INSOL International

Update on Shareholder and Equity - Related Claims in Insolvency Proceedings

October 2013

Technical Series Issue No. 28

Update on Shareholder and Equity-Related Claims in Insolvency Proceedings

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Acknowledgement

INSOL International is very pleased to present the 28th Technical Paper under its Technical Papers Series titled “Update on Shareholder and Equity - Related Claims in Insolvency Proceedings”.

English law has maintained the long standing principle that shareholders are not entitled to share in the assets of an insolvent company and can only expect to have any recovery in the event that a solvent liquidation is achieved and all creditors have been paid in full. Canada has recognised a similar position and this is based on the notion that debt claims and equity investments are fundamentally different. The position in the USA is stated in the Bankruptcy Code where section 510(b) expressly provides for the mandatory subordination of a broad range of claims that arise from equity interests.

This paper discusses the exceptions to this position and also reveals some interesting differences, and how each country has adapted to the problems that arise because of this legal position in all three countries.

INSOL International sincerely thanks Brian Empey, Brendan O’Neill and Caroline Descours Goodmans LLP (Canada) ; Adam Gallagher, Craig Montgomery and Dan Butler of Freshfields Bruckhaus Deringer LLP (UK) and James Millar Wilmer Cutler Pickering Hale and Dorr LLP (USA) for writing this excellent paper.

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Update on Shareholder and Equity-Related Claims in Insolvency Proceedings

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I. Introduction

This article provides an international update on the legal treatment of shareholder and other equity-related claims in the context of insolvency and reorganization proceedings in Canada, the United States and the United Kingdom. Interested readers are encouraged to also read Janis Sarra's 2007 Technical Paper published by INSOL International entitled "*Securities Law Claims in Insolvency Proceedings*"[2] for a discussion of the policy considerations associated with the treatment, and more particularly the subordination, of securities claims in insolvencies and reorganizations.

Practitioners charged with modern insolvencies and reorganizations must deal with an increasingly difficult and varied set of claims and proceedings against the debtor. Whereas at one time the key claims against a debtor may have simply been the banks, the bonds and the trade, today practitioners are called upon to also consider the nature and priority of an increasingly broad array of new claims against debtors, including shareholder class action lawsuits, fraud claims, claims by securities regulators, claims by third party co - defendants seeking contribution and indemnity from the debtor, and other forms of equity - related claims.

This paper looks across Canada, the US and the UK to analyze how the latest cases and the latest laws are handling this increasingly broad array of securities claims against debtors and to discuss the extent to which each jurisdiction is (or is not) subordinating these claims to the claims of "ordinary creditors" in accordance with the generally - accepted "fundamental corporate principle" (in Canada) or "absolute priority rule" (in the US) that shareholders are not entitled to participate in a distribution of the assets of an insolvent corporation, unless all ordinary creditors have been paid in full. In the end, the analysis illustrates some interesting differences and distinctions in the manner and extent to which various forms of securities claims have (or have not) been subordinated under the latest cases and the latest law.

II. The UK Scene

A. First Principles

In a fashion similar to other common law jurisdictions, English law has maintained the long standing principle that shareholders (or members, to adopt the terminology commonly used in English statutes) are not entitled to share in the assets of an insolvent company and can only expect to have any recovery in the event that a solvent liquidation is achieved and all creditors have been paid in full.

This principle has a long history, with its origins predating the decision in *Salomon v Salomon & Co Ltd*[3] and belonging to a time when the separation of a company from its members had yet to be fully recognised and when companies and partnerships were not marked by the distinct differences which characterise them today. It was an established rule of partnership law that, subject to certain exceptions, a partner in an insolvent firm could not prove in competition with the debts of third party creditors in any dissolution of the partnership.[4] Lord Lindley explained the rule as follows:

> "[The creditors of the firm] are, in fact, his own creditors, and he cannot be permitted to diminish the partnership assets to the prejudice of those who are not only creditors of the firm, but also of himself. If, therefore, a partner is a

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[2] Prof. J. Sarra, "*Securities Law Claims in Insolvency Proceedings*" INSOL International Technical Series Issue No 2 (September 2007). *See* also Prof. J. Sarra, "*From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings*" (2007) 16 Int. Insolv. Rev. 181.

[3] [1897] A.C. 22

[4] *See* the judgment of the Court of Appeal given by Peter Gibson LJ in *Soden v British & Commonwealth Holdings Plc* [1998] A.C. 298 at 308.

> creditor of the firm, neither he nor his separate creditors (for they are in no better position than himself) can compete with the joint creditors against the joint estate." [5]

After it had been firmly established that a company validly incorporated under the Companies Acts is a corporate entity with a legal personality distinct from those of its members, it naturally followed that the company's creditors were also not creditors of the members. This is acknowledged across the common law world as a central feature of a company formed with limited liability and one which crucially serves to differentiate it from a partnership.

Another key feature of company law which has influenced the development of the principle of shareholder subordination is reflected in a line of authority concerning the raising and maintenance of a company's share capital. Since 1862 the UK Companies Acts have consistently given effect to the rule (which again predates the decision in *Salomon v Salomon & Co Ltd*) that the creditors of an insolvent company are entitled to have recourse to the company's paid - up share capital in order to satisfy their claims.[6] This doctrine has endured through a succession of statutory formulations.

It is from the above common law and statutory traditions, therefore, that English law derives its modern expression of the principle of shareholder subordination, which is set out in section 74(2)(f) of the Insolvency Act 1986 and provides as follows:

> *"[A] sum due to any member of the company (in his character of a member) by way of dividends, profits, or otherwise, is not deemed to be a debt of the company, payable to that member in a case of competition between himself and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves."*

However, section 655 of the Companies Act 2006 (previously section 111A of the Companies Act 1985, inserted by the Companies Act 1989) provides that:

> *"A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to subscribe for shares or to be included in the company's register of members in respect of shares."*

Accordingly, the question arises as to whether a shareholder's claim for damages arising from the insolvent company's fraud, misrepresentation or other misconduct ought to be characterised as a claim "in his character of a member", and therefore subordinated to the claims of unsecured creditors. (It is clear that purely contractual claims, for example under a loan agreement between the shareholder and the company, are not within the scope of section 74(2)(f) of the Insolvency Act.)[7] Alternatively, if such a claim should not be so characterised, it follows that a successful action would allow the shareholder to prove in the company's insolvency and that the claim would rank *pari passu* with those of its unsecured creditors.

