COURT FILE NUMBER	1903 04121
COURT	COURT OF KING'S BENCH OF ALBERTA
JUDICIAL CENTRE	EDMONTON
	IN THE MATTER OF THE TRUSTEE ACT, R.S.A. C.T-8, SECTIONS 43 AND 46
APPLICANTS	WESTPOINT INVESTMENT TRUST BY ITS TRUSTEES MUNIR VIRANI AND MARNIE KIEL
RESPONDENTS	WESTPOINT CAPITAL CORPORATION, WESTPOINT CAPITAL MANAGEMENT CORPORATION, WESTPOINT CAPITAL SERVICES CORPORATION, WESTPOINT SYNDICATED MORTGAGE CORORATION, CANDIAN PROPERTY DIRECT CORPORATION, WESTPOINT MATER LIMITED PARTNERSHIP, RIVER'S CROSSING LTD., 1897869 ALBERTA LTD., 1780384 ALBERTA LTD. AND 1897837 ALBERTA LTD.

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BENCH BRIEF OF ROBERT (ALLAN) ROBERTS
APPLICATION BEFORE THE HONOURABLE ACJ NIELSEN – AUGUST 30, 2023

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I. INTRODUCTION

1. For the purposes of consistency with the Brief filed by the Contesting Noteholders, except as otherwise defined herein, capitalized terms used herein shall have the meaning ascribed to them in the Brief of the Contesting Noteholders, the A&R Declaration of Trust and the Schedule as the case requires.

2. The Trust is a mutual fund trust established pursuant to the A&R Declaration of Trust dated September 3, 2015, having retroactive effect to June 30, 2015.

3. The Trust is as a result of a Plan of Arranagement pursuant to the *Business Corporations Act* of the Province of Alberta by two pre-existing MICs.

4. The result of the establishment of the Trust is that parties who held shares in the MICs became unit holders in the Trust.

5. A further result of the Plan of Arrangement was that shareholders who had requested redemption of their shares in the MICs prior to the Plan of Arrangement (the "Redeeming Shareholders") would, upon the implementation of the Plan of Arrangement, be issued a Redemption Note by the Trust.

6. The rights of unit holders are governed by the A&R Declaration of Trust and the Schedule (the "Governing Documents").

7. The Governing Documents provide for a process by which unit holders can redeem their units and provides for the method of payment when redemption is requested.

8. In cases where the Trust did not have sufficient funds to pay a redemption request when made, the Governing Documents provided for a process to secure payment to the redeeming unit holder by issuing a Redemption Note and provided for a subordination/priority of the claims of each Redeeming Unitholder such that redemptions would be paid in the order that the unitholders sought redemption.

9. The subordination/priority system is defined in the Governing Documents as the Redemption Security Queue.

10. The Trust has funds available to make payment on account of outstanding Redemption Notes but has insufficient funds to make payment to all outstanding Redemption Notes.

11. The Trustee is proposing that the available funds in the Trust be distributed in accordance with the terms of the Governing Documents, including the application of the subordination/priority provisions contained therein.

12. There is a question of whether the Redemption Notes received by the Redeeming Shareholders are subject to all of the terms of the Governing Documents.

13. There is also a question as to whether the claims of some holders of Redemption Notes, whether they be Redeeming Shareholders or Redeeming Noteholders, have been statute-barred by the *Limitations Act*.

14. It is the position of Robert (Allan) Roberts ("Roberts") that he is a bona fide creditor of the Trust holding a Redemption Note issued to him as a Redeeming Shareholder and that he is entitled thereto to be paid in priority to the claims of Redeeming Unitholders holding Redemption Notes issues pursuant to the Governing Documents.

15. If Roberts' Redemption Note is subject to the terms of the Governing Documents, it is his position that only valid claims that are not statute-barred can be paid from the available funds and that many of the claims of noteholders, whether they be Redeeming Shareholders or Redeeming Unitholders, are barred by reason of the *Limitations Act*.

16. If Roberts' Redemption Note is subject to all of the terms of the Governing Documents, and subject to determination of whether any of the claims of Redemption Noteholders are statute-barred, Roberts supports the distribution of available funds pursuant to the terms of the Governing Documents, including the Redemption Security Queue.

17. The proposed distribution is consistent with both the Governing Documents and does not offend the *pari passu* principle.

18. There is nothing unfair or inequitable in distributing the available funds in accordance with the Governing Documents, which govern the rights of all parties who invested in the trust.

19. Anyone objecting to the proposed distribution bears the onus of establishing that it is not in accordance with the terms of the Governing Documents or otherwise contrary to law.

II. ISSUES

20. The first issue before this Court is whether all of the provisions of the Governing Documents apply to the Redemption Notes issued to the Redeeming Shareholders and the effect that has on the distribution of available funds.

21. A further issue before this Court is whether any of the claims of any holder of a Redemption Note are statute-barred by reason of the *Limitations Act*.

22. After determination of the foregoing, and any other issues that the Court needs to determine, the issue is what is the proper distribution of the available funds.

III. FACTS

23. The Trust was established pursuant to an arrangement agreement entered into by various parties pursuant to s. 193 of the *Business Corporations Act*, R.S.A. 2000, c.B-9 (the "Arrangement").

24. The Arrangement was approved by the Court of King's Bench of Alberta by final Order dated July 14, 2015.

25. The A&R Declaration of Trust was originally dated June 1, 2015, and was amended and restated by agreement dated September 3, 2015, having a retroactive effect to June 30, 2015.

26. Prior to the Trust being established, the assets of the Trust were held by two MICs.

27. Roberts had invested in one of the MICs, being Westpoint Capital High Yield Mortgage Investment Corporation ("HMIC").

28. Roberts had purchased shares in HMIC for the sum of $1,000,000.00.

29. The articles of HMIC contained a redemption process for redeeming shares of HMIC which was similar to the redemption process set forth in the Governing Documents, but without the provision for the issuance of Redemption Notes.

30. By Request to Redeem Shares dated January 22, 2014 (which date is prior to the Arrangement, any application to the Court to approve the Arrangement or the implementation of the Arrangement), Roberts sought redemption of all shares held by him in HMIC.

[Exhibit "A" to the Affidavit of Robert (Allan) Roberts, sworn August 3, 2023]

31. Prior to the Arrangement being approved, Roberts received a Management Information Circular providing a description of the Arrangement including the effect the Arrangement would have on the redemption of his HMIC shares.

[Exhibit "B" to the Affidavit of Robert (Allan) Robets, sworn August 3, 2023]

32. The Arrangement provided that any HMIC shareholder who had submitted a Redemption Notice prior to the date of the meetings held to consider the Arrangement and whose shares had not been redeemed would receive a Redemption Note from the Trust dated July 1, 2015.

33. Upon implementation of the Arrangement, Roberts received a Redemption Note in accordance with the foregoing, which Note is dated July 1, 2015 and in the amount of $750,001.00, being the calculated fair market value of his HMIC shares as of the date of his Redemption Request ("Roberts' Redemption Note").

[Exhibit "C" to the Affidavit of Robert (Allan) Roberts, sworn August 3, 2023]

34. Roberts' Redemption Note attached a copy of the Declaration of Trust dated June 1, 2015, which in turn attaches the schedule of unit rights to the Declaration of Trust (the "Original Schedule").

35. The Original Schedule contained a definition of Redemption Note as follows:

> "Redemption Note" means a non-interest bearing, unsecured, subordinate Promissory Note issued by the Trust:
>
> (i) Pursuant to the Plan of Arrangement in satisfaction of the redemption price for shares tendered for redemption by a Shareholder prior to the Effective Date; or
>
> (ii) to a Redeeming Unit Holders pursuant to section 6.4(a)(ii) herein."

36. As indicated, the original A&R Declaration of Trust was dated June 1, 2015, and it was amended and restated by agreement dated September 3, 2015, having a retroactive effect of June 30, 2015.

37. The definition of Redemption Note in the Schedule attached to the A&R Declaration of Trust is as follows;

> "Redemption Note" means a non-interest bearing, unsecured, subordinate Promissory Note issued by the Trust to a Redeeming Unitholder pursuant to section 6.4(a)(ii) herein."

38. The Roberts Redemption Note provides, *inter alia*, "…. that the entire principal amount shall be repaid in full no later than 3 years after the issuance date."

39. Roberts' Redemption Note matured on July 1, 2018.

40. Roberts commenced an action in the Court of Queen's Bench (now King's Bench) of Alberta as Action No. 1803 19884 on October 9, 2018 against the Trustees and the Trust seeking judgment for the amounts due to him under Roberts' Redemption Note.

41. The proceedings commenced by Roberts were stayed by the Judicial Trustee Order.

42. After completion of the Arrangement, the Trust held the beneficial interest in the assets previously held by the MICs (these, together with the other assets transferred pursuant to the Arrangement are hereinafter referred to as the "Trust Assets").

43. The Trust Assets were held by various companies for the benefit of the Trust.

44. Pursuant to an application made by the Trustees of the Trust pursuant to the provisions of the *Trustee Act*, R.S.A. c.T-8, on March 8, 2019, the Court granted the Judicial Trustee Order appointing BDO Canada Limited ("BDO") as Judicial Trustee.

45. In addition, the Court granted the Interim Receiver Order appointing BDO as Interim Receiver of the companies holding and managing the Trust Assets.

46. On April 10, 2019, the Court granted the Receivership Order appointing BDO as Receiver of the companies over which they were initially an Interim Receiver, and adding an additional company to be subject to the Receivership Order.

47. As Receiver, BDO has arranged for, and with the approval of the Court, sold the Trust Assets, and to the extent authorized by the Court, paid the obligations of the companies which were subject to the Receivership proceedings.

48. BDO, in its capacity as Judicial Trustee, obtained Orders of this Honourable Court to pay all unsecured creditors of the Trust, except for the holders of Redemption Notes regardless of whether they were Redeeming Unitholders or Redeeming Shareholders.

49. Upon completion of the aforesaid, there is approximately $4,000,000.00 available to the Trust for payment by it to claimants against the Trust (the "Fund").

50. In the Judicial Trustee's Fourth Report to the Court, the Trustee seeks a Court Order to distribute the Fund in accordance with the Governing Documents and applying the subordination/priority provisions described as the Redemption Security Queue.

51. The result is that approximately the first seventy five (75) investors listed on the Redemption Security Queue will be paid.

52. All of the Redeeming Shareholders who received Redemption Notes are listed as the first seventy five (75) investors on the Redemption Security Queue.

53. The Contesting Noteholders dispute the proposed distribution.

IV. LAW AND ARGUMENT

A. General

54. It should be noted at the outset that the distribution of the Fund is not being made in the context of either a receivership, bankruptcy or some other insolvency proceeding.

55. The Trust is not in receivership, is not bankrupt, and is not subject to any insolvency proceedings.

56. There is no application before this Court for the winding up or dissolution of the Trust.

57. Simply put, the Trust presently has no debts owed to third parties and has a fund of money available to satisfy its obligations to the holders of Redemption Notes.

B. Effect of the Amendment to the Schedule

58. As indicated above, the Original Schedule defined Redemption Notes to include Redemption Notes issued by the Trust pursuant to the Plan of Arrangement in satisfaction of the Redemption Price for shares of Redeeming Shareholders.

59. The Original Schedule was then amended and Redemption Notes issued to Redeeming Shareholders are not included in the definition of Redemption Note in the Schedule that is attached to the A&R Trust Declaration.

60. The result is that Roberts holds a Redemption Note that apparently is not subject to the vast majority of the provisions of the Schedule.

61. He is simply a bona fide creditor of the Trust, entitled to be paid on his Redemption Note.

62. As indicated above, Roberts has sued to recover the amounts due under his Redemption Note. His lawsuit is stayed by the provisions of the Judicial Trustee Order.

63. If the foregoing is the result of the amendment to the definition of the Redemption Note in the Trust, then Roberts, being a bona fide creditor of the Trust, is, by reason of the amended Schedule, and Article 6.7 thereof, to rank in priority to all Trust Notes, as that term is defined in the Schedule, which term includes all Redemption Notes issued to Redeeming Unitholders.

64. Roberts' Redemption Note contains a subordination by him in favour of all bona fide debts of the Trust as defined therein, which includes trade payables, operating and capital liabilities, etc.

65. The effect of this on the priority of payment of available funds is as follows:

    (a) First, to bona fide debts of the Trust, not being debts owed to Redeeming Shareholders holding Redemption Notes or Redeeming Unitholders holding Redemption Notes;

    (b) Second, to Redeeming Shareholders holding Redemption Notes;

    (c) Third, to Redeeming Unitholders holding Redemption Notes (which is further subject to the Redemption Security Queue).

66. All of the debt of the Trust, other than amounts owed on Redemption Notes held by Redeeming Shareholders and Redeeming Unitholders have been paid.

67. As indicated above, all of the Redeeming Shareholders' Redemption Notes are listed as the first seventy five (75) parties on the Redemption Security Queue.

68. In the circumstances, Roberts is entitled to have his Redemption Note paid in full in priority to the claims of any Redeeming Unitholder holding a Redemption Note.

C. Limitations

69. It would appear that the only party who has commenced an action to enforce their claim on their Redemption is Roberts.

70. There is a question as to whether the claims of a portion of the holders of Redemption Notes are statute-barred by the *Limitations Act*, R.S.A. c.L-12.

71. The result is that may of the claims of the holders of Redemption Notes may be barred and cannot be paid by the Trust.

72. With respect to redemptions by unitholders, the Schedule provides for the process for redemption of units, the payment of the Redemption Price and the issuance of Redemption Notes.

73. Pursuant to Article 6.2 of the Schedule, a unitholder can tender a Redemption Request.

74. The Trust then approves and accepts the Redemption Request and records the date and time thereof, which becomes the Acceptance Time.

75. The Receiver has attached the Redemption Security Queue as Exhibit 8 to its Second Report dated August 4, 2022, which sets forth the date and time of the redemption.

76. Pursuant to Article 6.4, the Redemption Price for the units is to be paid on the Redemption Date.

77. Redemption Date is defined as the last day of the month in which the Redemption Request was accepted. That would be the last day of the month corresponding with the dates listed on the Redemption Security Queue.

78. Article 6.4 provides that payment of the Redemption Price "shall" be made on the Redemption Date (being the last day of the month in which the Redemption Request was accepted) by:

(a) Cash payment and/or;

(b) Issuance of a Redemption Note.

79. The result is that the Redemption Notes are issued on the last day of the month in which the redemption was made as indicated on the Redemption Security Queue.

80. Article 6.4(d) provides that the Redemption Price is conclusively deemed to have been made upon, *inter alia*, the issuance of the Redemption Note.

81. It further provides that the Trust is discharged of all liability except for payment of amounts due on the Redemption Note.

82. Article 6.5(d) provides that unless otherwise expressly agreed by a unitholder in writing, Redemption Securities (of which Redemption Notes are one) shall have a maturity date not later than the third anniversary of the Issue Date. (The Issue Date of a Redemption Note is as set forth in paragraph 6.4 and is the last day of the month of redemption as indicated on the Redemption Security Queue.)

83. As indicated, a term of the Redemption Note is that it has a maturity date three (3) years after issuance. At that point, the redeeming unitholder would have a cause of action against the Trust to recover the amounts due under the Note.

84. The *Limitations Act* provides that it is necessary to commence an action within two (2) years of when the cause of action arose, otherwise the claim is not enforceable. An additional seventy five (75) days is added to that limitation period as a result of the suspension of the *Limitations Act* because of the Covid-19 pandemic.

85. The result is that as of August 1, 2023, any party holding a Redemption Note on the Redemption Security Queue having a Redemption Date prior to May 17, 2018, who has not commenced an action to recover the amounts due on the Redemption Notes is barred pursuant to the *Limitations Act*.

86. Roberts' Redemption Note bears an issue date of July 1, 2015.

87. It states that it is matures three (3) years from the issue date, which would be July 1, 2018.

88. The *Limitations Act*, together with the Covid-19 extension, would provided that Roberts has until October 14, 2020 to commence action to recover on his Redemption Note.

89. Roberts commenced an action the Trust and the Trustees to recover amounts due under his Redemption Note by King's Bench Action No. 1803 19884 on October 9, 2018.

90. Roberts' action was subsequently stayed by the Judicial Trustee Order.

91. The result is that Roberts' claim on his Redemption Note is not barred by the provisions of the *Limitations Act*.

92. Although the Judicial Trustee Order contains at paragraph 10 thereof a stay of commencement of any proceedings against the Trust or the previous Trustees of the Trust without the written consent of the Judicial Trustee or leave of the Court, there is an exception.

93. The exception contained in paragraph 10 specifically provides that it does not "...prevent any person from commencing a proceeding regarding a claim that might otherwise become barred by statute or an existing agreement if such proceeding is not commenced before the expiration of the stay provided for....".

94. The result is that the Judicial Trustee Order did not dispense the running of the limitation periods applicable to claims under Redemption Notes but specifically provides for and puts potential claimants on notice that they have to take steps to protect their claims from the provisions of the *Limitations Act*.

95. A search has been conducted of the Court of King's Bench (formerly Court of Queen's Bench) for actions commenced against the Trust and the only action commenced with respect to the enforcement of a Redemption Note as revealed by that search is the action commenced by Roberts to recover on his Redemption Note.

96. The result is that, as of August 1, 2023, any person holding a Redemption Note with a Redemption Date prior to May 17, 2018, who has not commenced an action to enforce recovery on the Redemption Note, does not have a valid claim and cannot participate in any distribution of the Fund.

97. It is submitted that the distribution of the available funds can only be made to those parties who have valid and enforceable claims against the Trust.

D. Provisions of the Governing Documents

98. If the Court determines that notwithstanding the submissions above (and subject to the effect of the limitations submissions above), Roberts' Redemption Note remains subject to the terms of the Governing Documents, then it is submitted that it is necessary to review the provisions of the Governing Documents respecting the redemption of units by unitholders.

99. The Governing Documents include the A&R Declaration of Trust and the Schedule which is a schedule to the A&R Declaration of Trust.

