal), at Tab 4AA2, at paras 28-56

(E) The Appeal Will Not Unduly Delay the Action

85. The within appeal will not unduly delay the CCAA proceedings. The Court of Appeal for Alberta considered the test for this fourth criterion of the test for leave:

> [T]he 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 the prosecuting, hearing an deciding the appeal be of such length so as to unduly impeded the ultimate resolution of the matter by vote or court sanction.

Reference *Re Canadian Airlines Corp.* (2000), 19 C.B.R. (4th) 33 (Alta. C.A.) at para 41, E&Y Brief of Authorities, Tab 11

86. Court-ordered mediation is scheduled to proceed in the first half of September 2012. The Monitor has acknowledged that it will not seek to have a Plan of Arrangement approved prior to the mediation process. E&Y is committed to having this appeal heard as soon as possible.

(F) The Test for a Stay is Met

87. Pursuant to s. 106 of the *Courts of Justice Act*, this Honourable Court may on its own initiative or by motion by any person, stay any proceeding in the Court on such terms as considered just.

Reference *Courts of Justice Act*, R.S.O. 1990, c.43, s. 106, Schedule B

88. Pursuant to s. 134(1) of the *Courts of Justice Act*, a Court to which an appeal is taken, may make any order or decision that ought to or could have been made by the court or tribunal appealed from and make any other order or decision that is considered just.

Reference *Courts of Justice Act, s. 134(1),* Schedule B

89. The test for granting a stay is based on the same principles as those which govern the granting of an interlocutory injunction. An applicant for interlocutory relief must demonstrate that:

(a) there is a serious question to be tried;

(b) irreparable harm will be suffered if the relief is not granted; and

(c) that the balance of convenience favours it.

Reference *RJR MacDonald Inc. v. Canada (Attorney General)* (1994), 111 D.L.R. (4th) 385 at pps. 410 - 411 (S.C.C.), , E&Y Brief of Authorities, Tab 12

90. In determining whether there is a serious question to be tried, the moving party need only satisfy the Court that the appeal is not frivolous or vexatious, and once satisfied, the motions Judge should proceed to consider the second and third branches of the test, even if of the opinion that the moving party is unlikely to succeed. A prolonged examination of the merits is generally neither necessary nor desirable. The threshold is a low one.

Reference *RJR MacDonald Inc, supra*, at. pp. 401 and 403, , E&Y Brief of Authorities, Tab 12

91. A high standard of justice is required when the right to pursue one's profession or employment is at stake.

Reference *Kane v. Board of Governors of University of British Columbia*, [1980] I S.C.R. 1105, page 6, E&Y Brief of Authorities, Tab 13

92. The Court's determination of the second branch of the test, whether the applicant will suffer irreparable harm if the stay is not granted, should be made on the basis that "irreparable" refers to the *nature* of the harm suffered rather than its magnitude. It is a harm which cannot be cured. The Supreme Court of Canada expressly noted that such harm includes instances where one party will be "put out of business" by the Court's decision.

Reference *RJR MacDonald, supra,* at. p. 405, E&Y Brief of Authorities, Tab 12

93. The Courts have held that the three requirements necessary to support injunctive relief do not constitute separate preconditions, but rather should be considered as part of an interrelated

test. 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, risk of harm to the parties from granting or withholding interlocutory relief.

Reference *Apotex Fermentation Inc. v. Novopharm Ltd.*, [1994] 95 Man. R. (2d) 241 (C.A.) at para.14, E&Y Brief of Authorities, Tab 14

94. The above analysis makes it clears that there is a serious issue to be tried.

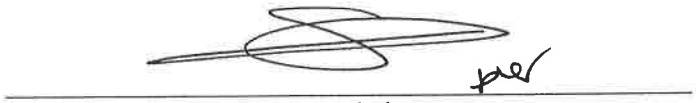
95. E&Y will suffer irreparable harm if the stay is not granted and the Order is interpreted in the Plan of Arrangement, as E&Y will not be able to have vote at a meeting of creditors convened to approve the Plan of Arrangement.

96. The balance of convenience favours E&Y. A short delay will no impede the progress of the CCAA proceeding unduly, whereas E&Y will be permanently and significantly affected without a stay of the Order.

97. E&Y requests that the leave be granted and the effect of the Order be stayed until such time as the appeal can be heard.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 20th day of August, 2012.

Peter H. Griffin



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TAB A

SCHEDULE "A"

LIST OF AUTHORITIES

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

2. *National Bank of Canada* v. *Merit Energy Ltd.*, 2001 ABQB, 583 (CanLII).

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

4. *Central Capital Corp.*, (1996), 132 D.L.R. (4th) 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. (4th) 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 B

SCHEDULE "B"

LIST OF LEGISLATION

Bankruptcy and Insolvency Act

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

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 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.

(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.

(3) A creditor may prove a debt not payable at the date of the bankruptcy and may receive dividends equally with the other creditors, deducting only thereout a rebate of interest at the rate of five per cent per annum computed from the declaration of a dividend to the time when the debt would have become payable according to the terms on which it was contracted.

(4) A claim in respect of a debt or liability referred to in paragraph 178(1)(b) or (c) payable under an order or agreement made before the date of the initial bankruptcy event in respect of the bankrupt and at a time when the spouse, former spouse, former common-law partner or child was living apart from the bankrupt, whether the order or agreement provides for periodic amounts or lump sum amounts, is a claim provable under this Act.

Companies' Creditors Arrangement Act

R.S.C., 1985, c. C-36

2. (1) In this 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 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;

[...]

6. (8) This Act extends and does not limit the provisions of any instrument now or hereafter existing that governs the rights of creditors or any class of them and has full force and effect notwithstanding anything to the contrary contained in that instrument.

[...]

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

Courts of Justice Act

R.S.O. 1990, CHAPTER C.43

Stay of proceedings

106.A court, on its own initiative or on motion by any person, whether or not a party, may stay any proceeding in the court on such terms as are considered just.

...

Powers on appeal

134.(1)Unless otherwise provided, a court to which an appeal is taken may,

(a) make any order or decision that ought to or could have been made by the court or tribunal appealed from;

(b) order a new trial;

(c) make any other order or decision that is considered just.

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

ONTARIO
SUPERIOR COURT OF JUSTICE
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