In light of the statutory position, it has fallen to the English courts to distinguish those shareholder claims which are brought in the character of a member from those which are considered to be outside of the scope of the rights and obligations imposed on the parties by the company's memorandum and articles of association (the so called "statutory contract").[8] For many years the courts operated what might be considered a broad brush approach to the issue, before more recently adopting a more purposive interpretation of the statute.

[5] Quoted in *Lindley & Banks on Partnership*, 19th ed. (2010) at 958
[6] See e.g. *Trevor v Whitworth* (1887) 12 App. Cas. 409 at 414
[7] See e.g. *Re Dale and Plant Ltd* (1889) 43 Ch. D. 255
[8] *Soden v British & Commonwealth Holdings Plc* [1998] A.C. 298 at 323

B. Types of Shareholder Claims: Initial Distinction

The English common law had previously acknowledged a rule, established in *Houldsworth v. City of Glasgow Bank* (1880) 5 App. Cas. 317, that a shareholder was prohibited from claiming damages from a company for misrepresentation inducing his subscription for shares unless he had first rescinded the subscription contract, and that once a company had entered liquidation such recission was impossible. This was largely nullified by section 111A of the Companies Act 1985 (as inserted by section 131(1) of the Companies Act 1989) but the rule was central to early judicial treatment of shareholder claims and operated to negate any detailed consideration of the issue of subordination prior to the amendment of the 1985 Act.

The English courts first considered the point in *Re Addlestone Linoleum Co.* (1887) 37 Ch.D. 191. In *Addlestone*, the company had issued £10 shares described as being fully paid at a discount of £2 10s. When the company went into liquidation a call of £2 10s per share was made, the shareholders paid the call but then sought to prove in the winding up for damages of £2 10s per share "for breach of contract or otherwise in respect of the shares." In deciding the matter at first instance, Kay J held that the claim was excluded by the *Houldsworth* principle. However, he also ruled that the claim must also fail due to section 38(7) of the Companies Act 1862 (the contemporary equivalent of section 74(2)(f) of the Insolvency Act 1986):

> "Now, unquestionably the applicants… are making such claims in the character of members of the company, and the only question is whether such claims are for sums due 'by way of dividends, profits or otherwise.' … Practically, what these applicants are seeking to recover by their proof is a dividend in respect of the £2 10s per share which they have been compelled to pay in the winding up. But as shareholders they have contracted that they will pay this money, and that it shall be first applied in payment of the creditors whose debts are not due to them as members of the company - that is, they are practically admitting their liability to pay the £2 10s per share to such other creditors and yet seeking to get part of it back out of the pockets of those very creditors themselves. I confess it seems to me that the money so claimed is not only claimed in the character of members but that the claim is just as unreasonable as if it were a claim of dividends or profits, and that, accordingly, it comes within the words 'or otherwise' which I have read from section 38."[9]

Regrettably, this point received only limited consideration when the case reached the Court of Appeal, with the majority deciding the case on the basis of the *Houldsworth* principle. Lopes LJ agreed with the construction of section 38(7) of the 1862 Act outlined above but declined to elaborate on the point.

However, Kay J was subsequently to return to the question of what constituted a claim "in the character of a member" in *Re Dale and Plant Ltd* (1889) 43 Ch D 255, where he held that arrears of the salary due to the director of a company, in which directors were obliged by the articles of association to be shareholders, and damages for the breach of the director's contract of employment, were not due to the director in his character of a member. Kay J addressed the issue in the following terms:

> "What does 'character of member' mean? The intervening words seem to me to show that clearly. The words are: - 'by way of dividends' - that is, on his shares - 'profits' - that again is in respect of his shares - 'or otherwise.' The words 'or otherwise' must mean something analogous to dividends or profits on his shares. That shows the meaning. Dividends are due to him in his character of member: profits are due to him in his character of member: there may be something else equally due to him in his character of member which this clause was intended to include. To my mind it is clear that the clause does not include money due for goods which a member has supplied to the company; otherwise it would be so expressed. Nor can it include payment for

[9] (1887) 37 Ch.D. 191 at 197-198

> particular work which he has special skill in doing, and which he has done for the company. I am of the opinion that this money which ought to have been paid to this claimant solely as managing director is money for which he may prove in competition with other creditors."[10]

The approach in *Dale and Plant* was followed by the High Court, on materially similar facts, in *Re New British Iron Co.*; *Ex parte Beckwith* [1898] 1 Ch. 324. The influence of Kay J's line of reasoning was also clear in the Australian case of *Re WH Eutrope & Sons Pty. Ltd.* [1932] V.L.R. 453, in which the Supreme Court of Victoria emphasised that a shareholder's claim against a company in respect of a debt created under a bilateral contract would not be subordinated by statute.

This distinction, between those claims deriving from a member's shareholding and those with their origins in a member's separate, parallel relationship with the company, was reinforced by the judgment of the High Court of Australia in *Webb Distributors (Aust.) Pty. Ltd. v State of Victoria* (1993) 11 A.C.S.R. 731 - which drew heavily on the decisions of Kay J in *Addlestone* and *Dale and Plant*. *Webb* concerned claims in the tort of deceit by holders of non - withdrawable shares in three building societies, who argued that they were misled as to the nature of the shares, which they had been told were redeemable and shared the characteristics of a deposit. The High Court considered the Victorian equivalent of section 74(2)(f) of the Insolvency Act and, although the language in question was not identical,[11] held that the statutory interpretation adopted in *Addlestone* was correct.

The court also maintained the distinction between shareholders' contractual claims against a company and those related to the shares themselves, ruling that:

> "[Statute] will not prevent claims by members for damages flowing from a breach of contract separate from the contract to subscribe for the shares.… But, in the present case, the members seek to prove in the liquidation damages which amount to the purchase price of their shares, which is a sum directly related to their shareholding. Moreover, they sue as members, retaining the shares to which they were entitled by virtue of entry into the agreement and they seek to recover damages because the shares are not what they were represented to be. Accordingly, the claim falls within the area which [statute] seeks to regulate: the protection of creditors by maintaining the capital of the company."[12]

It is clear, therefore, that by the end of the 19th century the English courts had arrived at a settled approach to the subordination of shareholder claims and one which received positive judicial treatment elsewhere in the common law world. However, the advent of section 111A of the 1985 Act and its impact on the *Houldsworth* principle would inevitably invite fresh consideration of this approach.

C. A Change in Approach: The House of Lords Decision in Soden

The decision of the House of Lords in *Soden v British & Commonwealth Holdings Plc* [1998] A.C. 298 marked a departure from the English courts' previous approach to the subordination of shareholder claims. The case concerned a claim from a take over bidder against a target company for negligent misrepresentation when its financial distress became known following completion of the takeover. The target subsequently went into administration and became the subject of a scheme of arrangement with its creditors; the administrators applied to the High Court for directions as to whether the parent company's claim for damages, if successful, would be subordinated to the claims of the target's other creditors.