100. Most of the provisions governing redemption and payment to noteholders are found in the Schedule.

101. As indicated above, Roberts was never a holder of a unit in the Trust. He received his Redemption Note as part of the implementation of the Arrangement.

102. Since Roberts' Redemption Note may be subject to the provisions of the Governing Documents, in order to understand the position of Roberts, it is useful to understand the process by which unit holders of the Trust can redeem their units.

103. The process of redemption and payment to the redeeming unit holder is as follows (the following is a summary of the provisions of the Schedule dealing with redemptions):

    (a) A unitholder is entitled to require the Trust to redeem at any time at the demand of a unitholder all or any part of the trust units registered to that unitholder (A&R Trust Declaration Article 6.1, Schedule Article 6.1);

    (b) The redemption right is exercised by the unitholder providing a Redemption Request (Schedule Article 6.2(a));

    (c) Trust units are deemed to have been tendered for redemption on the date and time at which the Trust approves and accepts the Redemption Request (the "Acceptance Time") (Schedule Article 6.2(c));

    (d) From and after the Acceptance Time, the Redeeming Unit Holder ceases to have voting rights or entitlements with respect to the units submitted for redemption, except to receive the Redemption Price and any Distributions declared in the period ending on the last day of the calendar month immediately preceding the Acceptance Time (Schedule Article 6.2(d);

(e) The unit holders are entitled to received a Redemption Price equal to the Fair Market Value of the redeemed units as determined by the Trustees on an annual basis following receipt of the Trust's audited financial statements, less the applicable discount (if any) (Schedule Article 6.3);

(f) The Trust shall pay the Redemption Price in cash, if permitted (as detailed below) and if not paid in cash, then:

i. With respect to trust units held in a registered plan under the *Income Tax Act*, either:

1. A Redemption Note if requested, or

2. Class D units at the rate of 1 Class D Unit for each dollar of principal of redemption price;

ii. If the trust units are in an unregistered plan, then by issuing a Redemption Note in the principal amount of the Redemption Price (Schedule Article 6.4);

(g) The Trust is not entitled to pay the Redemption Price in cash unless:

i. Payment would not impair the ability of the Trust to carry on its business or otherwise satisfy its liabilities as they fall due "... as determined by the Trustees, acting reasonably, and taking into account all of the Trust obligations and commitments." (Schedule Article 6.4(b));

(h) Redemption Securities (which includes Redemption Notes) include, *inter alia,* the following terms:

i. they are unsecured and are subordinate to bona fide debts of the Trust;

ii. have a maturity date not later than the third anniversary of the Issue Date thereof;

iii. the indebtedness owing under the Redemption Note is not payable if at the relevant time it would impair the ability of the Trust to carry on its business "... as determined by the Trustees acting reasonably, and taking into account all of the Trust's current and pending commitments and liabilities." (Schedule Article 6.5);

(i) an additional and specific term of a Redemption Note as provided for at Articles 6.5(e) of the Schedule is that when there is more than one Redemption Security outstanding, the Redemption Security Queue comes into effect and the Redemption Notes are placed into priority based on the applicable Acceptance Time of the Redemption Request and priority is given to the Redemption Notes in accordance with the Acceptance Time of the Redemption Request (Schedule Article 6.5(e)).

E. Effect of the Governing Documents

104. The effect of the foregoing is to create a subordination/priority applicable to all Redemption Notes.

105. The Redemption Security Queue results in all Redemption Notes being junior debt to all Redemption Notes in the Redemption Security Queue before it and all Redemption Notes are senior debt to all Redemption Notes in the Redemption Security Queue after it.

106. The result is that the Redemption Notes are paid in priority based on the date that the Redemption Request was received and accepted by the Trust, which priority is recorded in the Redemption Security Queue Master List attached as Exhibit 8 to the Judicial Trustee's Second Report to the Court dated August 4, 2022 (the "Redemption List").

107. The terms of the Governing Documents clearly indicate that when funds are available to satisfy Redemption Notes, they are satisfied in the order of priority as set forth in the Redemption Security Queue.

108. In this case, there are available funds, comprising approximately $4,000,000.00.

109. The Trustee has proposed that the Fund be distributed in accordance with the Redemption Security Queue.

110. At paragraph 27 of the Contesting Noteholders Brief, they point to Articles 6.4(b) and 6.5(f) of the Schedule and submit that these provisions would prohibit the Trustee from making payment.

111. However, those provisions provide a discretion to the Trustee.

112. It is the Trustee who determines whether the payments can be made in accordance with the Governing Documents. The Trustee takes into account liabilities of the Trust present and pending (of which there are none) and the Trust's current and pending commitments and obligations (of which liability to the noteholders in accordance with the provisions of the Governing Documents is paramount) and determines whether the payment of available funds should be made.

113. In the circumstances, the Trustee has applied to the Court for payment to the noteholders in accordance with the Governing Documents and the Redemption Security Queue.

114. In the circumstances, the Trustee has determined in all of the circumstances that the payment can be made.

115. The Contesting Noteholders further argue that Article 6.8 of the Schedule modifies the priorities set forth in the Redemption Queue and provide that "Matured Notes" are payable in priority.

116. Article 6.8 of the Schedule was clearly intended to give Matured Notes rights in addition to the other rights provided to Redemption Notes in the Schedule. It does not purport to affect the subordination/priority system set up for the payment of Redemption Notes and described as the Redemption Security Queue.

117. All that Article 6.8 provides for is that Matured Notes will have priority over those parties listed in Article 6.8(b) and Non-Matured Redemption Notes would not have priority over those parties.

118. Article 6.8 does not require that a payment to Matured Notes be made pro rata. It does not purport to terminate the subordination/priority set forth in the Redemption Security Queue.

119. All that it does is give to Matured Notes a priority over claims listed in Article 6.8(b).

120. The result is that, as in the case before the Court, where there is insufficient monies available to pay all claims in full, and in fact not sufficient funds to pay all the Matured Notes in full, then payment to Matured Notes would be subject to the subordination/priority of the Redemption Security Queue and result in payment of the oldest Matured Note first.

121. In this way, the priority given to Matured Notes in Article 6.8 is recognized while preserving the method of agreed priorities between Redemption Notes generally as reflected by the Redemption Security Queue.

122. Although we submit that the Redemption Security Queue and the subordination/priority system is applicable to the payment to Matured Notes under Article 6.8, if the Court finds otherwise, then we submit that it is appropriate that only those Redemption Notes that were Matured Notes as of the date of the Judicial Trustee Order, being March 8, 2019, should participate.

123. There is no reasonable justification for changing the status of the holder of a Redemption Note from and after the granting of the Judicial Trustee Order.

124. If a Redemption Note was a Matured Note as of the date of the Judicial Trustee Order, it should be treated as a Matured Note.

125. A Redemption Note that was not a Matured Note as of the date of the Judicial Trustee Order should not be entitled to a change of status and a change of priority simply by reason of the lapse of time while the Judicial Trustee accumulated the available funds to make payment.

126. It is to be noted that the Judicial Trustee Order contains a stay staying all parties from taking actions against the Trust or Trustees or continuing any proceedings are recommenced.

127. It would be unfair to those parties holding Matured Notes to be stayed from taking any steps to recover on those Notes but at the same time continue to allow other parties holding Redemption Notes to elevate their priority status simply by the lapse of time.

128. The Contesting Unitholders also refer to Article 7 of the Schedule, and specifically Article 7.1 and 7.2.

129. Both of those provisions are predicated upon an event of liquidation, dissolution or winding up of the Trust.

130. With respect to dissolution or winding up of the Trust, and liquidation of its assets, those proceedings are specifically provided for in Article 14 of the A&R Declaration of Trust.

131. Pursuant to that Article, there are only two ways to wind up and dissolve the Trust.

132. Firstly, under Article 14.1, the term of the Trust ends twenty one (21) years after the date of death of the last surviving issue of Her Majesty the Queen Elizabeth II, alive at the date of the Declaration of Trust. For the purposes of terminating the Trust on that date, the Trustees are directed to commence winding up the affairs of the Trust on a date to be determined by them.

133. The foregoing has not occurred, so winding up of the Trust pursuant to Article 14.1 has not occurred.

134. The second way to wind up the Trust is pursuant to Article 14.2, which provides that the Trust can be terminated by a special resolution of the voting unitholders. If termination is authorized by the unitholders, the Trustee is to windup the affairs of the Trust.

135. There has been no special resolution of the voting unitholders to terminate the Trust.

136. In each of the winding up/termination processes set forth in Article 14 of the A&R Declaration of Trust, the Trustee is directed to liquidate the assets of the Trust.

137. The result is that the Trust has not been wound up or terminated (dissolved) in accordance with the terms of the A&R Declaration of Trust and any sale of the assets of the Trust has not occurred in accordance with the Trustee's mandate to liquidate.

138. Further, no party has made an application to the Court for the winding up, termination or dissolution of the Trust.

139. It is submitted that Article 7.2 of the Schedule needs to be interpreted in the context of the provisions of the A&R Declaration of Trust and specifically Article 14 thereof.

140. The result is that there has been neither a winding up, dissolution or liquidation of the Trust as contemplated by the Governing Documents, and therefore Article 7.2 of the Schedule has no application.

141. Since there has been no process undertaken pursuant to the Governing Documents to wind up or terminate the Trust, it is consistent to simply follow the provisions of the Governing Documents and distribute funds in accordance with the priorities set forth in the Redemption Security Queue.

F. *Pari Passu* Rule

142. As stated above, these proceedings are not insolvency proceedings.

143. These proceedings were commenced pursuant to the *Trustee Act*, which is not an Act of the Province of Alberta relating to insolvency.

144. All that is happening is that a Judicial Trustee appointed by the Court who is operating under the terms of the Governing Documents has received funds which are now available to pay the outstanding claims of noteholders against the Trust.

145. The Trustee is simply applying the terms of the Governing Documents, which clearly provide for a priority/subordination system that sees the noteholders paid in priority of their redemption date.

146. As a result, the *pari passu* principle is simply not applicable, because it is a principle that is only applicable in insolvency proceedings.

147. Even if the *pari passu* principle is applicable in these circumstances, the principle has not been violated by the redemption process and specifically the subordination/priority set forth by the Redemption Security Queue.

148. The *pari passu* principle does not stand for the proposition that subordination/priority agreements are not effective in these circumstances.

149. There are two stages in making payment to a class of creditors in an insolvency proceeding.

150. The first stage is to establish the fund that is available for that class.

151. The second stage is the payment of those funds to persons in the class.

152. The *pari passu* principle applies to the first stage, the setting of the fund. It does not apply to the second stage, the payment to persons in the class.

153. Once the fund is set, any existing subordination/priority agreements between parties within the class are then applied to determine who gets those monies.

154. The *pari passu* principle is directed at ensuring that the potential available fund for a class of creditors is not eroded by agreements entered into by one or more creditors and the debtor which give to those creditors an advantage or benefit that is not given to other creditors in the class.

155. Once the fund is protected, and available for the class, any priority/subordination agreements between members of the class are applicable and the funds otherwise payable to a creditor are distributed in accordance with any subordination/priority agreement in favour of any other creditor in the class.

156. This issue was examined by the Chancery Division of the Courts of Great Britain in *Re Maxwell Communications Corp. plc (No. 2),* [1994] 1 All.E.R. 737. [**TAB 1**]

157. The issue in that case was whether a subordination agreement was enforceable in bankruptcy proceedings or whether that subordination agreement offended the *pari passu* rule or other governing principles of insolvency.

158. The facts of the case are complicated, but the essence was whether a subordination agreement was applicable in insolvency proceeding because if it was, there would be no funds available to certain creditors, making their claims in an arrangement valueless.

159. The headnote of the case succinctly states the *pari passu* principle and that the enforcement of subordination agreements between creditors does not offend that principle.

160. The headnote states at page 738 in part:

> "...The *pari passu* rule prevented a creditor from arranging to obtain some advantage in the winding up of a company to which insolvency principles did not entitle him but subordination in no way undermined that principle. Accordingly, there was no principle of insolvency law which rendered invalid a subordination agreement. Therefore the subordination agreement was valid and enforceable."

161. Justice Vinelott summarized the *pari passu* "rule" at page 750. He had reviewed a decision of the British Courts entitled British Eagle where there was a question of whether clearance arrangements amongst a number of airlines and airports, resulting in a series of set-offs between the parties resulting in a net claim or debt offended the *pari passu* principle. He stated that:

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

162. Justice Vinelott was referred to and examined a number of cases dealing with the prohibition in insolvency proceedings of the enforcement of agreements that negated the right of set-off upon a bankruptcy and found that principle to be sound (in essence it was an anti-deprivation issue).

163. At page 746, he examines whether that principle or the underlying public policy of that principle is applicable to subordination agreements and states that:

> The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after the commencement of a bankruptcy or winding up. I do not think that it does. It seems to me plain that after the commencement of a bankruptcy or a winding up a creditor must be entitled to waive his debt just as he is entitled to decline to submit a proof. There might, in any given case, be a question whether a waiver was binding on him but that that is irrelevant for this purpose. If the creditor can waive his right altogether I can see no reason why he should not waive his right to prove, save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full, or, if he is a preferential creditor, to agree that his debt will rank equally with unsecured non-preferential debts.
>
> So also, if the creditor can waive his right to prove or agree the postponement of his debt after the commencement of the bankruptcy or winding up, I can see no reason why he should not agree with the debtor that his debt will not be payable or will be postponed or subordinated in the event of a bankruptcy or winding up. The reason for giving effect to an agreement in these terms seems to me to be if anything stronger than that for allowing the creditor to waive, or postpone, or subordinate his debt after the commencement of a bankruptcy or winding up; for other creditors might have given credit on the assumption that the agreement would be binding.

164. Justice Vinelott was also referred to a number of authorities from jurisdictions which derived their insolvency laws from, or otherwise are similar to, English law and found that a number of those jurisdictions allow the application and subordination agreements in bankruptcy proceedings.

165. In conclusion he finds that subordination agreements are enforceable in bankruptcy proceedings in Great Britain.

166. The decision in *Maxwell* was examined and approved by Justice Farley of the Ontario Superior Court of Justice in *Re Air Canada*, 2004 CanLII 34416 (ONSC) [**TAB 2**].

167. In that case, Justice Farley was examining whether subordination agreements between creditors were enforceable in the *Companies Creditors Arrangement Act* proceedings of Air Canada. Further, he examined the question whether a subordination needs to be applicable to all creditors within a class or whether a junior creditor can subordinate in favour of select senior creditors.

168. At paragraph 14 of the decision, he concludes that:

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

169. In coming to that conclusion, Justice Farley examined a number of Canadian cases, learned articles and additional British authority, which have indicated that subordination agreements are enforceable in the context of insolvency proceedings including bankruptcy proceedings. His analysis of those cases and learned articles are reviewed at paragraphs 10 through 13 of his decision.

170. One of the cases Justice Farley examined was the decision of Justice Tysoe of the British Columbia Supreme Court in *Re Rico Enterprises Ltd.,* 1994 CanLII 996 (BCSC) [**TAB 3**].

171. *Rico* was a bankruptcy proceeding.

172. Justice Tysoe indicates that subordination/priority agreements are applicable in bankruptcy proceedings and gives us a practical roadmap to the distribution phase of a bankruptcy when subordination agreements are in effect.

173. What happens is that the fund that's available to the creditors is first established.

174. That fund would be established after examining any anti-deprivation issues including any violation of the *pari passu* principle.

175. Then, the distribution phase of the bankruptcy occurs.

176. In that phase, all creditors in the fund are allocated their proportionate share of the fund; however, when making payment, the Trustee would apply any subordination/priority agreements and make payment in favour of the senior creditor from funds otherwise available to the junior creditor until the claim of the senior creditor is paid in full.

177. Justice Tysoe states, at page 22:

> In the event that the agreements conceded to have been made by T.K. Holdings Ltd. and Davis & Company are not overridden by s.139, their claims are subordinated to the claims of the Second Round Investors. There is no evidence that they subordinated their claims to all other claims ranking in priority to the claims of the Second Round Investors and that result does not automatically flow from a subordination to the Second Round Investors. If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.
>
> It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the same class as the subordinating creditor should not receive the benefit of a subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination was granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

178. The *Maxwell* and *Air Canada* decisions have been further adopted by the Quebec Superior Court in *Re: Homburg Invest Inc.*, 2014 QCCS 3135 (CanLII) [**TAB 4**].

179. Relying on those decisions, Chief Justice Schrager states, commencing at paragraph 42, as follows:

> 42. It is accepted in Canadian insolvency law that in proposals under the *Bankruptcy and Insolvency Act ("BIA")* to which CCAA arrangements are fundamentally similar, the rights of the debtor vis-à-vis its creditors is altered under the proposal but not the rights of the creditors *inter se*.
>
> 43. Subordination clauses are fully enforceable in a bankruptcy or insolvency context. Giving effect to a subordination clause as HII proposed does not make a plan unfair or unreasonable as the fair and reasonable criterion for court sanction of a CCAA plan of arrangement does not require equal treatment of all creditors.
>
> 44. Subordination clauses not containing express language addressing the effect of the subordination in a bankruptcy are given effect in a bankruptcy, nonetheless.
>
> 45. Subordinate creditors have been ordered to turnover to senior creditors monies received in an insolvency based on general subordination language – i.e. absent a turnover clause.
>
> 46. Significantly, in *Stelco*, the Ontario Court of Appeal confirmed Farley, J. that a debtor may group subordinate with senior debt in classification. The creditors are classified according to their rights vis-à-vis the debtor. Both Stichting and Taberna are unsecured note or debenture debt. It is their rights *inter se* which differ.

180. The Governing Documents do nothing to give any noteholder an advantage over any other noteholder within the class and therefore do not offend the *pari passu* principle.

181. What the Governing Documents do is create a priority/subordination system whereby each noteholder subordinates their claim in favour of the noteholder who gave redemption notice prior to them.

182. The result is that the *pari passu* principle is not offended and based on the authorities cited above, the subordination/priority agreement is applicable and results in payment in accordance with the Redemption Security Queue provided for in the Governing Documents.