In a judgment delivered by Lord Browne - Wilkinson, their Lordships held that the parent company's claim was not subordinated as it had purchased the shares in the target in the market and not via subscription. Lord Browne - Wilkinson distinguished the decisions in *Addlestone* and *Webb* on the basis that no reduction of capital (and thus prejudice to

[10] (1889) 43 Ch. D. 255 at 259-260

[11] Section 360(1) of the Victorian Code referred to a "sum due to a member in his *capacity* as a member" [emphasis added].

[12] (1993) 11 A.C.S.R. 731 at 741

unsecured creditors) could result from a claim where the shareholder in question had not been required to contribute to the company's capital in the first place:

> "[T]he reasons given by Kay J for treating the case as falling within section 38(7) [of the 1862 Act] are directed exclusively to matters relevant to a claim involving the issue of shares by the company but irrelevant to a claim relating to the purchase of fully paid shares from a third party …. There is nothing in the *Addlestone* case to justify the application of that decision to cases where the claim against the company is founded on a misrepresentation made by the company on the purchase of existing shares from a third party. To allow proof for such a claim in competition with the general body of creditors does not either directly or indirectly produce a reduction of capital. The general body of creditors are in exactly the same position as they would have been had the claim been wholly unrelated to shares in the company."[13]

Prima facie, therefore, *Soden* sets out a fairly limited exception to the established rule that "rights of members as members come last": damages claims of subscribing shareholders will be subordinated, but not those of transferees. However, Lord Browne - Wilkinson made clear that, while he expressed no view on the point, it was likely that claims of subscribing shareholders would also be affected to some extent by section 111A of the 1985 Act.

Furthermore, in *Sons of Gwalia Ltd v Margaretic* [2007] H.C.A. 1, on facts materially identical to *Soden*, the High Court of Australia held that section 563A of the *Corporations Law* (which is materially similar to section 74(2)(f) of the Insolvency Act) did not operate to subordinate shareholders' claims for damages, irrespective of whether the shareholder was a subscriber or a transferee. Gummow J went so far as to note that section 111A of the 1985 Act "*appears to reflect a policy* … *which denies any such subordination of shareholder claims*."[14]

Indeed, in light of this statutory provision, there seems no logical reason for distinguishing between shareholders' misselling claims on the basis of whether the shares were acquired as a subscriber or a transferee. *Soden* clearly established that the claims of transferee shareholders were not subordinated; however, rather than legislating to address or even reverse the effect of this decision, Parliament subsequently re - enacted section 111A of the 1985 Act as section 655 of the Companies Act 2006. The law therefore remains unclear on this point: while submissions to this effect have yet to be formally rejected by the courts, equally it has not been possible to secure an affirmative ruling.[15]

D. Prospects for Reform

Following the decision in *Sons of Gwalia*, over 5,300 individual shareholder claims, for a total of over AUS $240 million in damages, were submitted in the company's insolvency. This prompted concerns regarding the potentially huge impact the decision might have on the assets available to creditors in an insolvency, and ultimately resulted in the passage of legislation in Australia which reversed the effect of the High Court's decision and codified the priority of unsecured creditors over all shareholder claimants, including those whose claims arise from alleged misselling by the insolvent company.[16]

However, despite the present state of uncertainty as to the common law position in the UK, there seems little prospect of legislation being introduced to address the question raised by *Soden*. As mentioned above, to the extent Parliament has addressed the question of subordination at all it has merely been to confirm in the 2006 Act the right of shareholders to pursue claims for damages against a company.

Although high profile corporate collapses are certainly not a rarity in the UK since the onset of the financial crisis, no insolvency has been affected by shareholder misselling claims to

[13] [1998] A.C. 298 at 325-326

[14] [2007] H.C.A. 1 at [41]

[15] For example, it was submitted in *Re Cattles Plc* that shareholders with misselling claims against the company ought to convene as a single class of creditors for the purposes of voting on a scheme of arrangement, on the basis that neither subscribers nor transferees would be subordinated. While the composition of the classes of scheme creditor was approved in two separate judgments ([2010] EWHC 3611 (Ch) and [2011] EWHC 530 (Ch)) neither judge expressed any view as to the merits of this argument.

[16] The Corporations Amendment (Sons of Gwalia) Act 2010, amending the Corporations Act 2001.

the same extent as *Sons of Gwalia* and thus the issue of shareholder subordination has not been directly addressed before the courts in the years since *Soden*. The UK has certainly seen a large number of such claims pursued against financial institutions such as the Royal Bank of Scotland, but as yet we have been afforded no more recent opportunity to study the English courts' approach to their interaction with insolvency legislation. Whether a future judicial decision will clarify the position or radically alter the landscape remains to be seen, but for the time being at least the issue remains in the domain of the courts rather than the legislature.

III. The Canadian Scene

A. The Basic Subordination of Shareholders

In Canada, it has long been recognized that shareholders are not entitled to share in the assets of an insolvent corporation unless all ordinary creditors have been paid in full.[17] This principle is based on the accepted notion in Canada and elsewhere that the nature of debt claims and equity investments is fundamentally different. Shareholders are higher risk takers who carry the risk of total loss but have the benefit of unlimited upside; whereas creditors are lower risk takers who have claims limited to the amount of their debt, which the debtor has agreed to repay, but with no potential for upside beyond that contracted-for amount. As such, when the company becomes insolvent and the bet by definition goes bad, shareholders must face the reality of their risk and loss, while creditors may continue to pursue their claims. According to the "fundamental corporate principle", as one Canadian court called it, "shareholders cannot reasonably expect to maintain a financial interest in an insolvent company where creditors' claims are not being paid in full."[18]

Based on this notion, Canadian courts have on many occasions applied the common law to subordinate the basic claim of a shareholder for the return of its investment.

B. Increasing Challenges in Classifying Debt and Equity Claims

Beyond these basic shareholder claims, as the types of securities available on the market became increasingly complex, Canadian courts faced greater challenges in determining whether various new forms of shareholder claims were properly debt or equity claims in the context of an issuer's insolvency proceedings.

In handling these cases, Canadian courts traditionally relied upon the seminal decision on the characterization of debt versus equity in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*[19], wherein the Supreme Court of Canada, recognizing that the Canadian financial and capital markets had developed a variety of new hybrid investments in which debt and equity elements co - existed, held that the characterization issue must be decided by determining the intention of the parties. The Supreme Court instructed courts to look to the *substance* of the particular transaction and not be distracted by aspects which are only incidental or secondary in nature to the main purpose of the agreement.[20] With this guiding principle in mind, Canadian courts considered over the years an array of shareholder - type claims in insolvency situations. The results, however, were not necessarily consistent, which is not surprising given that the analysis was, per the Supreme Court's guidance, focussed on the intention of the parties and the substance of the transaction in question in each case.[21]

[17] *Central Capital Corporation, Re* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at para. 149 [*Central Capital*]; *I. Waxman & Sons Ltd., Re* (2008), 40 C.B.R. (5th) 307 (Ont. S.C.J. [Commercial List]) at para. 18 [*Waxman*]; *Blue Range Resource Corp.*, *Re*, (2000), 15 C.B.R. (4th) 169 (Alta Q.B.) at para. 17 [*Blue Range*].

[18] *Blue Range, ibid.* at para 29; *Canadian Airlines Corp, Re*, (2000), 20 C.B.R. (4th) 1 (Alta Q.B.) at para. 143.

[19] (1992), 97 D.L.R. (4th) 385 (S.C.C.).

[20] *Ibid.* at paras. 52 and 55.

[21] In *Blue Range,* the Court found that shareholder losses resulting from misrepresentation by the debtor company derived from and were inextricably connected to the shareholder's interest in the company and, as such, the nature of the claim was in substance a claim by a shareholder for a return of its investment and not an ordinary tort claim.
In *National Bank of Canada v. Merit Energy Ltd.* (2001), 28 C.B.R. (4th) 228 (Alta Q.B.) [*Merit*], the Court held that the indemnification claims of flow-through shareholders were equity claims since the shareholders were in substance seeking a return of their equity investment, whereas the indemnification claims of the underwriters, auditors, directors and officers were not subordinate equity claims because they were based on contractual, legal, and equitable duties owed by the debtor and distinct from a claim for return of shareholders' equity.
In *Waxman*, the Court distinguished the *Blue Range* and *Merit* cases, which involved causes of action asserted by shareholders with no judgment having yet been rendered, and found that in certain circumstances equity could become debt. Here, the shareholder had obtained a judgment for a money award in respect of the equity-related claims, which the Court found rendered the claims into debt, despite their origin.

C. The Call for Insolvency Reform in Canada

This at times inconsistent treatment of various kinds of shareholder - related claims, coupled with a concern that Canadian insolvency laws might not be able to adequately address the myriad of shareholder and other equity - related claims that were emanating out of the wave of corporate scandals and subsequent litigation that emerged in North America in the early 2000s, eventually led to a call for insolvency law reform in Canada on the issue of the status of equity and equity-type claims in Canadian insolvencies and reorganizations. The key report of Canada's Standing 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*, presented in 2003, concluded 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. 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 repaid in full."[22]

Likewise, beginning in 2002, a joint task force of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals recommended that Canada's insolvency legislation be amended to provide that "all claims against a debtor in an insolvency proceeding that arise under or relate to an instrument that is in the form of equity, including claims for payment of dividends, redemption or retraction or repurchase of 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."[23]

This intent to clearly and comprehensively subordinate equity claims in Canadian insolvency legislation was given effect in Canada with the Bill C-12 amendments to the *Bankruptcy and Insolvency Act* (the "**BIA**") and the *Companies' Creditors Arrangement Act* (the "**CCAA**") that came into force on September 18, 2009. With these amendments, the BIA and the CCAA now both expressly postpone "equity claims" and expressly prohibit any distributions to holders of equity claims prior to payment in full of all non-equity claims[24]. The amendments also expressly prohibit holders of equity claims from voting on a proposal or plan, unless the court orders otherwise.[25]

D. The 2009 Amendments to the BIA and the CCAA

The amended BIA and CCAA now broadly define an "equity interest" as: (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.[26] More importantly, the amended BIA and CCAA broadly define an "equity claim" as 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;

[22] Report of the Standing 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*, November 2003, at 158-159.

[23] Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, *Report of the Joint Task Force on Business Insolvency Reform*, March 2002, proposal # 62.

[24] BIA, sections 60(1.7) and 140.1; CCAA, section 6(8).

[25] BIA, section 54(2)(d); CCAA, section 22.1.

[26] BIA, section 2; CCAA, section 2(1).

(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).[27]

As the post-amendment cases below demonstrate, these broad definitions of equity interests and equity claims, coupled with express statutory prohibitions on voting and distributions for equity claimants, have introduced a relatively expansive and deep subordination of equity and equity - related claims in Canada.

E. Post - Amendment Case - Law: How Deep is the Subordination in Canada?

(i) *Nelson Financial* - Broad Subordination of Shareholder Claims in Canada

One of the first post - amendment cases in Canada was *Re Nelson Financial Group Ltd.*[28], which quickly demonstrated the extent and impact of the new subordination provisions. As part of its business, Nelson Financial had issued preferred shares with a 10% per annum dividend, payable monthly. At the time of its CCAA filing, Nelson Financial owed approximately $50,000 in declared but unpaid dividends on the preferred shares, and approximately $75,000 of accumulated dividends. Prior to the amendments, claims for dividends were typically disallowed in a CCAA proceeding, however claims for declared but unpaid dividends had been treated as debt, notwithstanding that at one time they were only equity claims.[29]

Based on the amendments now in force, the noteholders in the *Nelson Financial* CCAA case brought a motion seeking to subordinate all of the preferred shareholders' claims, both in respect of straight dividends and declared but unpaid dividends. Reading the new amendments, the noteholders argued that it no longer made any difference that the dividends had been declared and were unpaid, the preferred shareholders held "equity interests" and were making a claim for dividends in respect of those equity interests, which constituted a subordinated "equity claim" under part (a) of the new statutory definition of "equity claims".