V. CONCLUSION

183. Based on the foregoing, it is submitted that Roberts' claim under his Redemption Note should be paid in full.

184. Firstly, given the definition of Redemption Note contained in the Schedule, Roberts' Redemption Note is not affected by the vast majority of the provisions dealing with redemption

by unitholders. His Note stands alone as a bona fide debt of the Trust. Article 6.7 of the Schedule subordinates all Unitholders Redemption Notes to bona fide debts of the Trust. They are therefore subordinated to Roberts' Redemption Note.

185. Since there is sufficient funds to pay all of the Redemption Notes issued to Redeeming Shareholders, Roberts' Redemption Note should be paid in full.

186. If the foregoing is not applicable, then it is submitted that by reason of the *Limitations Act*, the vast majority of claims on the Redemption Security Queue are statute-barred. Roberts' claim is not statute-barred since he commenced action within the limitation period.

187. There is sufficient funds to pay the claims of all parties whose claims are not statute-barred.

188. Roberts' claim should be paid in full.

189. If the foregoing are not applicable, it is submitted that there is nothing contained in the Schedule or process for payment of Redemption Notes that affects the application of the Redemption Security Queue for subordinations and priorities.

190. The result is that payments are made in accordance with the priority set forth in the Redemption Security Queue. The result is that Roberts' claim gets paid in full.

VI. RELIEF REQUESTED

191. An Order directing the Judicial Trustee to make payment in the full amount of $750,001.00 to Roberts in satisfaction of Roberts' Redemption Note and an Order granting costs to Roberts payable from the Fund.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 4 day of August, 2023.

OGILVIE LLP

PER: _____
KENTIGERN A. ROWAN, K.C.

LIST OF AUTHORITIES

TAB	REFERENCE
1	*Re Maxwell Communications Corp. plc (No. 2),* [1994] 1 All.E.R. 737
2	*Re Air Canada*, 2004 CanLII 34416 (ONSC)
3	*Re Rico Enterprises Ltd.* (1994), 1994 CanLII 996 (BCSC)
4	*Re: Homburg Invest Inc.*, 2014 QCCS 3135 (CanLII)

Re Maxwell Communications Corp plc (No 2)

CHANCERY DIVISION

VINELOTT J

18, 19, 26 MARCH 1993

Company law – Scheme of arrangement – Scheme of arrangement between company and creditors – Subordination agreement – Company guaranteeing bonds of another company – Claims of bondholders subordinated under guarantee to claims of surety company's own creditors – Whether subordination agreement valid – Whether necessary to obtain consent of bondholders to scheme of arrangement.

In June 1989 a company, MFJ, issued convertible bonds which were guaranteed by another company, MCC, under a guarantee which provided that MCC's liability to the bondholders was subordinated to MCC's liabilities to other unsecured creditors and that if MCC entered into a composition with its creditors the unsubordinated creditors were entitled to have their claims satisfied in full before any payment was made to the holders of the MFJ bonds. The guarantee further provided that payments under the guarantee were to be made to a Swiss bank, SBC, on behalf of the MFJ bondholders. The guarantee and the subordination agreement were subject to Swiss law, which did not recognise trusts. Accordingly, the payments to SBC could not give rise to a trust and it was also accepted that they did not constitute an assignment from the subordinated creditors to SBC. Both MFJ and MCC became hopelessly insolvent and the administrators of MCC's English assets and the examiner appointed to control MCC's United States assets agreed a distribution scheme whereby secured and preferential creditors in England and creditors with priority claims in the United States would be paid out of the English or the United States assets as appropriate, the net balance would be pooled and remaining claims would be paid pari passu out of the pool. The scheme relating to the English assets was made pursuant to s 425 of the Companies Act 1985. The question arose whether the subordination agreement was valid, since if it was then, because both MCC and MFJ were insolvent, there was no question of MCC being able to satisfy any of its liabilities under the guarantee and therefore it would not be necessary to obtain the consent of the MFJ bondholders for the purpose of the s 425 arrangement since as creditors whose claims were valueless they would have no interest in the arrangement.

Held – The subordination agreement was a valid contract since neither the rule making insolvency set-off mandatory nor the pari passu rule of distribution made the agreement invalid. There was no rule of public policy, arising out of the rule invalidating an agreement between a debtor and a creditor excluding the creditor's right of set-off or the waiver by the creditor of his right of set-off, even after the commencement of the bankruptcy or winding up, which similarly invalidated an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and precluded the waiver or subordination of the creditor's claim after the commencement of a bankruptcy or winding up. Since a creditor could waive his debt or decline to submit proof, there was no reason why he should not, prior to any insolvency proceedings, agree to subordinate his claim to that of other creditors in the event of the debtor company's insolvency. The pari passu rule

prevented a creditor from arranging to obtain some advantage in the winding up of a company to which insolvency principles did not entitle him, but subordination in no way undermined that principle. Accordingly, there was no principle of insolvency law which rendered invalid a subordination agreement. Therefore the subordination agreement was valid and enforceable (see p 746 *b* to *j*, p 751 *a b* and p 755 *a* post).

Rolls Razor Ltd v Cox [1967] 1 All ER 397, *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] 1 All ER 641 and *Re British and Commonwealth Holdings plc (No 3)* [1992] BCLC 322 considered.

Notes

For schemes of arrangement, see 7(2) *Halsbury's Laws* (4th edn reissue) paras 2135–2147, and for cases on the subject, see 10(2) *Digest* (2nd reissue) 290–308, *11637–11788*.

For the Companies Act 1985, s 425, see 8 *Halsbury's Statutes* (4th edn) (1991 reissue) 486.

Cases referred to in judgment

Akt Kreuger & Toll, Re (1938) 96 F 2d 768, US Ct of Apps (2nd Cir).
Ashby v White (1703) 1 Bro Parl Cas 62, 1 ER 417, HL.
Ayr Harbour Trustees v Oswald (1883) 8 App Cas 623, HL.
Barnett , Ex p, re Deveze (1874) LR 9 Ch App 293, LJJ.
British and Commonwealth Holdings plc, Re (No 3) [1992] BCLC 322, [1992] 1 WLR 672.
British Eagle International Airlines Ltd v Cie Nationale Air France [1975] 2 All ER 390, [1975] 1 WLR 758, HL; *rvsg in part* [1974] 1 Lloyd's Rep 429, CA; *affg* [1973] 1 Lloyd's Rep 414.
British Guiana Bank v Official Receiver (1911) 104 LT 754, PC.
Cooper v A & G Fashions (Pty) Ltd, ex p Millman 1991 (4) SA 204, CPD.
Credit Industrial Corp, Re (1966) 366 F 2d 402, US Ct of Apps (2nd Cir).
De Villiers, Ex p, re Carbon Developments (Pty) Ltd (in liq) 1993 (1) SA 493, SA SC App Div; *rvsg* 1992 (2) SA 95, Witwatersrand LD.
Deering v Hyndman (1886) 18 LR Ir 467, Ir CA; *affg* 18 LR Ir 323, Ir DC.
First National Bank of Hollywood v American Foam Rubber Corp (1976) 530 F 2d 450, US Ct of Apps (2nd Cir).
Holthausen, Ex p, re Scheibler (1874) LR 9 Ch App 722, LJJ.
Horne v Chester & Fein Property Developments Pty Ltd [1987] VR 913, Vict SC.
Lind v Lefdal's Pianos Ltd (in liq) [1929] TPD 241, SA SC.
National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd [1972] 1 All ER 641, [1972] AC 785, [1972] 2 WLR 455, HL; *rvsg* [1970] 3 All ER 473, [1971] 1 QB 1, [1970] 3 WLR 625, CA.
Rolls Razor Ltd v Cox [1967] 1 All ER 397, [1967] 1 QB 552, [1967] 2 WLR 241, CA.
Spurling v Bantoft [1891] 2 QB 384, DC.
Victoria Products Ltd v Tosh & Co Ltd (1940) 165 LT 78.

Cases also cited

Barlow Clowes Gilt Managers Ltd, Re [1991] 4 All ER 385, [1992] Ch 208.
Barrow Borough Transport Ltd, Re [1989] BCLC 653, [1990] Ch 227.
Bishopsgate Investment Management Ltd (in prov liq) v Maxwell, Cooper v Maxwell, Mirro Group Newspapers Ltd v Maxwell [1992] 2 All ER 856, [1993] Ch 1, CA.
Bristol Airport plc v Powdrill [1990] 2 All ER 493, [1990] Ch 744, CA.
Charnley Davies Ltd, Re (No 2) [1990] BCLC 760.

Industrial Welding Co Pty Ltd, Re (1978) 3 ACLR 754, NSW SC.
James, Ex p, re Condon (1874) LR 9 Ch App 609, [1874–80] All ER Rep 388, LJJ.
Levitt (Jeffrey S) Ltd, Re [1992] 2 All ER 509, [1992] Ch 457.
Mackay, Ex p, ex p Brown, re Jeavons (1873) LR 8 Ch App 643, LJJ.
Marlborough Concrete Constructions Pty Ltd, Re [1977] Qd R 37, Qld SC.
Morris v Director of Serious Fraud Office [1993] BCLC 580.
NBT Builders Pty Ltd, Re (1984) 8 ACLR 724, Vict SC.
Orion Sound Ltd, Re [1979] 2 NZLR 574, NZ SC.
Portbase Clothing Ltd, Re [1993] 3 All ER 829, [1993] Ch 388.
Price Mitchell Pty Ltd, Re [1984] 2 NSWLR 273, NSW SC.
Rendell v Doors & Doors Ltd (in liq) [1975] 2 NZLR 191, NZ SC
St Ives Windings Ltd, Re [1987] 3 BCC 634.
Tea Corp Ltd, Re, Sorsbie v Tea Corp Ltd [1904] 1 Ch 12, CA.
Walker Construction Co Ltd (in liq), Re [1960] NZLR 523, NZ SC.
Webb v Whiffin (1872) LR 5 HL 711.

Application

Andrew Mark Holman, Colin Graham Bird, Jonathan Guy Anthony Phillips and Alan Rae Dalziel Jamieson, the joint administrators of Maxwell Communications Corp plc (MCC), applied to the court pursuant to s 14(3) of the Insolvency Act 1986 for directions on the question whether they and MCC were entitled to exclude from a scheme of arrangement under s 425 of the Companies Act 1985 which they proposed to submit to the creditors, and, if approved, for the sanction of the court, the holders of convertible subordinated bonds of Maxwell Finance Jersey Ltd (MFJ), which were guaranteed by MCC. The question was whether liabilities to the bondholders under the guarantee were effectively subordinated to MCC's liabilities to other unsecured creditors. The respondent to the application was Swiss Bank Corp, representing the holders of 125m Swiss francs $5\frac{1}{2}\%$ convertible bonds 1989–94 issued by Maxwell Finance Jersey Ltd. The facts are set out in the judgment.

John Cone (instructed by *Norton Rose*) for the administrators.
Charles Purle QC and *Mark Phillips* (instructed by *Gouldens*) for Swiss Bank Corp.

Cur adv vult

26 March 1993. The following judgment was delivered.

VINELOTT J. This is an application for directions by the administrators of Maxwell Communications Corp plc (MCC). The question on which directions are sought is whether MCC is entitled to exclude from a scheme of arrangement under s 425 of the Companies Act 1985, which the administrators propose to submit to the creditors, and if approved for the sanction of the court, the holders of convertible subordinated bonds of Maxwell Finance Jersey Ltd (MFJ) which were guaranteed by MCC.

It is not in question that MFJ will be unable to meet its liabilities under the bonds and that the liabilities of MCC far exceed its assets, so that if, as the title to the bonds suggests, liability to the bondholders was subordinated to MCC's liabilities to other unsecured creditors the bondholders will receive nothing. The question is whether liabilities to the bondholders under the guarantee were effectively subordinated to MCC's liabilities to other unsecured creditors.

A similar situation arose in *Re British and Commonwealth Holdings plc (No 3)* [1992] BCLC 322, [1992] 1 WLR 672. In that case the company had issued

convertible subordinated loan stock and the trust deed governing the loan stock provided that the claims of holders of the stock were 'in the event of the winding up of the company subordinated in right of payment to the claims of all other creditors of the company'. The administrators estimated that the debts owing to other creditors who benefited under the scheme (the scheme creditors) amounted to £1,200m and that the deficiency of the assets available to meet those debts was £800m. The question was whether the administrators could convene a meeting of the scheme creditors and exclude the trustee of the subordinated loan stock (who did not admit that in a winding up there would inevitably be a deficiency) and whether the court could then sanction the scheme, notwithstanding the opposition of the trustee of the loan stock.

I took the view that to the extent that the assets of the company were insufficient to meet the liabilities to unsecured creditors, other than the holders of the loan stock, the holders of the loan stock had no interest in the assets of the company and no right to vote at a meeting of unsecured creditors, that, in the very unlikely, indeed, merely theoretical possibility, that the realisation of the company's assets would suffice to meet the claims of the scheme creditors, the rights of the holders of the unsecured creditors would be unaffected by the scheme, and that in these circumstances the liquidator could properly call a meeting of the scheme creditors alone, and if the scheme of arrangement was approved, apply to the court to sanction the scheme.

Mr Purle QC, who appeared for Swiss Bank Corp (SBC), a representative of the bondholders, did not challenge the correctness of my decision on the facts of that case. However, there is one vital distinction. In *Re British and Commonwealth Holdings plc* the subordination of the subordinated loan stock did not rest solely on the terms of a contract between the company and the trustee of the subordinated loan stock. The trust deed governing the issue of the subordinated loan stock provided that any moneys payable to the trustee would be held in trust to apply the same in payment of its own expenses and remuneration and then towards payment of the claims of other creditors submitted to proof in the winding up.

That machinery, which is a very common means of ensuring that debt is effectively subordinated, was not available in the instant case because the guarantee is governed by Swiss law, which does not recognise trusts. Under Swiss law a provision for the subordination of debt is recognised and effective, but to the extent that English assets of MCC fall to be dealt with in an insolvent winding up, the distribution of the assets will be governed by English law. In these circumstances I must now decide whether a contractual provision for the subordination of a debt unsupported by the trust mechanism used in *Re British and Commonwealth Holdings plc* is effective under English law.

Before turning to that question I should, I think, set out the relevant facts in greater detail. In June 1989 MFJ issued $5\frac{1}{2}\%$ convertible bonds 1989–94 (the MFJ bonds) in the nominal amount of 125m Swiss francs. Clause 4 of the MFJ bonds provided:

> 'The due and punctual payment by [MFJ] of the nominal value (or, in the case of an Event of Default only, of the Paid Up Value) of the Bonds and interest on the Paid Up Value of the Bonds ... is unconditionally and irrevocably guaranteed on a subordinated basis, in accordance with article 111 of the Swiss Federal Code of Obligations by Maxwell Communications Corporation.'

Under the guarantee MCC undertook to pay on first demand by SBC in summary, in the event of default, the paid-up value of the outstanding bonds with interest. It was provided:

> 'The guarantee of payment of the nominal value (or in the case of an Event of Default only of the Paid Up Value) and interest with regard to the Bonds and of Paid Up Value of the Preference Shares under this Guarantee, constitutes an unsecured and subordinated obligation of the Guarantor in that in case of any distribution of assets by the Guarantor, whether in cash or otherwise, in liquidation or bankruptcy of the Guarantor, during a period in which a suspension of payment is granted to the Guarantor or in case the Guarantor negotiates with all its creditors with a view to a general settlement, creditors of unsubordinated indebtedness of the Guarantor should be entitled to be paid in full before any payment shall be made on account of payments under the Bonds of Preference Shares but that payments to Bondholders, Couponholders and Preference Shareholders shall be made before any payment shall be made in such cases to the holder of any class of stock in the Guarantor.'

The rights of MCC as guarantor to indemnity by MFJ were in turn subordinated to the rights of the bondholders to recovery in full against MFJ. Lastly, it was provided that payments under the guarantee would be made to SBC on behalf of the bondholders and that the form and contents of the guarantee would be governed by Swiss law. The SBC have been appointed to represent the bondholders in this application.

There is no dispute between the experts in Swiss law instructed by the administrators and by the SBC respectively. The guarantee constitutes an indemnity independent of the validity and enforceability of the bonds, and creates a direct undertaking to pay on demand by SBC on confirmation that MFJ has not met its obligations under the bonds. The provision subordinating the liability of MCC is valid and effective. Under Swiss law a creditor can waive his right to equal treatment with the other creditors in the insolvency of a debtor. However, no trust of any moneys received by SBC in the winding up of MCC can be implied. Swiss law does not recognise trusts and the agreement for subordination cannot be given effect as an implied agreement by SBC to assign any moneys taken in the winding up of MCC to the other unsubordinated creditors.

MCC, as is well known, is hopelessly insolvent and so is MFJ. Administrators have been appointed in England, and in the United States the Chapter 11 procedure has been invoked. The administrators and the examiner appointed in the Chapter 11 proceedings have agreed a scheme of arrangement and a plan of reorganisation to put before the English and United States creditors which is designed to harmonise the United States and English procedures for the distribution of MCC's assets. In very broad outline, secured and preferential creditors in England and creditors with priority claims in the United States, will be paid out of the English or the United States assets as may be appropriate. The net balance will be pooled; claims will be notified to the administrators or the United States court in accordance with the procedure appropriate to the jurisdiction where the claim falls to be made, but these claims will be paid pari passu out of the pool.

Contractual subordination is recognised and given effect under the United States code. The scheme of arrangement and the plan for reorganisation have been prepared on the assumption that the contractual subordination of the rights

of bondholders under the guarantee (which is the only subordinated debt of MCC) is also recognised in English law and would be applied in the winding up of MCC. There would be grave and possibly insuperable difficulties in negotiating an overall distribution to English and United States creditors out of the pooled assets if this assumption were ill-founded.