The Court in *Nelson Financial* concluded that, notwithstanding that claims for declared but unpaid dividends had previously been treated as debt, all claims for dividends were now subordinated "equity claims" under the definitions set out in the amended CCAA. Based on the "clear and unambiguous" language of the amendments, the Court concluded that all of the following claims were now subordinated "equity claims" under the new CCAA definitions:

- claims for declared but unpaid dividends;
- claims for unperformed requests for redemption;
- claims for compensatory damages for loss on the purchase of the preferred shares resulting from alleged negligence or fraud by Nelson; and
- claims for payment of the amounts due upon the rescission or annulment of the purchase or subscription for the preferred shares.[30]

Under the Court's analysis, through the 2009 amendments, Parliament had clearly intended to subordinate all of the foregoing shareholder claims, regardless of how they might have been treated previously. In passing, the Court made two additional

[27] BIA section 2; CCAA, section 2(1).
[28] (2010), 71 C.B.R. (5th) 153 (Ont. Sup. Ct. J. [Commercial List]) [*Nelson Financial*].
[29] *Central Capital, supra* note 17 at paras. 95 and 148.
[30] *Nelson Financial, supra* note 28at paras. 33-34.

interesting observations. First, while it had in an earlier case treated a money judgment awarded in respect of a shareholder's claim for losses as a debt claim (because, notwithstanding its origin in equity, it became a debt when the Court granted a judgment in respect of the claim),[31] the Court noted that under the 2009 amendments that claim might now be subordinated as it would likely fall within the parameters of the CCAA's "clear and broad" definition of equity claims. Second, the Court observed that, notwithstanding the very disturbing nature of the allegedly fraudulent conduct by Nelson, the CCAA amendments did not afford any flexibility to consider such matters; if the claims related to losses on "equity interests" and were "equity claims", then the new provisions compel subordination. The Court wrote that:

> "[w]hile some, and most notably Professor Janis Sarra, advocated a statutory amendment that provided for some flexibility in cases involving damages arising from egregious conduct on the part of the debtor corporation and its officers, Parliament opted not to include such a provision. [The new subordination provisions of the CCAA for "equity claims"] allow for little if any flexibility. That said, they do provide for greater certainty in the appropriate treatment to be accorded to equity claims."[32]

The Court thought its findings in this regard were consistent with prior Canadian and US cases which had found that, even where a shareholder claimed to have been defrauded, its claim for losses based on the fraud was still inextricably intertwined with its status as a shareholder and, as such, its claim was subordinate to the general creditors when the company was insolvent.[33] For example, in *Blue Range*, defrauded shareholders claimed that they were owed a debt based on their tort claim against the debtor and thus ranked with other creditors. The Court found that the shareholders' losses resulting from the debtor's misrepresentations derived from and were inextricably connected to the shareholder's equity interest in the company and, as such, the nature of the claim was still in substance a claim by a shareholder for a return of its investment and not a tort claim. The Court noted that even defrauded shareholders are presumed to have assumed the risk of fraud in making their investment:

> "It is true that Big Bear does not claim rescission, 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 the "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."[34]

Accordingly, the shareholder's tort claims were subordinated to the claims of the unsecured creditors in the reorganization.

(ii) *EarthFirst* - The Subordination of Indemnification Claims by Shareholders

In *Re EarthFirst Canada Inc.*[35], shareholders of a CCAA debtor sought to elevate their status to that of creditors by asserting contractual indemnification rights against the company under the terms of their flow-through shares. The definition of "equity claim" under the amendments to the CCAA was considered by the Court as they were about to come into force. The Court found that the potential contractual indemnification claims of holders of the company's flow - through shares derived from the status of the shareholders as subscribers of the shares, that their indemnity claims were acquired as part of an investment in the shares, and that, most importantly, if successful, the

[31] In *Waxman*, the Court found that the shareholders' claim had become a debt claim when it obtained a judgment for a money award in respect of its oppression claim. "By virtue of the judgment, the money award becomes debt and is properly the subject of a proof of claim in bankruptcy." *Waxman*, *supra* note 17 at paras. 24-25.
[32] *Nelson Financial, supra* note 28 at para 34.
[33] *Nelson Financial, supra* note 28 at para. 26.
[34] *Blue Range, supra* note 17 at para. 23.
[35] (2009), 56 C.B.R. (5th) 102 (Alta Q.B.) [*EarthFirst*].

indemnity claims would result in a recovery of a portion of the shareholders' original investment. Accordingly, consistent with the 2001 decision of the same court in *Merit*, all of these claims or obligations were at their core equity obligations rather than debt obligations, and therefore subordinate to the claims of creditors.

(iii) *ROI* - The Subordination of Indemnification Claims by Directors and Officers

The issue of the status of indemnification claims was again considered in the case of *Return on Innovation Capital v. Gandi Innovations Limited*[36], where a shareholder sought to be compensated for the loss of its equity interest and commenced arbitration proceedings against the debtor company's directors and officers. These directors and officers then made indemnity claims against the debtor company in its CCAA proceedings in respect of the shareholder's claims, which they claimed ranked as general unsecured claims in the bankruptcy case. The Court considered the definition of "equity claims" under the 2009 amendments (which had not yet come into force) and found that the contractual indemnification claims being asserted by the directors and officers against the debtor company were subordinated as equity claims on the basis that the underlying claim of the shareholder was an equity claim. According to the Court, the characterization of the directors' and officers' indemnity claims against the debtor turned on the characterization of the underlying claim against them, which was a shareholder claim for loss of investment.

The Court expressly rejected the argument of the directors and officers that their claims were not equity claims because they were based on breaches of contract, tort and equity. The Court held that it was not the "legal tools" that were important; rather, it was the fact that the directors' and officers' claims would result in a recovery of an equity investment that affected the characterization of the claim.[37] Accordingly, the directors' and officers' claims for indemnification were held to be equity claims for the purposes of the CCAA and were subsequent in priority to the claims of unsecured creditors.

(iv) *Sino-Forest* - The Subordination of Third Party Indemnity Claims

Perhaps the most extensive consideration of the impact of Canada's new subordination regime was in the recent, high - profile restructuring of Sino - Forest Corporation. Sino - Forest was a Chinese timber company with a Canadian parent that was listed on the Toronto Stock Exchange in 1995. Following its TSX listing, Sino - Forest raised over $3 billion in the Canadian debt and equity markets through three equity offerings and four note offerings. At its height, Sino - Forest had a market capitalization of over $6 billion but, in June 2011, a short - seller published a report claiming that Sino - Forest was a ponzi scheme and a near total fraud. In the days that followed, Sino - Forest's shares plunged 71 percent and the company soon found itself the subject of numerous class actions, regulatory investigations and, eventually, a CCAA proceeding.

In its CCAA proceeding, Sino - Forest attempted to sell its assets but was eventually required to carry out a debt - for - equity plan in which a new company would be created and the equity of the company handed over to Sino - Forest's creditors. Sino - Forest's auditors and underwriters, all of whom had been sued in the class action proceedings for many billions of dollars, claimed to be principal creditors of the company based on their engagement letters with Sino - Forest, which contained indemnities in connection with the earlier share and note offerings. Sino - Forest's bondholders, holding approximately $1.8 billion of bond debt, objected to the auditors' and underwriters' indemnification claims on the basis that these claims were fully subordinated, as "equity claims".

The indemnification claims arising out of the noteholder class actions were not brought before the CCAA Court. However, in determining the status of the indemnification claims made against Sino - Forest by the third party defendants to the shareholder class action claims (being principally Sino - Forest's auditors and underwriters), Mr. Justice Morawetz of the Ontario Superior Court of Justice noted the trend by the courts towards an expansive interpretation of the definition of "equity claims" in order to achieve the

[36] (2011), 83 C.B.R. (5th) 123 (Ont. S.C.J. [Commercial List]) [*ROI*]; aff'd (2012), 90 C.B.R. (5th) 141).
[37] *Ibid*. at para 59.

purposes of the CCAA and found that the 2009 amendments had further broadened the scope of equity claims.[38] On appeal by the auditors and underwriters, the Ontario Court of Appeal agreed that the definition of "equity claim" expanded the pre - existing common law and likewise found that courts were adopting a more expansive approach with respect to the types of claims that would be captured by the definition of "equity claim" under the CCAA.[39]

As a result, all of the shareholder class action claims against Sino - Forest for losses relating to the purchase of shares were decisively found to fall under the CCAA definition of "equity claims" and were subordinated to the claims of the creditors (being, the holders of Sino - Forest's bond debt). The Court held that the shareholder class action claims against the company for, among other things, damages resulting from the purchase of shares of the company at inflated prices were clearly equity claims on the basis that they were claims in respect of a monetary loss resulting from the ownership, purchase or sale of an equity interest in the company. Accordingly, the shareholder class action claims were subordinated to creditor claims against the company in accordance with the CCAA. The Court's finding in respect of the subordination of the shareholder class action claims was not appealed by the plaintiffs in the class action proceedings.

Importantly, the Court also found that the characterization of the auditors and underwriters' claims for indemnification from the company in respect of the shareholder class action claims against them turned on the characterization of the underlying primary claims against them.[40] The Court held that the definition of "equity claim" is not confined to a claim that is advanced by a shareholder or a holder of an equity interest and that the plain language in the definition of "equity claim" did not focus on the identity of the claimant, but rather on the nature of the claim. Thus, where a shareholder claim leads to an indemnity claim, or, in other words, where an indemnity claim is being used to recover an equity investment, such indemnity claim also falls within the definition of "equity claim" under the CCAA.[41]

The auditors and underwriters in *Sino - Forest* argued, among other things, that their claims were creditor claims derived from retainers by and / or on behalf of the company and its subsidiaries and their relationship with the debtor was that of a service provider, not an investor. The Ontario court dismissed these arguments finding that it "would be totally inconsistent to arrive at a conclusion that would enable either 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. To hold otherwise would indeed provide an indirect remedy where a direct remedy is not available."[42] In other words, treating the auditors' and underwriters' contribution and indemnity claims as creditor claims would result in shareholders achieving creditor status through the auditors and underwriters despite the fact that their direct claims against the company were clearly subordinated equity claims.[43] On appeal, the Court of Appeal affirmed the lower Court's decision to subordinate all of the indemnity claims, restating the key rationale as follows:

> "In our view, in enacting s. 6(8) of the CCAA, Parliament intended that a monetary loss suffered by a shareholder (or other holder of an equity interest) in respect of his or her equity interest *not* diminish the assets of the debtor available to general creditors in a restructuring. If a shareholder sues auditors and underwriters in respect of his or her loss, in addition to the debtor, and the auditors or underwriters assert claims of contribution or indemnity against the debtor, the assets of the debtor available to general creditors would be diminished by the amount of the claims for contribution and indemnity."[44]

[38] *Sino-Forest Corporation, Re* (2012), 92 C.B.R. (5th) 99 (Ont. Sup. Ct. J. [Commercial List]) [*Sino-Forest I*].
[39] *Sino-Forest Corporation, Re* (2012), 98 C.B.R. (5th) 20 (Ont. Sup. Ct. J. [Commercial List]) [*Sino-Forest II*].
[40] *Sino-Forest I, supra* note 38 at para 84;
[41] *Sino-Forest I, supra* note 38 at para. 79; *Sino-Forest II, supra* note 39 at paras. 37 and 46.
[42] *Sino-Forest I, supra* note 38at para. 82.
[43] *Sino-Forest I, supra* note 38 at para. 84.
[44] *Sino-Forest II, supra* note 39 at para. 53.

In the end, the Sino - Forest decision characterized all of the following claims as subordinated "equity claims" with the result that they were not entitled to vote and were excluded from all distributions in the CCAA proceedings:

- the claims against Sino - Forest brought by its current and former shareholders on the basis of various alleged misrepresentations in its financial statements and other financing documents;

- the claims against Sino - Forest by its officers and directors, who were defendants to the shareholder class actions, for indemnity in respect of those actions (based on their indemnity agreement with Sino - Forest); and

- the claims against Sino - Forest by its auditors and underwriters, who were defendants to the shareholder class actions, for indemnity in respect of those actions (based on their engagement letters with Sino - Forest).

As a result of these findings, many billions of dollars' worth of shareholder claims and related indemnity claims against Sino - Forest were subordinated in the CCAA proceedings, with the result that the creditors of the company were able to obtain full ownership of the reorganized entity without dilution on account of these claims.

E. Some Open Issues After Sino

While the *Sino - Forest* decision confirmed that contribution and indemnity claims of third parties (be they directors, officers, auditors or underwriters) against a debtor in respect of underlying equity claims also constitute subordinated equity claims for the purposes of the CCAA, the classification of the indemnity claims made by the auditors and underwriters in respect of the *defence costs* incurred by the defendants in defending against shareholder claims was not decided by the Court in *Sino - Forest*. To the extent it was considered, the Court observed that where an auditor or an underwriter might successfully defend against the claims of shareholders, that auditor's or underwriter's claim against the debtor company for indemnification of the associated defence costs incurred might not be a claim arising as a result of "contribution or indemnity in respect of an equity claim" – which would be subordinated – as the underlying equity claim in question would have been found to be without merit in those circumstances. Accordingly, the Court found that there might not, in those circumstances, be a principled basis for subordinating that portion of the underwriter's or auditor's claim.[45] No determination was made on this and, as a result, the issue of whether indemnity claims against a debtor company in respect of defence costs in respect of an unsuccessful equity claim do or do not constitute subordinated "equity claims" under the CCAA remains undetermined in Canada.

Another issue that was not decided in *Sino - Forest* was the status of claims for indemnity by the auditors and underwriters in respect of claims for losses on the bonds (as compared to claims for losses on the shares) issued by *Sino - Forest*. This issue was not considered in the case, but it is interesting to note that the subordination provisions in Canada are centered on "equity interests" and "equity claims" which terms are defined in reference to shares, and not other forms of securities. This is different from the US where, as discussed below, the subordination provisions are tied to "securities", which is a broadly defined term under the US Bankruptcy Code that is not limited to shares only, and would include, for example, bonds.