The case for SBC is founded on the decision of the Court of Appeal and the House of Lords in *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] 1 All ER 641, [1972] AC 785. The majority of their Lordships (Lord Cross alone dissenting) agreed with the view expressed by the Court of Appeal in that case ([1970] 3 All ER 473, [1971] 1 QB 1) and in the earlier decision of the Court of Appeal in *Rolls Razor Ltd v Cox* [1967] 1 All ER 397, [1967] 1 QB 552 that the provisions for mutual set-off in s 31 of the Bankruptcy Act 1914 could not be excluded by agreement between a debtor and the creditors. Accordingly, a creditor could not validly make it a term of his contract with a debtor that he would not be entitled to set off a debt due to him against a debt due from him to the debtor, and could not waive his right to set-off after the commencement of the bankruptcy or winding up.

Section 31 of the Bankruptcy Act 1914 was expressed in mandatory terms. It was introduced into the winding up of an insolvent company by s 317 of the Companies Act 1948 which provided that in the winding up of an insolvent company the same rules should prevail with regard to the respective rights of secured and unsecured creditors and to debts payable as were in force under the law of bankruptcy.

Section 33 of the 1914 Act set out the order of priority of payments out of the property of a bankrupt. The several subsections of s 33 were all expressed in mandatory terms. Subsection (7) provided: 'Subject to the provisions of this Act, all debts proved in the bankruptcy shall be paid pari passu.' The case for SBC is that the decision of the Court of Appeal in the *Halesowen* case and in *Rolls Razor Ltd v Cox* and of the House of Lords in the *Halesowen* case (if the point was decided by the House of Lords) that the provisions for set-off of mutual debts in s 31 cannot be excluded by agreement between a debtor and the creditor, rested upon the mandatory language used in s 31, and that the same principle must apply to the order of priority of debts and to the application pari passu of any balance after meeting debts ranking in priority to unsecured non-preferential debts.

Under the new legislation the administration of a property of an insolvent company is not dealt with by reference to the bankruptcy legislation, but is the subject of a separate code. However, there is no material distinction between the new code and the earlier legislation which it replaces. Section 107 of the Insolvency Act 1986 (which is in substantially the same terms as s 302 of the Companies Act 1948) provides that in a voluntary winding up, subject to the provisions of the Act as to preferential payments 'the company's property ... shall ... be applied in satisfaction of the company's liabilities pari passu ...' The distribution of a company's property in a compulsory winding up is not dealt with in the 1986 Act itself but in the Insolvency Rules 1986, SI 1986/1925, made under s 114 of that Act. Rule 4.181, which is headed 'Debts of insolvent company to rank equally', provides:

> '(1) Debts other than preferential debts rank equally between themselves in the winding up and, after preferential debts, shall be paid in full unless the assets are insufficient for meeting them, in which case they abate in equal proportions between themselves ...'

The provisions for set-off, which were formerly contained in s 31 of the 1914 Act, so far as applicable to insolvent companies are now also to be found in the 1986 rules (see r 4.90).

In *Rolls Razor Ltd v Cox* [1967] 1 All ER 397, [1967] 1 QB 552 the defendant was a door-to-door salesman employed by the plaintiff company. He sold washing machines and was provided with a van. He was remunerated by a commission but was required to pay his receipts to the company at stated intervals without retaining his commission. On repaying his commission the company was entitled to keep back a retention fund up to a stated limit which was to be available to meet claims against the salesman and would be paid to him only after the determination of the agreement.

The company became insolvent and the question was whether the defendant could set off moneys received by him on the sale of the company's goods and the value of goods remaining in his possession against the retention fund. It was held in the Court of Appeal that s 31 applied and permitted the set-off of the sums received by the salesman and, by a majority, that it permitted the set-off also of the value of the retained goods. It was, therefore, unnecessary for the Court of Appeal to decide whether s 31 could have been excluded by agreement; the agreement did not purport so to provide. However, Lord Denning MR rejected the claim that the agreement excluded the right of set-off ([1967] 1 All ER 397 at 403–404, [1967] 1 QB 552 at 570):

> '... for the simple reason that the parties cannot contract out of the statute. Where there are mutual dealings, the statute says that "the balance of the account, and no more, shall be claimed or paid on either side". That is an absolute statutory rule which must be observed (see *Re Deveze, Ex p. Barnett* (1874) LR 9 Ch App 293 at 295) per LORD SELBORNE, L.C.).'

Danckwerts LJ said ([1967] 1 All ER 397 at 405, [1967] 1 QB 552 at 573):

> 'A question was raised whether the statutory set-off could be excluded by the terms of the agreement between the parties. The authorities are meagre on this point and not very clear, but in my opinion the statutory set-off, being a matter of statute, cannot be excluded.'

The Court of Appeal was not referred to the decision of the Irish Court of Appeal in *Deering v Hyndman* (1886) 18 LR Ir 467, the only case in which this point fell to be decided and in which the Irish Court of Appeal had upheld unanimously the Irish Divisional Court decision (see 18 LR Ir 323) that a creditor could waive a right of set-off given by the Irish bankruptcy laws. The observation by Lord Selborne LC relied on by Lord Denning MR was obiter.

In the *Halesowen* case [1972] 1 All ER 641, [1972] AC 785 the Halesowen company had a loan account which was overdrawn at National Westminster Bank and a trading account in credit at Lloyds Bank. On 4 April 1968 it was agreed that the trading account would be transferred to an account at the same branch of the National Westminster Bank, where the loan account was held. The loan account (the no 1 account) would be frozen and the current account (the no 2 account) operated only when it was in credit. That agreement was to continue, in the absence of a material change of circumstances, for four months.

On 20 May the company gave notice convening a meeting of creditors at 2.30 pm on 12 June to consider a winding-up resolution. The bank took no steps to terminate the agreement. On 12 June a cheque was paid into the no 2 account. Later on the same day the creditors' meeting confirmed a resolution for the winding up of the company. The case for the bank, which succeeded at first

instance, was that the bank was entitled independently of s 31, which was not relied upon, to consolidate the two accounts.

In the Court of Appeal the bank also relied on s 31. It was held by the Court of Appeal that the right of the bank to combine the accounts without notice to the customer was excluded by the agreement and by a majority (Buckley LJ dissenting) that the dealings on the two accounts were not mutual dealings within s 31. It was again unnecessary for the Court of Appeal, in the light of its decision, to consider whether s 31 could have been excluded by agreement. However, Lord Denning MR said ([1970] 3 All ER 473 at 479, [1971] 1 QB 1 at 36):

> 'I must mention finally the section as to mutual credit and set-off which is contained in s 31 of the Bankruptcy Act 1914, and is applied to companies' winding-up by s 317 of the Companies Act 1948. It has been held in this court that the parties cannot contract out of this section: see *Rolls Razor Ltd v Cox* [1967] 1 All ER 397 [1967] 1 QB 552.'

Section 31 is not mentioned by Winn LJ. Buckley LJ, after referring to observations in the Supreme Court of British Guiana and in the Privy Council as to whether a right of set-off under similar provisions in the local law could be excluded, added ([1970] 3 All ER 473 at 490, [1971] 1 QB 1 at 48):

> 'It has since been held in this country in *Rolls Razor Ltd v Cox* that the operation of s 31 of the Bankruptcy Act 1914 cannot be excluded by agreement between the parties. The ground of the Privy Council decision in *British Guiana Bank v Official Receiver* (1911) 104 LT 754 is accordingly not available in this court.'

In the House of Lords the decision of the Court of Appeal that the dealings on the two accounts were not mutual dealings within s 31 was reversed. It was also held that the agreement did not in its terms purport to exclude s 31. Thus, it was again unnecessary for the House of Lords to consider whether s 31 could have been excluded by more apt words. However, the question was fully argued, and all the members of the Appellate Committee who heard the appeal expressed their opinion on it.

Lord Cross, after a very full and lucid analysis of the earlier decisions, concluded ([1972] 1 All ER 641 at 660, [1972] AC 785 at 818):

> '... I can see no reason in principle why the section should not be excluded by agreement; I do not think that Lord Selborne intended to indicate that he thought that it could not be excluded by agreement; and I prefer the decision in *Deering v Hyndman* to that in the *Rolls Razor* case. Therefore if, contrary to my opinion, the agreement in this case did not determine on the winding up and was intended to exclude the operation of s 31 I would think that the company were entitled to succeed.'

However, Viscount Dilhorne, after reviewing the authorities, concluded ([1972] 1 All ER 641 at 649, [1972] AC 785 at 805):

> '... the terms of s 31 and of the sections that follow it show that "shall" was used in all those sections in its directory and mandatory sense, prescribing the course to be followed in the administration of the bankrupt's property.'

Lord Kilbrandon agreed ([1972] 1 All ER 641 at 665, [1972] AC 785 at 824):

> 'In my opinion, accordingly, the rule now is that the terms of s 31 are mandatory in the sense that not only do they lay down statutory directives

for the administration of claims in bankruptcy, but they also make it impossible for persons effectively to contract, either before or after an act of bankruptcy has occurred, with a view to the bankruptcy being administered otherwise in accordance with the statutory directives. In other words, as Lord Denning MR said in *Rolls Razor v Cox* [1967] 1 All ER 397 at 403, [1967] 1 QB 552 at 570, "the parties cannot contract out of the statute". I must admit to having been impressed by the argument that such a rule—enunciated as it was for the first time in 1967, otherwise than by obiter dicta, albeit some of great weight—may be expected to form a serious embarrassment to those wishing to adopt the beneficial course of agreeing to moratoria for the assistance of business in financial difficulties. But if that be so, it seems to call for the intervention of the legislature. It is, in any event, generally agreed that a restatement of law of bankruptcy, both for England and for Scotland, is overdue.'

Lord Simon dealt with the position more fully and I should, I think, read that passage in his judgment in full ([1972] 1 All ER 641 at 652, [1972] AC 785 at 808–809):

'I turn finally, then, to the question whether s 31 can be excluded by agreement. On this matter I concur in the reasoning and conclusions of my noble and learned friends, Viscount Dilhorne and Lord Kilbrandon. The maxim "Quilibet potest renunciare juri pro se introducto" (Broom's Legal Maxims (10th edn, 1929), p 477 begs the question whether the statutory provision in s 31 was introduced for the benefit of any particular person or body of persons or was prescribing a course of procedure to be followed in the administration of a bankrupt's property. I appreciate that the imposition of a duty on a public officer does not necessarily preclude a private right arising therefrom: *Ashby v White* (1703) 1 Bro Parl Cas 6, 1 ER 417. But in Broom the maxim is, for good reason, translated "Anyone may at his pleasure, renounce the benefit of a stipulation or other right introduced *entirely in his own favour*". [Lord Simon's emphasis.] It is also significant that, in the discussion of this maxim, s 31 of the Bankruptcy Act 1914 is nowhere mentioned. Having regard both to the terminology of s 31 and to its statutory context, it seems to me to be impossible so to construe the wording of the section as introducing a right entirely in favour of anyone. The change in terminology between the Bankruptcy Act 1849, s 171, and the Bankruptcy Act 1869, s 39 ("may" to "shall") must have been, at the least, to avert doubts. This part of the Act is laying down a code of procedure whereby bankrupts' estates (and, by reference, insolvent companies) are to be administered in a proper and orderly way; this is a matter in which the commercial community generally has an interest, and the maxim has no application in a matter where the public have an interest (see Broom p 481, citing *Ayr Harbour Trustees v Oswald* (1883) 8 App Cas 623 and *Spurling v Bantoft* [1891] 2 QB 384). There is a clear preponderance of authority against there being a right to contract out of the section; and I agree with the analysis of the case law made by my noble and learned friend, Viscount Dilhorne. It was argued for the respondent company that, if there could be no contracting out of s 31, a very usual type of compromise between the creditors, in their common interest to keep an insolvent afloat, would be impossible. To this there are, I think, two answers: first, there would be nothing to prevent any such agreement after an act of bankruptcy had been committed; and, secondly, so far as companies are concerned, s 206 of the

> Companies Act 1948 gives power, subject to the sanction of the court, for a compromise to be made in certain circumstances with creditors which will be binding on all the creditors (or all creditors of the class involved). But the mere fact that this argument could be advanced at all in view of the conflict of dicta and what I cannot but regard as a clear preponderance of authority emphasises the desirability that the promised legislation in this field should not be unduly delayed.'

As I see it, the decision of the majority in the House of Lords did not rest solely on the mandatory language used in s 31 alone, but on the mandatory language used coupled with the proposition that the liquidator and the general body of creditors might have an interest in ensuring that debts due to and from a creditor arising from mutual dealings are set off. This is quite explicit in the speech of Lord Simon, who considered and rejected the claim that the section could be construed 'as introducing a right entirely in favour of anyone'.

That proposition, it seems to me, must rest upon the inconvenience and potential unfairness to the trustee or liquidator and so to other creditors that might arise if a creditor was entitled either to exercise or, at his option, not to exercise the right of set-off. For otherwise, the creditor might prove in the bankruptcy or winding up leaving it to the trustee or liquidator to recover the debt due to the estate in proceedings which might be protracted and expensive, and which might not result in the recovery of the full amount due. In the meantime the distribution of the insolvent estate might be held up and a question might arise whether a creditor who had waived his right of set-off would be entitled to a dividend while proceedings to recover the debt due from him were still on foot. An agreement between the debtor and the creditor excluding the creditor's right of set-off, or the waiver by the creditor of his right of set-off, even after the commencement of the bankruptcy or winding up, might thus equally hinder the rapid, efficient and economical process of bankruptcy.

The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after the commencement of a bankruptcy or winding up. I do not think that it does. It seems to me plain that after the commencement of a bankruptcy or a winding up a creditor must be entitled to waive his debt just as he is entitled to decline to submit a proof. There might, in any given case, be a question whether a waiver was binding on him but that is irrelevant for this purpose. If the creditor can waive his right altogether I can see no reason why he should not waive his right to prove, save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full, or, if he is a preferential creditor, to agree that his debt will rank equally with unsecured non-preferential debts.

So also, if the creditor can waive his right to prove or agree the postponement of his debt after the commencement of the bankruptcy or winding up, I can see no reason why he should not agree with the debtor that his debt will not be payable or will be postponed or subordinated in the event of a bankruptcy or winding up. The reason for giving effect to an agreement in these terms seems to me to be if anything stronger than that for allowing the creditor to waive, or postpone, or subordinate his debt after the commencement of a bankruptcy or winding up; for other creditors might have given credit on the assumption that the agreement would be binding.

Mr Purle submitted that the reason for excluding such an agreement is that the liquidator ought not to be required or entitled to look behind a proof to determine whether a creditor submitting a proof was entitled to payment pari passu with other unsecured creditors. I find this reason unconvincing. There are situations under the 1986 Act in which an unsecured debt is postponed to other unsecured debt. Under s 74(2)(f) (which re-enacts s 212(1)(g) of the 1948 Act) sums payable to a member are not to be deemed to be a debt payable to that member in a case of competition between himself and any other creditor not a member. Under s 215(4) where the court makes a declaration of fraudulent or wrongful trading under ss 213 or 214 in relation to a creditor, the court may direct that the debt shall rank in priority after all other debts owed by the company and after interest on those debts. In these cases the liquidator has to give effect to a subordination created by statute. However, I can see no reason why the liquidator should have any greater difficulty in giving effect to a contractual subordination. If it is plain that the assets will be insufficient to meet the claims of unsecured creditors, whose claims are not subordinated, the proof of the subordinated creditor (which is no more than a document asserting a claim: see r 7.73(3)) can be rejected; if admitted before it becomes plain that the assets will not suffice to meet the claims of other creditors, then when the position is crystallised the proof can be expunged or varied (see rr 4.85 and 4.86.)

Mr Purle also relied on certain observations made by Templeman J at first instance (see [1973] 1 Lloyd's Rep 414) and by Lord Simon in the House of Lords in *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 2 All ER 390, [1975] 1 WLR 758. That case concerned a very complex arrangement for the clearance of debt between airlines which were members of the International Air Transport Association (IATA). These agreements and the issue between British Eagle and Air France are succinctly and, I think, sufficiently set out by Russell LJ, who gave the judgment of the Court of Appeal, in a passage which I will read in full (see [1974] 1 Lloyd's Rep 429 at 430–431):

> 'Stated shortly, the position was this. Most major airlines are members of IATA. For the general convenience of world-wide air passengers and consignors of cargo, it is the practice of airline "A" to issue, for example, to an air passenger a ticket through to his destination, though airline "A" does not supply flights the whole way. The passenger would need to change at some stage to airline "B" for the rest of the journey. Airline "A" would receive payment for the whole flight from the passenger in the currency of the country of departure. This system would involve a proportionate payment by airline "A" to airline "B" on the basis that the latter had rendered services to the former. That is a very simple example of the rendering of services by one airline to another, and there were many different circumstances in which such services would be rendered between airlines, giving rise to a complicated network of debits and credits, with added complications in currency matters. It would obviously be of major convenience if a clearing house was set up by the major airlines and IATA whereby each airline could avoid settling with each of the 70 or more other airlines separately the balance in terms of debit and credit in respect of services rendered between it and the other airline. This is what was done by agreement between IATA and all airline members of IATA wishing to participate in the clearing house. The clearing house was not itself a corporate or other body; it was an activity conducted by IATA—a Canadian corporate body, pursuant to the agreement to which all "clearing house" members of IATA and IATA itself were parties. Expressed in its simplest

terms, the system was that in respect of every calendar month there was a clearance: sums for services inter se rendered to and by clearing house members based upon returns of the month to the clearing house were brought into calculation: in the result some airlines were in respect of the month in overall debit on clearance and others in overall credit on clearance: the former would pay the respective amounts of their overall debits to the clearing house (IATA) and the clearing house would pay to the latter the respective amounts of their overall credits on clearance. On Nov. 6, 1968, British Eagle (an English limited company) ceased to operate, and on Nov. 8 resolved upon a creditors' voluntary winding up. At this time British Eagle had rendered services to the defendant Air France since the end of August, 1968 (cross services in respect of which month had been fully settled all round through the clearing house) to a value substantially in excess of services rendered to British Eagle by Air France in respect of the same period. But in respect of the same period other members had rendered net services to British Eagle to a value greatly in excess of the last-mentioned value, and if all inter-airline services for the period up to Nov. 6, 1968, are processed through the clearing house, British Eagle will be shown to be net debtors on clearance in a substantial sum. In this action the liquidator of British Eagle sues Air France in the name of British Eagle for a sum of money on the footing of debt for net services rendered by British Eagle to Air France after setting off contra services by Air France to British Eagle. He contends that he is entitled to sue for that sum as a debt from Air France disregarding the clearing house agreement. The operation of the clearing house agreement if carried through will, he asserts, result in the sum claimed not being available to the general body of British Eagle's creditors, but on the contrary being made available to a limited body of creditors for net services rendered to British Eagle. This is correct. It is to be observed that it is a matter of indifference to Air France whether they pay the sum to the liquidator or (so to speak) bring it into the clearing house pool in reduction of Air France's debtor-on-clearance position: in fact it is held by IATA on suspense: if the liquidator succeeds, the clearance will be adjusted so that Air France does not pay twice, and all airlines which have a net credit against British Eagle will prove for their respective net credits as unsecured creditors: if the liquidator fails, IATA will prove for the net sum for which British Eagle is debtor on clearance, any deficiency in a 100 per cent. dividend falling proportionately upon those airlines whose services to British Eagle in the period exceeded in value British Eagle's contra services to them respectively. Air France is therefore fighting not so much its own battle as a battle on behalf of IATA and those airlines who are in net services credit vis-à-vis British Eagle.'