F. Observations on Canada

As a result of the 2009 amendments to the BIA and CCAA, Canada now has strict subordination language in respect of shareholder and other equity - related claims which the courts have described as being clear, broad and unambiguous. There are presently no exceptions to the subordination provisions (none for egregious facts and none for any sort of regulatory claims, as in the US) and the broad array of different types of equity claims discussed above have all been subordinated under the new provisions or pre - existing case

[45] *Sino-Forest I, supra* note 38 at paras. 92-32.

law in Canada. Time will tell whether the Courts or Parliament will introduce exceptions to this treatment.

IV. The US Scene

A. The Statute and Underlying Policy

Section 510(b) of the United States Bankruptcy Code, 11 U.S.C. § 101 et seq. (the "Bankruptcy Code"), expressly provides for the mandatory subordination of a broad swath of claims that arise from equity interests. It states:

> 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.

This section effectuates an underlying policy of American law: "that creditors are entitled to be paid ahead of shareholders in the distribution of corporate assets."[46] Even if the shareholders are blameless in a given situation, they may not shift the risk of loss to creditors.[47] "One of the primary purposes of section 510(b), therefore, is to prevent disappointed shareholders, sometimes the victims of corporate fraud, from recouping their investment in parity with unsecured creditors."[48]

In enacting Section 510(b) as part of a broader rewriting of the bankruptcy laws in 1978, Congress adopted two underlying rationales for giving priority to creditors over shareholders.[49] First, creditors and shareholders have dissimilar risk and return expectations.[50] Creditors seek repayment of their debt.[51] Shareholders, by contrast, make a choice to receive the potential upside from the proceeds of the business attendant to an ownership interest.[52] Second, shareholders should not be entitled to recover from the "equity pool" upon which creditors rely in deciding to extend credit to the debtor.[53] Courts recognize, however, that this is a "less important rationale".[54] These two rationales have guided the courts' application of the statutory language to a wide variety of scenarios and claims.

B. Application

Section 510(b) applies to three distinct categories of claims: (1) a claim arising from rescission of a purchase or sale of a security of the debtor; (2) a claim for damages arising from the purchase or sale of a security of the debtor; and (3) a claim for reimbursement or contribution on account of either of the first two.[55] As the case law makes clear, however, the underlying policies guide the application of the statute, not the specific statutory language.

With respect to the first category, when the statute was first enacted, Congress anticipated that rescission claims would involve efforts by holders of securities to unwind their purchase and assert a claim for damages.[56] The primary focus was rescission based on fraud by the issuing company.[57] That said, rescission also envelopes instances where the parties agree

[46] *Racusin v. Am. Wagering, Inc. (In re Am Wagering, Inc.)*, 493 F.3d 1067, 1071 (9th Cir. 2007).
[47] *Id.*
[48] *Id.*
[49] *Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 461 F.3d. 251, 255-56 (2d Cir. 2006).
[50] *Id.*
[51] *See Id.*at 256-57.
[52] *See Id.*
[53] *Id.* at 256.
[54] *CIT Group Inc. v. Tyco Int'l Ltd. (In re CIT Group Inc.)*, 460 B.R. 633, 643 (Bankr. S.D.N.Y. 2011), aff'd, 479 Fed. Appx. 393 (2d Cir. 2012).
[55] *SeaQuest Diving, LP v. S&J Diving, Inc. (In re SeaQuest Diving, LP)*, 579 F.3d 411, 418 (5th Cir. 2009).
[56] *Id.* at 418-19.
[57] *Id.* at 419.

as a matter of contract to rescind the purchase of a security, as opposed to the circumstance where a court imposes rescission as a remedy for securities fraud.[58]

In *In re SeaQuest Diving LP*, the company and one of its investors agreed to resolve a post - issuance dispute through the company's return of the investor's assets that it had contributed when the investor obtained its limited partnership interest.[59] When the company did not perform per the rescission agreement, the investor obtained a judgment in state court for breach of contract.[60] Six days later, the company filed bankruptcy and sought to subordinate the investor's claim based on the judgment.[61]

In affirming the lower court's conclusion that the investor's claim should be subordinated, the United States Court of Appeals for the Fifth Circuit reasoned that the parties agreement "rescinded" the original investment.[62] The state court judgment acknowledged the rescission by ordering the company to return the investor's contributed assets.[63] The mere fact of a "judgment," however, did not mean that the investor had rights of a creditor, as opposed to holder of equity. Rather, the court concluded that it may "look behind" the state court judgment to find that it was based on a claim that arose from an agreement to rescind the purchase of an equity security.[64]

Even though the rescission was by agreement of the parties based on a dispute that arose after the initial investment, the court found that subordination was appropriate given the underlying policy reasons of Section 510(b). The parties structured the original investment as an equity investment rather than a loan, and thus the investor assumed the risk of future insolvency.[65] In addition, the company's creditors presumably relied on the equity cushion provided by the investor in extending credit to the company.[66] The investor should thus not be permitted to share ratably with those creditors that never bargained for an equity position.[67] Whether by court order or voluntary agreement of the parties, courts uniformly subordinate claims for rescission of an equity investment to claims of general creditors.

In addition to rescission claims, another category of subordinated claims are those claims for damages that arise from the purchase or sale of a security of the debtor. Finding the language ambiguous, US courts do not attempt hyper-technical constructions of the words of the statute. Rather, they look to advance the underlying policy concerns and in doing so, enforce a broad application of the subordination provision.

Thus, in *In re Med Diversified, Inc.,* the Second Circuit concluded that subordination was proper even where the promised common stock was never issued.[68] In that case, the company and one of its officers entered into a termination agreement, pursuant to which the officer's employment would terminate, each party granted the other a release, and the company would issue a fixed number of shares to the officer.[69] The company failed to perform, and the former officer brought suit for breach of contract and fraudulent inducement.[70] The company then filed for relief under chapter 11 of the Bankruptcy Code and sought to subordinate the officer's claim under Section 510(b).[71] The bankruptcy court and the district court both found that subordination was appropriate, and the officer appealed to the Second Circuit.[72]

Focusing on the underlying policy concerns, the court determined that, in the termination agreement, the officer bargained "not for cash but to become a stockholder in the debtor."[73] Even if the shares are never issued and the individual never had the actual opportunity to share in the upside, subordination is still appropriate because of the "greater financial