Russell LJ agreed (at 433) with Templeman J:

'... British Eagle having contracted with every other member of the clearing house and with IATA not to enforce its net claim for services against, for example, Air France otherwise than through the clearing house, it could not while a member do so.'

On that footing the clearing house arrangement clearly did not contravene any principle of insolvency law. As Russell LJ observed (at 434):

'Those laws require that the property of an insolvent company shall be distributed pro rata among its unsecured creditors: but the question here is whether the claim asserted against Air France is property of British Eagle.'

In the House of Lords Lord Morris and Lord Simon both agreed with this analysis of the arrangements. Lord Cross, with whom Lord Diplock and Lord Edmund-Davies agreed, having set out the relevant terms of the clearing house arrangement and having analysed the balance of debt as between British Eagle and Air France, said ([1975] 2 All ER 390 at 409, [1975] 1 WLR 758 at 778):

'On this aspect of the case we heard much argument as to whether the right of British Eagle to have any given claim against Air France settled through the clearing house system could properly be called a debt due by Air France to British Eagle notwithstanding that British Eagle could not bring legal proceedings against Air France to enforce payment of the sums due from it. I have no doubt that in common parlance the right would be called a debt and the framers of the regulations—some of whom were presumably lawyers—had no hesitation in describing the rights in question as "debts" in reg 18(c). It is to my mind undesirable that the law should give a more limited meaning to a word than the ordinary man would do unless there is a good ground for doing so; and personally I can see no reason why the law should refuse to describe the legal right of British Eagle to be paid the sums in question by Air France as "debts" because the contract under which the right to be paid arose did not permit British Eagle to sue Air France for payment but provided for payment exclusively through the medium of the clearing house. But this question—as I see it—is simply a dispute as to the proper use of words which had no bearing on the decision of the case, and for my part I am prepared to assume in favour of Air France that the legal rights against Air France which British Eagle acquired when it rendered the services in question were not strictly speaking "debts' owing by Air France but were innominate choses in action having some, but not all, the characteristics of "debts".'

On that analysis the claim by the clearing house creditors was clearly a claim to be entitled to be preferred to other unsecured creditors on the basis—

'that they [had] achieved by the medium of the "clearing house" agreement a position analogous to that of secured creditors without the need for the creation and registration of charges on the book debts in question.'

That claim was clearly 'repugnant to our insolvency legislation' (see [1975] 2 All ER 390 at 410–411, [1975] 1 WLR 758 at 780).

It seems to me, therefore, that the only real issues in the *British Eagle* case related to the construction and the proper analysis of the rights and obligations conferred and imposed by the clearance agreement. There was no issue as to the principles of insolvency law to be applied.

Section 31 and the decision in the *Halesowen* case were not referred to in the Court of Appeal. They are not referred to in the speech of Lord Morris in the House of Lords. Lord Cross, having observed that the liquidator rightly applied s 31 in relation to his claim against Air France, added ([1975] 2 All ER 390 at 411, [1975] 1 WLR 758 at 781):

'But so far as I can see the section has no bearing on anything that we have to decide in this appeal. It is therefore unnecessary for us to say anything

> about the recent case in this House of *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] 1 All ER 641, [1972] AC 785.'

Lord Simon stated his conclusion ([1975] 2 All ER 390 at 403, [1975] 1 WLR 758 at 771):

> '... no party to the interline agreement had any right to claim direct payment for interline service: its right thereafter was to have the value of such service respectively credited and debited in the monthly IATA clearing house settlement account.'

He added:

> 'I agree that *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* applies by analogy to s 302 of the Companies Act 1948, so that one cannot contract out of its terms. But, in view of para (2) of art VI of the interline agreement (and the consequent provisions of the IATA Regulations and Manual of Procedure), the "property" of British Eagle (for the purpose of s 302) did not include any direct claim against Air France for the value of interline services performed by British Eagle for Air France but merely the right to have the value of such services brought into the monthly settlement account.'

This observation reflects an observation of Templeman J at first instance ([1973] 1 Lloyd's Rep 414 at 434). Having stated the submission of counsel for the liquidators of *British Eagle*, Mr Heyman QC, as regards s 302 to be that 'you cannot contract out of the requirement that the property of a company must be used to pay its creditors *pari passu* any more than you can contract out of sect. 31, which says you must have a set-off when there are mutual dealings', he added:

> '... in my judgment, Mr. Heyman is quite right. If there was a debt, that is to say a debt owed by Air France to British Eagle, which at the date of liquidation was vested in British Eagle, or was vested in IATA as an agent for British Eagle, with instructions to pay off the creditors in the clearing house, but no other creditors, or if that debt had been assigned to IATA, which had exactly the same instructions, namely to pay off the creditors of the clearing house but no other creditors, then in my judgment that debt would be the property of the company British Eagle. The result of it being vested in a company, say what you will about the rights of agents and the rights of assignees, would be to infringe sect. 302 of the Companies Act, 1948, and that cannot be allowed. In my judgment, Mr. Heyman is right when he says if you look closely at the *Halesowen* case the parallel is exact. But, of course, that all turns on whether there was a debt vested in British Eagle on the date of liquidation ...'

These observations were clearly obiter and were made in the context of a case in which if the clearance arrangements had had the effect contended for by Air France they would clearly have put a member of the clearance arrangements in a position which would have been better than the position of other unsecured creditors. The arrangements would therefore unquestionably have infringed a fundamental principle of bankruptcy law, which is reflected in but not derived from s 302 or its predecessor, that a creditor cannot validly contract with his debtor that he will enjoy some advantage in a bankruptcy or winding up which is denied to other creditors.

In my judgment I am not compelled by the decisions of the House of Lords in the *Halesowen* case [1972] 1 All ER 641, [1972] AC 785 and the *British Eagle* case [1975] 2 All ER 390, [1975] 1 WLR 758 or by the decisions of the Court of Appeal in those cases, or in *Rolls Razor Ltd v Cox* [1967] 1 All ER 397, [1967] 1 QB 552 to conclude that a contract between a company and a creditor, providing for the debt due to the creditor to be subordinated in the insolvent winding up of the company to other unsecured debt, is rendered void by the insolvency legislation. A contrary decision would have wide-reaching repercussions. It is not infrequently the case that a company can only continue to trade and incur credit with the financial support of a parent or associated company, or a bank which is willing to subordinate its debt to the debts owed to the other unsecured creditors. Subordinated debt is in many contexts treated for accountancy purposes as if it were part of the company's capital. So in this case the group balance sheet of MCC included the liability under MCC's guarantee of the bonds under the heading 'Minority Shareholders interest'. Under the Securities and Futures Authority Rules subordinated loans may be included amongst a company's financial resources as 'Eligible Capital Substitutes'. Of course, a loan can be effectively subordinated if the creditor constitutes himself a trustee for other unsecured creditors as in *Re British and Commonwealth Holdings plc (No 3)* [1992] BCLC 322, [1992] 1 WLR 672; or he may contract to assign the benefit of his debt to other unsecured creditors without in either case affecting the ordinary process of proof in the liquidation or the application of the company's assets pari passu amongst creditors whose proofs have been submitted. However, I think Mr Cone was right when he submitted that to recognise subordination by these means and not by a direct contract between the company and the creditor, would represent a triumph of form over substance.

I was referred by Mr Cone to a number of cases in other jurisdictions in which the insolvency laws are derived from, or similar to, English law in which a contractual subordination has been held to be valid.

In *Ex p De Villiers, re Carbon Developments (Pty) Ltd* 1992 (2) SA 95 Stegmann J refused the liquidator of the company leave to convene meetings of creditors and members to consider an offer of compromise (in effect a scheme of arrangement) on the ground that the company had been trading while it was insolvent and that the liquidator had failed to furnish the creditors with sufficient information as to the potential liability of the directors for fraudulent trading. His conclusion, that there was a possible claim against the directors which would be precluded if the compromise were sanctioned, and which ought to have been investigated was founded on the view that in deciding whether directors were liable for allowing the company to trade while insolvent, the liquidator would not be entitled to have any regard to the terms of a subordination agreement because to do so would entail a rearrangement of the statutory ranking of claims.

That view was rejected by the Court of Appeal of South Africa (Corbett CJ, Van Heerden, Goldstone JJA, Nicholas and Harms AJJA). Goldstone JA, giving the judgment of the Court of Appeal, described a subordination agreement in these terms (1993 (1) SA 493 at 504–505):

> 'The essence of a subordination agreement, generally speaking, is that the enforceability of a debt, by agreement with the creditor to whom it is owed, is made dependent upon the solvency of the debtor and the prior payment of its debts to other creditors. Subordination agreements may take many forms. They may be bilateral, ie between the debtor and the creditor. They may be multilateral and include other creditors as parties. They may be in the form of a *stipulatio alteri*, ie for the benefit of other and future creditors

> and open to acceptance by them. The subordination agreement may be a term of the loan or it may be a collateral agreement entered into some time after the making of the loan. Save possibly in exceptional cases, the terms of a subordination agreement will have the following legal effect: the debt comes into existence or continues to exist (as the case may be), but its enforceability is made subject to the fulfilment of a condition. Usually the condition is that the debt may be enforced by the creditor only if and when the value of the debtor's assets exceeds his liabilities, excluding the subordinated debt. The practical effect of such a condition, particularly where, for example, the excess is less than the full amount of the subordinated debt, would depend upon the terms of the specific agreement under consideration and need not now be considered. In the event of the insolvency of the debtor [that is the equivalent I think of vesting in the trustee], sequestration would normally mean that the condition upon which the enforceability of the debt depends will have become incapable of fulfilment. The legal result of this would be that the debt dies a natural death. [He then referred to some authorities and continued.] The result would be that the erstwhile creditor would have no claim which could be proved in insolvency. To the extent that it may have been suggested in *Cooper v A & G Fashions (Pty) Ltd: Ex parte Millman NO* (1991 (4) SA 204 at 207–208) that on insolvency a value should be placed upon such a debt, this is not correct. The debt would not normally survive sequestration. A contingent liability can only be valued and proved in insolvency where at the time the condition upon which the liability depends is still capable of fulfilment.'

Then having observed that in deciding whether the conduct of the directors in allowing the company to incur debt was fraudulent or reckless he added (at 505):

> 'In that context, the existence and terms of a subordination agreement would be material and relevant in deciding whether the persons conducting such business incurred the debts with the reasonable expectation of their being paid in the ordinary course. The fact that a major creditor has subordinated its claim and to that extent created a *moratorium* for the benefit of other creditors is obviously relevant in determining the subjective state of mind of the debtor or those conducting its business.'

He distinguished an earlier decision in *Lind v Lefdal's Pianos Ltd (in liq)* 1929 TPD 241 (which had been relied upon by Stegmann J) on the ground that:

> 'There certain creditors attempted to rearrange the order in which they would be paid by the liquidator. In the case of debt subordination, the creditor has no claim unless other creditors receive payment in full. There is no question of a rearrangement of the claims of creditors who are to be paid out of the unencumbered assets of the company. The position would be no different in principle from the case of a debtor who, for whatever reason, decided not to prove a claim with the liquidator. Indeed, where there is a probability of a contribution being levied upon creditors, it is a common occurrence for creditors to refrain from proving a claim.'

He then referred to the *British Eagle* case [1975] 2 All ER 390, [1975] 1 WLR 758 as being similarly distinguishable.

I have some doubt whether in English law a subordinated debt is accurately described as a contingent liability and the analysis of the learned Justice of Appeal of the nature of subordinated debt indicates that there may be some differences

between the law of England and the law of South Africa. In English law subordinated debt would not, I think, be accurately described as a 'contingent liability' even if the debt is expressed to be payable only in the event of a winding up and to be subordinated to other unsecured debts in a winding up. It may still be paid in full or in part. The position is a fortiori if, as is more usually the case, the debt may become payable while the company is a going concern but is subordinated to other unsecured debts in a winding up. A debt cannot be said to be a contingent debt merely because in a winding up it may rank behind other debts and because the assets of the company may not suffice to pay the other debts in full.

However, nothing turns on the question whether a subordinated debt is aptly described as a contingent claim. The essential feature pointed to by Goldstone JA is that it is a debt payable only to the extent that there is a surplus after meeting the claims of other unsubordinated creditors.

This question has also been considered in a number of cases in New Zealand and in the states of Australia. It is only necessary to refer to the most recent of them, *Horne v Chester & Fein Property Developments Pty Ltd* [1987] VR 913, in which Southwell J reviewed the earlier cases. In that case C and S, who had contracted to purchase restaurant premises, entered into an agreement with F under which a unit trust was established for the purpose of conducting the restaurant business. G was incorporated on 8 July 1982 for the purpose of becoming the trustee of the unit trust. Each of C, S and F held 25 units. It was provided by cl 4 of the unit holders agreement that all moneys advanced by C, S and F to G should be accepted by it as loans and should rank equally in priority as to the payment by G, but this was qualified by a proviso that if any of C, S and F made an additional loan to G exceeding his due proportion of the loans made by all of them the additional loan would be repaid before any other repayment to other unit holders.

It was common ground that C and S had made additional loans to G within the proviso. After summarising the facts in the *Halesowen* case Southwell J said (at 917):

> 'In the speech of Viscount Dilhorne, there is a discussion of a number of authorities, of which "the weight of opinion expressed ... appears to me to be in favour of the conclusion that it is not possible to contract out of s. 31". However, there, and, so far as I have seen, in most other relevant cases, the term "contract out" is used in circumstances where the contract relied upon is one the performance of which upon later insolvency, would adversely affect other creditors who were not parties to the contract. Viscount Dilhorne referred with approval ([1972] 1 All ER 641 at 648, [1972] AC 785 at 804–805) to *dicta* of Hallett J. in *Victoria Products Ltd. v. Tosh and Co. Ltd.* ((1940) 165 LT 78) where his Honour said that: "an attempt to leave outside that process some particular item is one which should be regarded as against the policy of the insolvency laws". Repeatedly, over the years, "the policy of the insolvency laws" has formed the basis of decision. That policy, as it appears to me, was never intended to alter the rights and obligations of parties freely entering into a contract, unless the performance of a contract would upon insolvency adversely affect the right of strangers to the contract. Authority for that proposition is to be found in *Ex parte Holthausen. In re Scheibler* ((1874) LR 9 Ch App 722 at 726–727) (referred to by Lord Morris in his dissenting speech in *British Eagle International Airlines Ltd. v. Compagnie*

> *Nationale Air France* ([1975] 2 All ER 390 at 402, [1975] 1 WLR 758 at 770–771)).'

He then summarised the facts in the *British Eagle* case and cited the observations by Lord Simon, which I have already cited. He cited also the passage from the speech of Lord Cross to which I have referred. His conclusion was that s 440 of the Companies (Victoria) Code (which is in substantially the same terms as s 33(7) of the 1914 Act)—

> 'does not require that in all cases a liquidator must distribute *pari passu*. He may distribute in accordance with an agreement between the parties where to do so could not adversely affect any creditor not a party to the agreement.' (See [1987] VR 913 at 922.)

Horne's case concerned an agreement between unit holders which was entered into before loans were made and indeed before the company to which they were made was incorporated. It would no doubt be easier in that context to give effect to the agreement by the implication of a term for the assignment of the benefit of the interest of F in the winding up to C and S to the extent necessary to meet the additional loans. However, that was not the ground on which Southwell J decided the case.

The Federal Bankruptcy Code

Section 510(a) of the US Federal Code (11 USC §510(a)) provides:

> 'A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.'

That provision gave effect to the law developed by the courts. In the earlier cases subordination agreements were given effect on a variety of grounds. However, in recent cases a subordination agreement has been recognised as having direct contractual effect. In *First National Bank of Hollywood v American Foam Rubber Corp* (1976) 530 F 2d 450 at 454 Van Graafeiland J, giving the judgment of the court, said:

> 'Various theories have been advanced to support the enforcement of subordination agreements in bankruptcy: equitable lien, equitable assignment, constructive trust and enforcement of contractual rights. [Having referred to a number of cases he continued.] This Circuit has favored the recognition of priorities based upon the "lawful contractual arrangement between the parties." *In re Aktiebolaget Kreuger & Toll* ((1938) 96 F 2d 768 at 770). As we stated in *In re Credit Industrial Corporation* ((1966) 366 F 2d 402 at 407), if the terms of the contract are unambiguous, there is no need to resort to "strained theories of third-party beneficiary, estoppel or general principles of equity" to determine the rights of the parties.'

I have not been referred to the law of any continental jurisdiction except Switzerland. It seems to me unlikely that in any system derived from the civil code the law will differ in this respect from the position under Swiss law. It seems from the speech of Lord Kilbrandon that under Scottish law a creditor can contract out of or waive his right to set-off and if so he can presumably validly agree that his debt be subordinated. I have set out the leading authorities in South Africa, the United States and Australia. It would, I think, be a matter of grave concern if, at a time when insolvency increasingly has international

ramifications, it were to be found that English law alone refused to give effect to a contractual subordination. I have reached the clear conclusion that such a clause is valid and effective and is not avoided by any consideration of public policy and I shall so declare.

Declaration accordingly.

Jacqueline Metcalfe Barrister.

Panayiotou and others v Sony Music Entertainment (UK) Ltd

CHANCERY DIVISION
SIR DONALD NICHOLLS V-C
29, 30 JUNE, 1, 6, 7, 15 JULY 1993

Evidence – Foreign tribunal – Evidence for purpose of civil proceedings – Production of documents – Jurisdiction – Letters rogatory requesting production of documents by foreign company – Whether English court having jurisdiction to issue letter of request seeking production of documents belonging to company and in its possession RSC Ord 39, r 2.

The plaintiff, a popular singer who had worldwide sales, entered into agreements with the defendant recording company by which he tied himself to the defendant in respect of all his performances as a recording artist for a substantial period of years. The plaintiff subsequently wished to be released from the agreements on the grounds that their terms were so unreasonable that they were an unlawful restraint of trade. He brought an action against the defendant claiming that he was not bound by the agreements and applied to the court to issue of a letter of request pursuant to RSC Ord 39, r 2[a] addressed to the New York court, seeking the production of certain documents by a New York company associated with the defendant which he believed were material to the issues in the action. The New York company acted as the central licensing body for other companies in the defendant company's group. The plaintiff sought, inter alia, production of the company's sub-licence agreements affecting the exploitation of the plaintiff's recordings outside the United Kingdom, details of recording agreements between the company and certain well-known artists and release schedules showing dates of release, actual or intended, throughout the world of each of the plaintiff's recordings delivered to the defendant. The defendant contended that although the English court could issue a letter of request for the attendance of a person to be examined before the foreign court and to give oral evidence and to produce documents, it had no jurisdiction to issue a letter of request concerned only with the production of documents.

Held – The court had inherent jurisdiction to issue a letter of request to the judicial authorities of a foreign country seeking the production of documents

a Rule 2, so far as material, is set out at p 760 *b c*, post

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

ONTARIO
SUPERIOR COURT OF JUSTICE
(Commercial List)

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED	*Sean F. Dunphy* and *Ashley John Taylor*, for the Applicants, Air Canada
AND IN THE MATTER OF SECTION 191 OF THE *CANADA BUSINESS CORPORATIONS ACT*, R.S.C. 1985, c. C-44, AS AMENDED	*Monique Jilesen*, for the Monitor, Ernst & Young Inc. *Kevin P. McElcheran*, for CIBC
AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF AIR CANADA AND THOSE SUBSIDIARIES LISTED ON SCHEDULE "A"	*Joseph M. Steiner*, for GTAA *Mark E. Meland*, for The Summitomo Trust & Banking Co. Ltd., and Tokyo Leasing Co., Ltd. *Gregory Azeff*, for GECAS Inc.
APPLICATION UNDER THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED	*Harvey Chaiton*, for Dr. Ratthey and Rainer Manthey (DM Bondholders) *S.R. Rickett*, for Bayerische Landesbank *David R. Wingfield* and *Kim Mullin*, for Tudor Investment Corp. and other Senior Financial Creditors *A. Kauffman*, for Ad Hoc Committee of various Financial Creditors **HEARD:** March 17, 2004

FARLEY J.

Re: Perpetual Subordinated Debt

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SF Bonds s. 7

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

Yen Loan Agreements para. 6.4.2

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Vinelott J. stated at p. 1416:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[16] The Trade Creditors motion is dismissed.

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

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

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

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

(emphasis added)

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

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

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

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

> Indebtedness until the Bonds and Coupons shall be paid in full and no such payments or distributions to the holders of Bonds or Coupons of cash, property or securities otherwise distributable to the holders of Senior Indebtedness shall, as between the Borrower, its creditors other than the holders of Senior Indebtedness, and the holders of Bonds or Coupons be deemed to be a payment by the Borrower to the holders of Bonds or Coupons, or for their account. It is understood that the provisions of this § 8 are and are intended solely for the purpose of defining the relative rights of the holders of Bonds or Coupons and the holders of other *pari passu* Indebtedness, on the one hand, and the holders of Senior Indebtedness, on the other hand.
>
> (5) No payment by the Borrower on the Bonds or Coupons (whether upon redemption or repurchase, or otherwise) shall be made if, at the due time o f such payment or immediately after giving effect thereto, (a) there shall exist a default in the payment of principal, premium, if any, sinking fund or interest with respect to any Senior Indebtedness, or (b) there shall have occurred an event of default (other than a default in the payment of principal, premium, if any, sinking fund or interest) with respect to any Senior Indebtedness, as defined therein or in the instrument under which the same is outstanding, permitting the holders thereof or any trustee under any such instrument to accelerate the maturity thereof, and such event of default shall not have been cured or waived or shall not have ceased to exist (except payments made if the Bonds are redeemed or acquired prior to the happening of such default or event of default).
>
> (7) The Borrower undertakes vis-à-vis the Trustee for the benefit of the holders of Bonds and Coupons that until such time as the Bonds or Coupons have been completely repaid the Borrower will ensure that the Bonds rank and will rank *pari passu* with all unsecured and subordinated Indebtedness of the Borrower other than Indebtedness preferred by law.

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

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

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

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

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

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

[24] Orders to issue accordingly.

J.M. Farley

Released: April 5, 2004

Date of Release: February 25, 1994

No. 144151 VA/92
Vancouver Registry

IN THE SUPREME COURT OF BRITISH COLUMBIA

IN BANKRUPTCY

IN THE MATTER OF THE BANKRUPTCY OF RICO ENTERPRISES LTD.	REASONS FOR JUDGMENT OF THE HONOURABLE MR. JUSTICE TYSOE (IN CHAMBERS)

Counsel for the Trustee in Bankruptcy, Deloitte & Touche Inc.:	Peter A. Spencer
Counsel for Johann Schupp and four other holders of promissory notes:	Arthur L. Edgson
Counsel for Wenzel Enterprises Ltd. and Helmut Wenzel:	John F. Grieve
Counsel for Rico Enterprises (Vancouver) Ltd. and Hans Rieder:	William D. Riley
Date and place of hearing:	February 16, 1994 Vancouver, B.C.

The Trustee in Bankruptcy has applied for directions relating to the distribution of dividends to the creditors of Rico Enterprises Ltd. (the "Bankrupt"). The issues to be resolved relate to the priorities between various creditors and the existence of an outstanding action which could affect the categorization and priority of moneys owed to a group of creditors who are the plaintiffs in that action.

FACTS

The Bankrupt was an investment vehicle for the construction and operation of two restaurants at Expo '92 in Seville, Spain. The persons who invested in the enterprise purchased units in numbered companies which, in turn, purchased units in the Bankrupt. Each unit consisted of shares and debt, with a nominal amount of the purchase price being allocated to the shares and the balance being allocated to the debt. Thus, an investor would receive shares in the numbered company plus a promissory note from the numbered company, and the numbered company would receive shares in and a promissory note from the Bankrupt. The investment was apparently structured in this manner for income tax reasons. Letters of credit were also involved but they were all drawn upon and, for the purpose of this application, they can be treated the same as cash advances made in exchange for promissory notes.

The numbered companies through which the initial group of individuals invested, which became known as the First Round Investors, contributed approximately $4 million to the project in the form of cash and letters of credit. Expo '92 was to open on April 20, 1992 and it became apparent by late 1991 or early 1992 that there were significant cost overruns and that a further capital injection of at least $2 million was required to complete construction of the restaurants. If additional financing could not be obtained, the restaurants would not open and, instead of the generous profits that were anticipated as a result of the success

of similar restaurants at Expo '86 in Vancouver, the project would be a financial disaster with all the First Round Investors and creditors (except the banks holding the letters of credit) losing all of their monies. The situation was desperate, although the outlook for the project was still optimistic if the construction of the restaurants could be finished prior to the opening of the fair.

On February 17, 1992 the Bankrupt received an investment proposal (the "Proposal") from 419776 British Columbia Ltd. ("Newco"). It proposed that Newco would provide financing of up to $2,160,000 for 18 units in the projects. There were numerous terms and conditions of the financing, including the payment of a $432,000 bonus to Newco, the right of Newco to appoint two members of the Bankrupt's board of directors and the substitution of two key officers with persons selected by Newco. The proposal also contained the following three paragraphs:

> 6. All profits (the definition of which shall be approved by Newco) of the Company shall be dispersed to those parties and in the order set out below:
>
> (a) Newco shall receive the Bonus;
>
> (b) Newco shall be repaid of all (sic) of its initial investment;
>
> (c) loans shall be paid as approved by the new Board of Directors of Rico;
>
> (d) accrued wages and salaries of related parties and invoices of Spanish Ventures and its principals all as approved and accepted by the new Board of Directors of Rico;
>
> (e) all remaining loans of the Existing Investors shall be repaid together with interest of 12% per annum for cash loans and 1% per annum for letter of

credit loans; and

(f) the remaining profits shall be shared by all investors equally.

.....

10. The terms and conditions of this proposal must be approved by a majority of the Existing Investors at a meeting of the Existing Investors called for this purpose.

11. This is a proposal only and shall be subject to preparation of formal documentation.

A meeting of the individuals who invested through the First Round Investors (who presumably were the group referred to in the proposal as the Existing Investors) was held on February 17, 1992 to consider the Proposal. The meeting approved the Proposal. Some of the individual investors did not attend the meeting and at least one of the individual investors who did attend voted against the approval of the Proposal.

The new investment did not go forward on the basis contemplated by the Proposal. Further investments in the form of cash advances and the posting of letters of credit in the aggregate of approximately $2.6 million were made but the investments were not made through the company that made the Proposal, 419776 British Columbia Ltd., and there was not the type of formal documentation one would have expected from paragraph 11 of the Proposal. The investments were made through six numbered companies, which have become known as the Second Round Investors. Four of the Second Round Investors were also numbered companies within the group of the First Round Investors. In terms of the individual investors,

five of the 18 units were purchased by previous investors and the other 13 units were acquired by persons who were new to the project.

The only documentation relating to the new investment were the shares, promissory note and letters of credit which comprised each unit, an offering memorandum that had a copy of the Proposal included within it and two agreements which I will describe shortly.

At the time of the investment made by the Second Round Investors, the Bankrupt had several types of creditors. I have already referred to the First Round Investors and the bankers which held letters of credit issued by the bankers of the First Round Investors. The Bankrupt also had normal trade creditors, some of which were related to the Bankrupt in the sense that the trade creditor or its principal had invested in the project through the First Round Investors. Approximately $500,000 was owed to the Bankrupt's directors or their associated companies on account of loan advances made by them. The Bankrupt also owed in excess of $100,000 in respect of loans made to it by persons who had not invested in the project as shareholders.

One of the individuals who invested in the project throught the First Round Investors was Mr. Hans Rieder who was the principal of a company called Rico Enterprises (Vancouver) Ltd. That company was owed $63,000 for consulting services and $240,000 for loans made to the Bankrupt. Rico Enterprises (Vancouver) Ltd.

and Mr. Reider (who I shall collectively refer to as "Reider") signed an agreement with the Bankrupt around the time of the second round of investments. The agreement was dated February 21, 1992 but it was signed in the first part of March 1992. In the agreement Reider agreed that it would not pursue its claims against Rico by way of court proceedings prior to October 12, 1992, which was the end of Expo '92. The agreement then contained the following two paragraphs:

> 2. It is further agreed that in consideration of the foregoing agreement to postpone any claims, such claims shall be settled as provided herein prior to distribution of profits in respect of the remaining loans of the Existing Investors (as prescribed in paragraph 6(e) of the proposal dated February 17, 1992).
>
> 3. It is further agreed that the terms of the letter of Clark, Wilson to Edwards, Kenny & Bray dated March 2, 1992 attached hereto as Schedule "A" shall form part of this Agreement, provided that the sum of $63,000.00 plus accrued interest referred to therein shall be deemed to be accrued wages for the purposes of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992).

The attached letter from Clark, Wilson stated that Mr. Rieder would release the Bankrupt from all claims related to his employment and termination of employment in exchange for payment of $63,000 plus interest and that Mr. Rieder would make himself available as a consultant for the project for up to a maximum of 20 days at a rate of $250 a day.

Another one of the investors who had invested in the project through the First Round Investors was Mr. Helmut Wenzel who

was the principal of a company called Wenzel Enterprises Ltd. That company was owed $120,000 for construction services and $203,000 for loans made to the Bankrupt. Mr. Wenzel and Wenzel Enterprises Ltd. (who I will collectively refer to as "Wenzel") also signed an agreement dated March 3, 1992 with the Bankrupt. Similar to the Rieder agreement, it provided that Wenzel would not pursue its claims against the Bankrupt by way of court proceedings prior to October 12, 1992. The agreement incorporated a Memorandum of Understanding that had been prepared by a solicitor acting for Wenzel. Paragraph C of the Memorandum of Understanding recited the $120,000 amount owing to Wenzel for construction services plus the interest owing on that amount and continued as follows:

> No payments have been made whatsoever in respect of those amounts and the same will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum.

Paragraph H(a) of the Memorandum of Understanding recited the loans made by Wenzel to the Bankrupt and continued as follows:

> The loans referred to in this paragraph (a) shall be paid not later than the loans referred to in the paragraph 6(c) of the letter dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum together with all accrued interest.

No other documentation regarding the priorities contemplated in paragraph 6 of the Proposal was signed around the time of the investment made through the Second Round Investors, but

two parties have sent letters to the Trustee in Bankruptcy in relation to the priorities of their claims. The first letter was sent by Mr. Doug Schafer, the principal of a company called T.K. Holdings Ltd. which was owed $57,500 for "wages" and approximately $10,000 on account of loans made by it to the Bankrupt. In his letter dated March 29, 1993 Mr. Schafer stated the following with respect to the priorities of the wages and loan advances:

> On February 25, 1992 I met with Harry and Greg and agreed that I would defer my accrued wages up to February 15th totalling ($57,500.00) plus accrued interest until the new investors received their investment plus bonus.
>
> .....
>
> With respect to the promissory note holders, these funds were advanced to assist with cash-shortfalls and were not part of any investment. All note holders were advised they would be paid before any disbursements to investors.

Mr. Schafer also stated in his letter that "it was always understood that trade creditors would be paid before investors".

The other relevant letter, which was sent to the Trustee's counsel, was a letter from Davis & Company dated April 8, 1993. Davis & Company provided legal services to the Bankrupt and one of its partners was an investor and a director of the Bankrupt. Davis & Company had previously filed a proof of claim in the amount of $123,476.20 without differentiating between the legal costs incurred prior to the second round of investments and the legal costs incurred after the final investments. Davis & Company had apparently also sent a letter to counsel for the Trustee

maintaining that its claim should be treated as a normal claim of a trade creditor. The letter dated April 8, 1993 indicated that the earlier letter had been in error and it contained the following statements:

> All the time and charges prior to February 17, 1992 were subordinated whereas the time incurred after that date was not ... The amount owing as at February 17, 1992 is $57,675.39 and we agree that this amount is subordinated to the claims of the Second Round Investors.
>
> .....
>
> As I indicated to you, the agreement that was reached between Davis & Company and Rico Enterprises Ltd. was to subordinate their previous fees and disbursements providing future fees and disbursements were paid in priority to the claims of all Investors.

As is obvious from its bankruptcy, the Bankrupt was not successful in the operation of the two restaurants at Expo '92. The construction of the restaurants was completed prior to the opening of Expo '92 but the businesses did not generate any profits. The Bankrupt filed a proposal under the ***Bankruptcy & Insolvency Act*** at the conclusion of the fair in October 1992. The proposal was rejected by the creditors in April 1993 and the bankruptcy ensued. The Trustee has received funds in excess of $800,000 with the recovery being mainly from the return of deposits that had been lodged by the Bankrupt.

After it was apparent that the project had not been successful, certain of the investors who invested through the First

Round Investors (the "Robson Group") commenced an action against the Bankrupt and others claiming rescission of their transactions. Statements of Defence and Third Party Notices were filed in the action. No further steps have been taken since June 1993.

DISCUSSION

None of the First Round Investors or the Second Round Investors attended at the hearing of the application. Counsel for the Trustee advised me that these Investors do not dispute that they fall under s. 139 of the ***Bankruptcy & Insolvency Act*** according to the criteria discussed in ***Laronge Realty Ltd. v. Golconda Investments Ltd.***[1]. I agree with the submission of the Trustee's counsel in this regard and I need not elaborate on the facts relating to this aspect. Hence, by virtue of s. 139, the two groups of investors are not entitled to be paid the amounts owing to them under the promissory notes until the claims of all other creditors of the Bankrupt have been satisfied.

In their action the Robson Group is claiming entitlement to rescind their investment transactions. The Trustee is concerned that if the Robson Group is successful in its rescission claim after the Trustee has made a distribution on the basis that all of the loans made by the First Round Investors fall within s. 139, the Robson Group could make a claim against the Trustee and say that

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[1] ***Laronge Realty Ltd. v. Golconda Investments Ltd.*** (1986), 63 C.B.R. 74 (B.C.C.A.)

the monies owed to the First Round Investors through which they invested no longer fall within s. 139. I authorize and direct the Trustee to make distributions to the creditors of the Bankrupt on the basis that the monies owing to all of the First Round Investors do fall within s. 139 unless, prior to any such distributions, the Robson Group obtains an Order of this Court preventing any such distributions or is successful in its rescission claim and had notified the Trustee. The Trustee may apply for further directions if the Robson Group is successful in its rescission claim before the monies available for the Bankrupt's creditors have been fully distributed. I also direct the Trustee to advise the Robson Group of my ruling in this regard at least 15 days prior to making the first distribution to the creditors.