[58] *Id.*
[59] *Id.* at 415-16.
[60] *Id.* at 416.
[61] *Id.*
[62] *Id.* at 419.
[63] *Id.*
[64] *Id.* at 423-24.
[65] *Id.* at 420.
[66] *Id.*
[67] *Id*
[68] *In re Med Diversified, Inc.)*, 461 F.3d. 254.
[69] *Id.* at 253.
[70] *Id.*
[71] *Id.*
[72] *Id.* at 254.
[73] *Id.*

expectations" that the individual held as compared to that of a creditor.[74] The individual thus need not be an actual shareholder for subordination to apply.[75]

By contrast, in *In re American Wagering, Inc.*, a financial advisor to a company had an agreement by which the company promised to pay the individual "4% of the final evaluation" of the company's shares of stock upon an initial public offering.[76] The company never upheld its end of the bargain, and the financial advisor sued and obtained a money judgment.[77] The company then filed for bankruptcy.[78]

The Ninth Circuit, in reversing a lower court decision, found that subordination was not warranted because his compensation was only to be valued based on the share price upon completion of the initial public offering.[79] The financial advisor was never to receive shares and "[h]is potential to earn greater profits as a shareholder did not exist."[80] This left the individual with a fixed prepetition debt that resulted in status as a creditor, "not the risk / return position of any equity investor in the now - bankruptcy corporation."[81] As these decisions make clear, the US courts do not focus on interpreting the words "arising from the purchase or sale of such a security," but rather on the underlying policy rationale concerning whether the claimant had bargained for the risk and reward expectations of a shareholder.

The final category for subordination are those claims for indemnity, reimbursement or contribution on account of either of the first two categories. A common scenario is where an officer or director of the debtor, or underwriter of the equity issuance of the debtor, is sued based on their conduct in connection with a purchase or sale of a security, and thereby seeks indemnification from the company. In that instance, the indemnification claims are likewise subordinated.

In the seminal case of *In re Mid - American Waste Systems, Inc.,* a class of equity holders alleged that certain officers and directors either knowingly or recklessly published or disseminated false financial statements and data causing the plaintiffs to buy stock at artificially high prices and suffer losses.[82] As is commonplace, the company had agreed to indemnify the officers and directors for any expenses and liability with respect to the lawsuit, which paralleled the indemnification provisions of Delaware law.[83] After the company filed for bankruptcy, the officers and directors asserted indemnification claims against the company based on the agreement and Delaware law.[84] A separate group of plaintiffs comprised of holders of subordinated notes sued not only officers and directors, but also the underwriters, who likewise filed indemnification claims against the company.[85] The company objected to the indemnification claims on the basis that they should be subordinated under section 510(b) of the Bankruptcy Code.[86]

The bankruptcy court found that Section 510(b) subordinates the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities.[87] Congress not only intended that the holders of securities law claims be subordinated, but also that the claims of other parties – officers, directors and underwriters – who played a role in the purchase and sale transactions which give rise to the securities law claims also be subordinated.[88] As the court found, all claims emanating from tainted

[74] *Id.* at 257 (quoting *In re Betacom of Phoenix, Inc.*, 240 F.3d 823, 830 (9th Cir. 2001)).
[75] *Id.* at 258. *See also Allen v. Geneva Steel Co. (In re Geneva Steel Co.)*, 281 F.3d 1173 (10th Cir. 2002) (debtor's alleged post-investment fraud that caused employees to retain rather than sell his security arose from a purchase or sale of the security); *In re Enron Corp.*, 341 B.R. 141 (Bankr. S.D.N.Y. 2006) (court subordinated employees' claims for damages allegedly suffered when they chose not to exercise stock options received as compensation because of debtor's fraud.)
[76] *In re Am Wagering, Inc.*, 493 F.3d 1071
[77] *Id.*
[78] *Id.*
[79] *Id.* at 1072
[80] *Id.*
[81] *Id.* at 1073. *See also CIT Group Inc. v. Tyco Int'l Ltd. (In re CIT Group Inc.)*, 460 B.R. 633 (Bankr. S.D.N.Y. 2011) (claim of former parent corporation under tax sharing agreement not subject to subordination because parent did not have equity's expected risks and rewards under such agreement), aff'd, 479 Fed. Appx. 393 (2d Cir. 2012).
[82] *In re Mid-American Waste Systems*, 228 B.R. 816, 820 (Bankr. D. Del. 1999).
[83] *Id.*
[84] *Id.*
[85] *Id.* at 819-20.
[86] *Id.* at 820.
[87] *Id.* at 824.
[88] *Id.* at 826.

securities law transactions should be junior to the claims of general creditors of the estate.[89] In sum, US courts find that indemnity claimants are in a better position to evaluate the risk of the issuance of securities – even if the claimants do not ultimately hold the securities themselves – and thus they cannot shift the risk of those securities to the company's creditors.[90] That analysis has been uniformly adopted by subsequent decisions of the US courts.[91]

Finally, a note about the level of subordination in the United States. When a claim related to common stock is subordinated under Section 510(b), it is subordinated to a level of equal priority as the common stock — not to a level below the stock. This is contrasted with subordination of a claim based on any other security, which is subordinated to a level immediately below such security. In this regard, when common stock is "in the money," subordinated claims with respect to that common stock should also be "in the money" and holders of those claims would be wise to pursue them.

V. Conclusion

This brief survey of a narrow legal issue across three jurisdictions sharing a rich common law history reveals interesting differences in how they have adapted to a relatively modern problem. In the UK, legislators have yet to clearly set out a policy that addresses the subordination of misselling or other shareholder claims that are commonly pursued in North American litigation. Perhaps a high profile insolvency case will lead to reform or allow the courts an opportunity to clarify an approach. In the US, by contrast, the subordination of certain types of securities and shareholder related claims has been codified for more than 30 years and there is a deep history of judicial interpretation of the policy. In Canada, the evolution of bankruptcy and insolvency laws has very much followed the needs of commerce. As Canadian businesses have become more intertwined with and dependent upon US trade and commerce, so have Canada's bankruptcy laws adopted more and more concepts from the US. The recent Canadian amendments, though they are not copied from the US Bankruptcy Code, are an example of this direction. Much like younger mountains having sharper peaks, with these fresh statutory amendments and little opportunity as of yet for judicial or legislative softening, it can be said that among the three jurisdictions, Canada currently has the strictest laws for subordination of equity and equity - type claims.

[89] *Id.*

[90] *Id.* at 828.

[91] *E.g., In re Touch Am. Holdings, Inc.*, 381 B.R. 95 (Bankr. D. Del. 2008); *In re Jacom Computer Servs., Inc.*, 280 B.R. 570 (Bankr. S.D.N.Y. 2002).