On its application for directions the Trustee proposes to the Court that the priorities contemplated in paragraph 6 of the Proposal be recognized and that, after payment of expenses and preferred claims, the available monies be distributed as follows:

(a) firstly, in payment in full of (i) the claims of the trade creditors who were not investors in the project, (ii) the claims of the trade creditors who were investors to the extent that they arose after February 17, 1992 and (iii) the claims of the lenders who were not investors;

(b) secondly, the balance to be paid to or at the direction of the Second Round Investors.

This proposed method of distribution would see

approximately $225,000 paid to the trade creditors, $142,000 paid to the non-investor lenders and the balance in the neighbourhood of $400,000 paid to or at the direction of the Second Round Investors. The following groups would receive nothing under the Trustee's proposed distribution:

(a) trade creditors who were investors to the extent that their claims arose before February 17, 1992 (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Davis & Company who are owed an aggregate of approximately $350,000 under this category);

(b) directors who made loans to the Bankrupt (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Hans Speck who are owed approximately $540,000 under this category).

Counsel for the Trustee urged me to find that there was an agreement between all affected parties along the lines of the order of priority set forth in paragraph 6 of the Proposal. Although I respect the views of the Trustee, I am unable to accede to its proposed method of distribution.

The persons who made their investments through the Second Round Investors appear to have held the view that a majority vote at a meeting of the individuals who invested through the First Round Investors would be sufficient to bind all affected creditors to the provisions of paragraph 6 of the Proposal. This view was misconceived and it is unfortunate that these persons made their investments while under such a misconception.

It is uncertain whether the vote at the meeting of the individuals who invested through the First Round Investors was binding on all of the First Round Investors irrespective of whether the individuals attended at the meeting or voted against the Proposal. It can be argued that the shareholders of each of the First Round Investors indicated their majority wishes at the meeting and that the majority votes at the meetings constituted agreement on behalf of each of the First Round Investors to the priorities set out in paragraph 6 of the Proposal. There was some evidence that at least one shareholder at the meeting believed that they were agreeing to the proposed transaction in principle only.

However that may be, it is clear that the vote of the meeting was not binding on the creditors of the Bankrupt who happened to be represented at the meeting. A vote at a meeting of shareholders of a company cannot be automatically binding on creditors of the company on the basis of commonality between some shareholders and some creditors. A person voting at a shareholders' meeting cannot be taken as agreeing to the subject matter of the vote in their capacity as a representative of a creditor of the company unless it is expressly stipulated to be the case. Indeed, this was recognized in the present case as a result of the agreement with Wenzel who attended the February 17 meeting. If he was to be bound in all capacities as a result of the February 17 meeting, it would not have been necessary to have Wenzel enter into the March 3, 1992 agreement with the Bankrupt.

The Proposal itself is not an enforceable agreement for several reasons. First, it is stated on its face to be a proposal only and subject to formal documentation. Second, the party who made the proposal, 419776 British Columbia Ltd., did not invest monies in the Bankrupt. Third, there are at least two uncertainties that are not capable of clarification by the Court. The term "profits" was never defined. In view of the fact that paragraph 6 of the Proposal mixes the ranking of debt and equity, the Court is not in a position to say that any particular definition of "profits" was intended by the parties because a traditional definition of "profits" is based on the payment of expenses in priority to the payment of equity. Also, the definition of the term was subject to the approval of Newco and there is no evidence as to what definition may have been acceptable to it. Further, clause (c) of paragraph 6 refers to loans generally but the evidence indicates that there was an intention to give different treatment to loans made by directors and loans made by non-investors. The formal documentation contemplated by paragraph 11 would presumably have dealt with these points and, while the Court will generally fill out the terms of an agreement to make it enforceable, the Court should not endeavour to write the agreement on behalf of the parties when critical aspects are not known with any certainty.

Counsel for the Trustee submitted that although the Proposal itself may not be enforceable, I should find that the parties agreed to the priorities contained in paragraph 6 of the

Proposal. I am unable to make such a finding because there is no evidence of such an agreement being reached. The only evidence before me in relation to priorities are the fact that a meeting of the individual investors approved the Proposal and the existence of the two agreements and the concessions in the two letters that I have described. It appears that the Second Round Investors proceeded on the erroneous assumption that all necessary parties had agreed to the priority contained in the Proposal.

In addition, the wording of s. 139 of the ***Bankruptcy & Insolvency Act*** should be considered. The relevant portion of the section is as follows:

> Where a lender advances money to a borrower ... under a contract with the borrower that the lender ... shall receive a share of the profits ... and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

This section must have been intended to apply notwithstanding a contrary agreement between the lender and the bankrupt. The agreement by the bankrupt to repay the monies as a loan carries with it the implication that the monies will rank in priority equally with the unsecured debt of the bankrupt. That is itself a contrary agreement which Parliament clearly intended to override. This means that in the present situation, an agreement between the Second Round Investors and the Bankrupt along the lines of paragraph 6 of the Proposal is subject to the provisions of s. 139. In other words, if there was an agreement between the Second Round

Investors and the Bankrupt to the effect of paragraph 6, s. 139 would render unenforceable the priority given to the Second Round Investors over the Bankrupt's unsecured creditors.

It may be that the Second Round Investors have priority agreements with creditors of the Bankrupt and the First Round Investors, and they may be able to enforce such agreements in separate proceedings. It is my view, however, that the distribution by the Trustee should only be affected by agreements between the Bankrupt and its creditors, and by agreements between creditors that are conceded. There would be no point in having the Trustee distribute monies to one creditor when it is admitted by that creditor that the monies should be paid to another creditor. In support of my view, I refer to the decision of the First Appellate Division of the Ontario Supreme Court in ***Re Orzy (Canadian Garment Company)***[2] where Ferguson J.A. said the following:

> ... the practice in bankruptcy does not permit of the adjustment of the rights and privileges of creditors *inter se* but only the rights, privileges and preferences of creditors as against the insolvent and his estate ..... the reason or principle governing being that bankruptcy proceedings are designed to administer the rights of creditors of the estate as against the debtor and his estate, and therefore the Court may not in that administration be delayed or hindered by being called upon to determine questions between creditors or between a creditor and another person such as assignee of a creditor, or as here a question as to whether or not one creditor is estopped from taking a dividend from the insolvent estate to the prejudice of

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[2] ***Re Orzy (Canadian Garment Company)*** (1923), 3 C.B.R. 737

another. (p. 741)

I turn now to the interpretation and effect of the two agreements that were entered into with the Bankrupt and the effect of the concessions contained in the letters from Mr. Schafer and Davis & Company.

Each of the Rieder and Wenzel agreements have separate paragraphs dealing with the monies owing on account of loans and the monies owing in respect of consulting/construction services. I will address the corresponding paragraphs in the two agreements at the same time.

The language in the Rieder and Wenzel agreements in relation to the loans owing to them is not sufficient to postpone the loans in priority to the monies owing to the Second Round Investors or any of the Bankrupt's creditors. Indeed, paragraph 2 of the Rieder agreement was contemplated to be in favour of Rieder because it was stated to be in consideration of Rieder agreeing in the previous paragraph that it would not pursue its claims against the Bankrupt prior to October 12, 1992. Paragraph 2 was an assurance to Rieder that although it had agreed not to pursue its claims for a specified period of time, it would be paid prior to the distribution of any monies to the First Round Investors. The paragraph does not say, either expressly or by necessary implication, that Rieder has postponed its claims to the rights of the Second Round Investors, the trade creditors or other parties who made loans to the Bankrupt.

If it was the intention of the draftsperson of the Rieder agreement to bind Rieder to the priority provisions of the proposal, they did not accomplish this intention. But it is doubtful that this was the intention of the draftsperson. Paragraph 2 of the Rieder agreement states the claims will be settled prior to distribution of profits in payment of the loans owing to the First Round Investors (as opposed to being paid at the same time as the loans referred to in clause 6(c) of the Proposal). There is no statement that the loans owing to Rieder would not be paid prior to the repayment of the new investment and bonus or any other amount. It would have been easy for the draftsperson of the Rieder agreement to state that Rieder agreed to be bound by the order of priority contained in paragraph 6 of the Proposal and that Rieder postponed its claims accordingly. There is no equivalent language in the Rieder agreement and one must conclude that the draftsperson had a different intention in drafting the language as they did.

Similarly, paragraph H(a) of the Memorandum of Understanding attached to the Wenzel agreement states that the loans owing to Wenzel will be paid not later than the loans referred to in clause 6(c) of the Proposal. There is no statement that the loans are not to be repaid prior to the new investment and bonus or any other amount. The language in paragraph H(a) of the Memorandum of Understanding is not sufficient to create a postponement or subordination of the loans owed to Wenzel.

The draftspersons of the Rieder agreement and the Memorandum of Understanding attached to the Wenzel agreement appreciated that monies owing to the two companies for consulting and construction services were not wages or salaries. The draftsperson of the Rieder agreement therefore used the words: "[the monies owing for the consulting services] shall be deemed to be accrued wages for the purpose of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992)". The draftsperson of the Wenzel Memorandum of Understanding used the words: "[the monies owing for the construction services] will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B.C. Ltd.". The issue is whether this language is enforceable to subordinate the claims for consulting/construction services to the claims of the Second Round Investors or any other creditor.

I have found that paragraph 6 of the Proposal is not enforceable because, among other reasons, there are at least two uncertainties that are incapable of clarification by the Court. The Court cannot realistically determine what the parties meant by the term "profits" and the approval of 419776 British Columbia Ltd. to any definition is absent. Also, the evidence indicates that there is uncertainty regarding the loans referred to in clause 6(c). If paragraph 6 of the Proposal itself is unenforceable for these reasons, it follows that paragraph 3 of the Rieder agreement and paragraph C of the Wenzel Memorandum of Understanding, which

appear to be attempts to incorporate the order of payment set out in paragraph 6 for the purposes of the payment of the consulting/construction services, are unenforceable for the same reasons.

Also, there is an argument that can be made to the effect that in addition to overriding agreements between a bankrupt and its equity type lenders, s. 139 overrides agreements between a bankrupt and its other creditors that would give equity type lenders a priority higher than the priority stipulated by s. 139 (such as the Rieder and Wenzel agreements). I will not address the argument at this time for reasons that will become apparent.

Even if the Court was in a position to formulate a definition for the term "profits", it would presumably bear a resemblance to the statement that the profits are the difference between the revenues and the expenses of the Bankrupt over a certain period of time. However, the Bankrupt's revenues never exceeded its expenses with the result that there is no profit to distribute. The language in paragraph 6 of the Proposal only deals with the distribution of profits and it does not address the present situation of a financial failure. If the new investors had directed their minds to the point, they may have insisted that the order of priorities apply to any distribution of the Bankrupt's assets but I cannot infer that Rieder or Wenzel would definitely have agreed.

The final two matters requiring consideration are the

concessions made by T.K. Holdings Ltd. and Davis & Company in the letters to the Trustee and its counsel. Neither T.K. Holdings Ltd. nor Davis & Company attended at the hearing of the application and it may not have occurred to them that there is an argument that their agreements with the Bankrupt may be overridden by the provisions of s. 139 of the Bankruptcy Act. Their agreements regarding subordination would not be overridden by s. 139 if they made the agreements directly with the Second Round Investors because the agreements could be enforced between the parties after the making of a distribution that did not violate s. 139. From a purist's point of view, it could be said that the trustee should make the distribution in compliance with s. 139 and leave it to the parties to the subordination agreement to deal with the priorities between them. But if the subordinating creditor concedes that it has subordinated its claim to the claim of a lender which falls within s. 139, I see no reason why the trustee could not pay the share of the subordinating creditor directly to the s. 139 lender as if the subordinating creditor had assigned its claim to the lender.

However, in the present case, the two letters from Mr. Schafer and Davis & Company appear to state that the agreements were made with the Bankrupt. Accordingly, I give them leave to make an application for the purpose of advancing an argument that s. 139 overrides their agreements. I do not expect they will definitely make such an application because I appreciate that they may also have made their agreements with the Second Round

Investors. In addition, even if there is a potential argument that their agreements with the Bankrupt are not binding in view of s. 139, they may feel a moral commitment to the Second Round Investors that they should not take the portion of the distribution allocable to their pre-February 17, 1992 services in priority to the Second Round Investors.

In the event that the agreements conceded to have been made by T.K. Holdings Ltd. and Davis & Company are not overridden by s. 139, their claims are subordinated to the claims of the Second Round Investors. There is no evidence that they subordinated their claims to all other claims ranking in priority to the claims of the Second Round Investors and that result does not automatically flow from a subordination to the Second Round Investors. If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.

It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the

same class as the subordinating creditor should not receive the benefit of an subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination was granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

CONCLUSION

In addition to the directions that I have already given, I direct the Trustee as follows:

1. To calculate the amounts for the distribution to the unsecured creditors on the basis that all of the parties who filed proofs of claim except the preferred creditors, the First Round Investors and the Second Round Investors are unsecured creditors of equal ranking;
2. To make the distribution to the unsecured creditors of their respective amounts except the sums that would be

payable to T.K. Holdings Ltd. and Davis & Company in respect of the indebtedness for services rendered up to February 17, 1992 ($70,666.00 and $61,476.20);

3. To pay these excepted sums to or at the direction of the Second Round Investors if so directed by T.K. Holdings Ltd. or Davis & Company, as the case may be, and, if not so directed by either of T.K. Holdings Ltd. or Davis & Company, to retain the funds in interest bearing accounts pending further Order of this Court on application of T.K. Holdings Ltd., Davis & Company, the Trustee or any other interested party.

This direction is without prejudice to the rights of the Second Round Investors to pursue any of the creditors receiving a portion of the distribution on the basis that such creditor agreed with the Second Round Investors that its claim would be subordinated to their claims.

The Trustee was acting reasonably in bringing this application. Although I did not agree with the Trustee's proposed manner of distribution, I order that the parties shall bear their own costs and that, subject to normal taxation, the Trustee's costs may be paid from the bankruptcy estate.

"D. Tysoe, J."

February 25, 1994
Vancouver, B.C.

SUPERIOR COURT
(Commercial Division)

CANADA
PROVINCE OF QUÉBEC
DISTRICT OF MONTRÉAL
N°: 500-11-041305-117

DATE : June 30, 2014

PRESIDING : THE HONOURABLE MARK SCHRAGER, J.S.C.

IN THE MATTER OF THE PLAN OF COMPROMISE OR ARRANGEMENT OF :

HOMBURG INVEST INC.
HOMBURG SHARECO INC.
CHURCHILL ESTATES DEVELOPMENT LTD.
INVERNESS ESTATES DEVELOPMENT LTD.
CP DEVELOPMENT LTD.
NORTH CALGARY LAND LTD.

Debtors / Petitioners

And

HOMCO REALTY FUND (52) LIMITED PARTNERSHIP
HOMCO REALTY FUND (88) LIMITED PARTNERSHIP
HOMCO REALTY FUND (89) LIMITED PARTNERSHIP
HOMCO REALTY FUND (92) LIMITED PARTNERSHIP
HOMCO REALTY FUND (94) LIMITED PARTNERSHIP
HOMCO REALTY FUND (96) LIMITED PARTNERSHIP
HOMCO REALTY FUND (105) LIMITED PARTNERSHIP
HOMCO REALTY FUND (121) LIMITED PARTNERSHIP
HOMCO REALTY FUND (122) LIMITED PARTNERSHIP
HOMCO REALTY FUND (142) LIMITED PARTNERSHIP
HOMCO REALTY FUND (190) LIMITED PARTNERSHIP
HOMCO REALTY FUND (191) LIMITED PARTNERSHIP
HOMCO REALTY FUND (199) LIMITED PARTNERSHIP

Mises-en-cause

And

STICHTING HOMBURG BONDS
Mise-en-cause

And

TABERNA PREFERRED FUNDIND VI, LTD.
TABERNA PREFERRED FUNDIND VIII, LTD.
TABERNA EUROPE CDO I P.L.C.
TABERNA EUROPE CDO II P.L.C.

Mises-en-cause

And

SAMSON BÉLAIR/DELOITTE & TOUCHE INC.

Monitor

JUDGMENT

JS 1319

FACTS

[1] The Debtors/Petitioners ("Debtors") were subject to an initial stay order issued on September 9, 2011 pursuant to the *Companies' Creditors Arrangement Act* [1] ("CCAA") by the Honourable Justice Louis Gouin. The latter has been charged with the management of the case but due to a conflict of interest with the attorneys the four (4) Taberna entities mises-en-cause in the instant proceedings ("Taberna"), the undersigned presided over the present matter.

[2] After a number of extensions of the CCAA stay order, the Debtors filed an arrangement which was accepted by the statutory majority of creditors under the

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[1] R.S.C., 1985, c. C-36.

CCAA and subsequently sanctioned by the Court on June 5, 2013. Implementation of this plan, including payments thereunder, has begun.

[3] The undersigned is called upon to adjudicate on the Debtor's Re-Amended Motion for Directions which was originally filed on January 25, 2013. The motion seeks resolution of issues regarding the rank *inter se* of, in essence, two series of debentures one held or administered by the mise-en-cause Stichting Homburg Bonds ("Stichting") referred to above and the other by Taberna.

[4] In May 2006, Homburg Invest Inc. ("HII"), one of the Co-Petitioners/ Debtors, entered into a trust indenture with Stichting as trustee providing, *inter alia*, for the issuance of bonds. In 2002, Homburg Shareco Inc. ("Shareco") another Co-Petitioner Debtor entered into an indenture also with Stichting providing for the issuance of additional bonds. The face-amount of the outstanding bonds as at the CCAA filing aggregated in excess of 400 Million Euros (or approximately 500 Million dollars) and constituted the largest single bloc of debt of the Debtor of approximately 1.8 Billion dollars.

[5] In July 2006, HII entered into a "junior subordinate indenture" with Wells Fargo Bank, N.A. ("Wells Fargo") providing for the issuance of 20 Million US dollar notes. A second indenture was signed at the same time providing for the issuance of 25 Million euro notes (hereinafter together, the 2006 Taberna Indentures).

[6] Both of the 2006 Taberna Indentures contained the following clauses:

> "**SECTION 12.1. Securities Subordinate to Senior Debt.**
>
> The Company covenants and agrees, and each Holder of a Security, by its acceptance thereof, likewise covenants and agrees, that, to the extent and in the manner hereinafter set forth in this Article XII, the payment of the principal of and any premium and interest (including any Additional Interest) on each and all of the Securities are hereby expressly made subordinate and subject in right of payment to the prior payment in full of all Senior Debt.
>
> **SECTION 12.2. No Payment When Senior Debt in Default; Payment Over of ProceedsUpon Dissolution, Etc.**
>
> (a) In the event and during the continuation of any default by the Company in the payment of any principal of or any premium or interest on any Senior Debt (following any grace period, if applicable) when the same becomes due and payable, whether at maturity or at a date fixed for prepayment or by declaration of acceleration or otherwise, then, upon written notice of such default to the Company by the holders of such Senior Debt or any trustee therefor, unless and until such default shall

have been cured or waived or shall have ceased to exist, no direct or indirect payment (in cash, property, securities, by set-off or otherwise) shall be made or agreed to be made on account of the principal of or any premium or interest (including any Additional Interest) on any of the Securities, or in respect of any redemption, repayment, retirement, purchase or other acquisition of any of the Securities.

(b) In the event of a bankruptcy, insolvency or other proceeding described in clause (d) or (e) of the definition of Event of Default (each such event, if any, herein sometimes referred to as a "Proceeding"), all Senior Debt (including any interest thereon accruing after the commencement of any such proceedings) shall first be paid in full before any payment or distribution, whether in cash, securities or other property, shall be made to any Holder of any of the Securities on account thereof. Any payment or distribution, whether in cash, securities or other property (other than securities of the Company or any other entity provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in these subordination provisions with respect to the indebtedness evidenced by the Securities, to the payment of all Senior Debt at the time outstanding and to any securities issued in respect thereof under any such plan of reorganization or readjustment), which would otherwise (but for these subordination provisions) be payable or deliverable in respect of the Securities shall be paid or delivered directly to the holders of Senior Debt in accordance with the priorities then existing among such holders until all Senior Debt (including any interest thereon accruing after the commencement of any Proceeding) shall have been paid in full.

(c) In the event of any Proceeding, after payment in full of all sums owing with respect to Senior Debt, the Holders of the Securities, together with the holders of any obligations of the Company ranking on a parity with the Securities, shall be entitled to be paid from the remaining assets of the Company the amounts at the time due and owing on account of unpaid principal of and any premium and interest (including any Additional Interest) on the Securities and such other obligations before any payment or other distribution, whether in cash, property or otherwise, shall be made on account of any Equity Interests or any obligations of the Company ranking junior to the Securities and such other obligations. If, notwithstanding the foregoing, any payment or distribution of any character on any security, whether in cash, securities or other property (other than securities of the Company or any other entity provided for by a plan of reorganization or readjustment the payment of which is subordinate, at least to the extent provided in these subordination provisions with respect to the indebtedness evidenced by the Securities, to the payment of all Senior Debt at the time outstanding and to any securities issued in respect thereof under any such plan of reorganization or readjustment) shall be received by the Trustee or any Holder in contravention of any of the terms hereof and before all Senior Debt shall have been paid in full, such payment or distribution or security shall be

> received in trust the benefit of, and shall be paid over or delivered and transferred to, the relevant holders of the Senior Debt at the time outstanding in accordance with the priorities then existing among such holders for application to the payment of all Senior Debt remaining unpaid, to the extent necessary to pay all such Senior Debt (including any interest thereon accruing after the commencement of any Proceeding) in full. In the event of the failure of the Trustee or any Holder to endorse or assign any such payment, distribution or security, each holder of Senior Debt is hereby irrevocably authorized to endorse or assign the same."
>
> (Underlined by the Court)

[7] Senior Debt is broadly defined in the 2006 Taberna Indentures and it is not contested that it includes the debt existing under and pursuant to the Stichting bonds.

[8] Thus, the 2006 Taberna notes were subordinate to the Stichting debt, in that once a payment of capital or interest on the Stichting debt was in default, no payment on account of the 2006 Taberna Indentures was permitted by HII.

[9] The 2006 Taberna Indentures further provided that they are governed by the laws of the State of New York.

[10] In 2011, HII was in default in virtue of certain financial covenants provided in the 2006 Taberna Indentures. Negotiations ensued between the business people followed by exchanges between the lawyers culminating in the signature of an Exchange Agreement on February 28, 2011 providing for the issuance of new indentures and new notes thereunder, to replace the 2006 Taberna Indentures and notes.

[11] Accordingly, and also on February 28, 2011, two new indentures and notes were issued to replace the Dollar and Euro 2006 Taberna Indentures (the "2011 Taberna Indentures"). These notes remain outstanding.

[12] Sections 12.1 and 12.2 referred to above were altered in that the pertinent portions of the said Sections 12.1 and 12.2 now read as follows:

> **"SECTION 12.1. Securities Subordinate to Senior Debt.**
>
> The Company covenants and agrees, and each Holder of a Security, by its acceptance thereof, likewise covenants and agrees, that, to the extent and in the manner hereinafter set forth in this Article XII, the payment of the principal of and any premium and interest (including any Additional Interest) on each and all of the Securities are hereby expressly made subordinate to the Senior Debt. Notwithstanding anything to the contrary contained herein, the securities issued pursuant to those certain Junior Subordinated Indentures, each dated as of the date hereof, between the

Company and the Trustee shall not be Senior Debt or otherwise entitled to the subordination provisions of this Article XII and the Securities shall rank pari passu in right of payment to such securities.

SECTION 12.2. No Payment When Senior Debt in Default.

(a) In the event and during the continuation of any default by the Company in the payment of any principal of or any premium or interest on any Senior Debt (following any grace period, if applicable) when the same becomes due and payable, whether at maturity or at a date fixed for prepayment or by declaration of acceleration or otherwise, then, upon written notice of such default to the Company by the holders of such Senior Debt or any trustee therefore, unless and until such default shall have been cured or waived or shall have ceased to exist, no direct or indirect payment (in cash, property, securities, by set-off or otherwise) shall be made or agreed to be made on account of the principal of or any premium or interest (including any Additional Interest) on any of the Securities, or in respect of any redemption, repayment, retirement, purchase or other acquisition of any of the Securities."

(Underlined by the Court)

[13] Of most significance and pertinent to these presents is the fact that Section 12(b) and (c) of the 2006 Taberna Indentures were deleted. Section 12.2(b) provided for full payment of the "Senior Debt" (in this case, Stichting) in priority to the Junior Debt (i.e. Taberna) in the event of a bankruptcy or insolvency of HII. Section 12.2(c) provided that in the event of payment received by Wells Fargo as trustee under the Taberna Indentures, in contravention of Section 12.2(b), then such proceeds would be remitted or turned over to Senior Debt holders. Such a clause is commonly referred to as a "turnover provision".

[14] The definition of "Senior Debt" and the New York choice of law have not been modified.

[15] The effect of the foregoing modifications in the context of the CCAA arrangement of the Debtors is the gravaman of this litigation.

[16] According to Taberna, the effect of the drafting changes taken with other factors to be discussed hereinbelow, is that the claim of Taberna notes is no longer subordinate to the Stichting claim and should be paid *pari passu* with Stichting under the plan of arrangement approved by the Court.

[17] As stated above, the Debtors' plan of arrangement was sanctioned by the Court on June 5, 2013, in other words after the Motion for Directions was filed but before the present matter was set down for hearing.

[18] Under the plan of arrangement, all ordinary creditors including holders of Stichting bonds and Taberna notes were grouped in one and the same class. The intention of the Debtors supported by the Monitor was to pay nothing on account of the Taberna claim given the provisions of the subordination clauses referred to above and the fact that Stichting would not, under the plan, be paid in full. This was and is not acceptable to Taberna. However, in order to allow the HII plan to be confirmed and allow HII to move forward with its reorganization, the following was provided in the plan:

> "9.6 b) Notwithstanding any other provision in the Plan, HII and the Monitor shall comply with the Taberna Order in making any distributions on account of the Taberna Claim under the Plan, using the reserves created under the HII/Shareco Plan, as applicable. To the extent that the Taberna Order directs that the distribution entitlement under the Plan in respect of the Taberna Claim shall be remitted to any Person or Persons other than the holders of the Taberna Claim, any Newco Common Shares Cash-Out Election made by any holders of the Taberna claim shall be null."
>
> "**Taberna order**" means a Final Order of the Court addressing the distribution entitlement of the holders of the Taberna Claim under the Plan in respect of the Taberna Claim and authorizing and directing HII and the Monitor to rely on such Order in connection with the Plan;"

[19] The present judgment is the Taberna order.

[20] By voting for the plan, the statutory majority agreed with HII that the issue of subordination between Stichting and Taberna would be resolved after the plan was sanctioned. Even though Taberna voted against the plan, it did not oppose this manner of proceeding or insist that HII's Motion for Directions be heard prior to the Court sanction of the plan.

[21] For purposes of the proof and hearing herein, the parties relied on the affidavit in support of the Motion for Directions as well as the exhibits filed by consent and admissions filed in the Court record. Only the expert witnesses testifying on the content and effect of New York law were heard *viva voce*.

SUMMARY OF THE PARTIES' POSITION

Position of Taberna

[22] Taberna submits that it should receive the same treatment as the Stichting bondholders under the plan of arrangement, or in other words be paid on a *pari passu* basis.

[23] Taberna contends that the subordination contained in Section 12 of the 2011 Taberna Indentures no longer has effect because the bankruptcy language and the turnover provisions found in the 2006 Taberna Indentures were deleted so that in a bankruptcy or insolvency, Taberna debt is no longer subordinate and Taberna no longer has the obligation to turnover any entitlements to Stichting.

[24] Taberna continues that the deletion of the language was a result of a negotiation between the business people followed by exchanges between the attorneys after HII's covenant default which led to the Exchange Agreement and the 2011 Taberna Indentures. It was part of the consideration for forbearing the covenant defaults. According to Taberna, the parties involved in the negotiation intended the result that Taberna no longer be subordinate in the event of a bankruptcy or insolvency.

[25] Moreover, the fact that Taberna was placed in the same class for purposes of the plan of arrangement as Stichting (and indeed the same class as all of the unsecured creditors) dictates that Taberna should receive the same treatment as the other unsecured creditors, or in other words not be treated in a subordinate fashion.

Position of the Debtor, Stichting and the Monitor

[26] The other parties contend that the drafting changes left the basic subordination language intact, so that the fundamental legal position of the Taberna debt remains unchanged – i.e. it is subordinate to Stichting and other HII creditors.

[27] The wording of the 2011 Taberna Indentures is clear that Taberna is subordinate and the Court should not and indeed is not permitted by New York law, to look beyond the clear terms of the agreement between the parties. Under the parole evidence rule of New York law, evidence extrinsic to the document should not be considered unless there is an ambiguity on the face of the document. In such regard, no comparison should be made between the 2011 Taberna Indentures and the wording of the 2006 Taberna Indentures, to draw any inference (or ambiguity) from the deletion of the portions of Section 12.2. Equally the Exchange Agreement should not be considered in reading or interpreting the 2011 Taberna Indentures.

[28] The parties other than Taberna add that there is no legal impediment under the CCAA to placing two (2) creditors in the same class for voting purposes though they may not under the plan of arrangement receive equal treatment on distribution or payment of dividends.

[29] It is underlined that Stichting was a third-party beneficiary of the 2006 Taberna Indentures (as well as the 2011 Taberna Indentures), such that its rights

could not be altered without its consent. Thus, the subordination from which it benefited under the 2006 Taberna Indentures could not be modified without its consent. Stichting was not a party to the Exchange Agreement nor to any of the negotiations leading up to the Exchange Agreement. Its consent was not obtained, nor even sought.

[30] Moreover, Section 12.6 of the 2011 Taberna Indentures (section 12.7 in the 2006 Taberna Indentures) provides that a waiver of the subordination may not be presumed so that the fact that the Debtor may have placed Stichting in the same class as Taberna under the plan of arrangement (and Stichting not protesting) cannot be interpreted against Stichting as a waiver of the subordination from which it benefits under the 2011 Taberna Indentures.

DISCUSSION

[31] In virtue of the choice of law clause in both the 2011 Taberna Indentures and the 2006 Taberna Indentures, the law of the State of New York applies. Though New York law applies to the interpretation and the validity of the contract, it is local law that applies to the insolvency estate established pursuant to the CCAA [2] so that issues of distribution in the insolvency or questions of priority of payment are decided by application of the *lex fori* [3]. In Québec private international law, insolvency laws are characterized as procedural, so that the conflict rule indicates that the law of the forum applies [4].

[32] Since New York law is taken as a fact to be proved by expert testimony, each of Taberna, Stichting and the Monitor called expert witnesses who also, in accordance with Article 402.1 C.C.P., had filed reports.

[33] Mr. Howard E. Levine, a practicing attorney and a former New York Court of Appeal Judge opined for Stichting that under New York law a clear and unambiguous contract is deemed "the definitive expression of the contracting parties' intent and must be enforced according to its terms, without reference to extrinsic evidence" (i.e. evidence other than the language used in the contract itself). Such extrinsic evidence may only be invoked where the language of the contract is ambiguous. Extrinsic evidence cannot be relied upon to create an ambiguity in the text of the contract. Since the subordination language used in the 2011 Taberna Indentures is clear and unambiguous, then, under New York law, extrinsic evidence would not be admitted. The lack of a turnover provision does not change the subordinated status of the Taberna notes. Mr. Levine was

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2 DICEY AND MORRIS, The Conflict of Laws, 2000, par. 31-040).

3 *Todd Shipyards Corporation vs Ioannis Daskalelis, The*, [1974] S.C.R. 1248; DICEY, op.cit., par. 7-032.

4 C. EMANUELLI, Droit International Privé Québecois, 3e ed., 2011 para. 582; J. WALKER, CASTEL & WALKER, Canadian Conflict of Laws, 6th ed., pp. 6-7 and 29-7.

adamant that the New York courts strictly apply this parole evidence rule but he conceded that interrelated contracts executed contemporaneously may be read together.

[34] Mr. Jeffrey D. Saferstein, a New York insolvency attorney, was called as an expert by the Monitor and echoed Mr. Levine's opinion on contract law and added an insolvency dimension.

[35] Mr. Saferstein agreed that the subordination language in the 2011 Taberna Indentures was clear and unambiguous so that given the default, "Senior Debt" (i.e. the Stichting claims) must be paid in full before any monies can be received by Taberna noteholders. Turnover provisions are usually found in New York subordination agreements, but the absence of such a clause does not dilute the effect of the remaining subordination language. The turnover language reinforces the subordination, but its absence does not fundamentally alter the subordinated rights. In a New York insolvency, the US Bankruptcy Court would look at New York state law as the law of the contract and based on the parole evidence rule would exclude extrinsic evidence and give effect to the clear terms of the subordination of the 2011 Taberna Indentures, according to Mr. Saferstein.

[36] Mr. Peter S. Partee, Taberna's expert, is also a New York insolvency lawyer. His quality as an expert was challenged since he is a partner in the law firm representing Taberna and it was argued that he did not have sufficient independence to be qualified as an expert. The undersigned dismissed the objection at the hearing, considering that the issue would go to probative value of the testimony rather than the qualification of Mr. Partee as an expert. This is particularly so because the principal concept of foreign law dealt with by the experts (i.e. the exclusion of extrinsic evidence when the terms of the parties' contract are clear and unambiguous) is not really that "foreign" at all. Québec law shares similar rules of evidence and interpretation.

[37] Mr. Partee finds in the fact of the deletion of the turnover provisions from the 2006 Tarberna Indentures and in the extrinsic evidence, proof of the parties' intent that the subordination of the Taberna debt cease to have effect in an insolvency filing. The presence of a turnover provision is common and the fact of its deletion is significant and does not constitute parole evidence, so that the deletion would be considered by a New York court in the opinion of Mr. Partee. Absent the turnover, a court would not impose such an obligation on Tarberna – i.e. to turnover any entitlement to or funds received in an insolvency. Mr. Partee analyzed the turnover clause in the context of US bankruptcy proceedings where turnover provisions allow senior and subordinated debts to be classified together in a plan (for voting purposes) but not to receive the same financial treatment since the subordinated creditor will be obliged to turnover what it receives pursuant to its contractual obligations.

[38] Mr. Partee also underlined in his testimony that the recitals of the 2011 Taberna Indentures refer explicitly to the concurrent Exchange Agreement which in turn refers to the 2006 Taberna Indentures. Thus, he argues, those documents are not extrinsic to the 2011 Taberna Indentures and may be considered in the interpretation exercise.

[39] Counsel for Taberna went further, arguing that certain drafting inconsistencies brought about ambiguity so that the negotiations and email exchanges between the business people and counsel of the Debtors and Taberna leading up to the signing of the 2011 Taberna Indentures should be considered by this Court.

[40] The undersigned does not believe that this Court must choose one expert's opinion over the other. The resolution of the differing expert's opinions does not change the outcome. The subordination clause clearly establishes the principal. The extrinsic evidence adduced by Taberna is not convincing of any intention to change the principal of subordination that existed under the 2006 Taberna Indentures. Canadian insolvency law (with Québec civil law as suppletive) provides that the effect of that subordination in the insolvency of the Debtor is that the Taberna debt is to be treated as subordinate and not paid unless and until full payment has been made to the Senior Debt (including Stichting) .

[41] The undersigned has considered the Exchange Agreement as a concurrent document and thus has considered it not to be extrinsic evidence. Since the Exchange Agreement specifically refers to the 2006 Taberna Indentures, the undersigned has considered the previous subordination drafting.

[42] It is accepted in Canadian insolvency law that in proposals under the *Bankruptcy and Insolvency Act* [5] ("BIA"¨) to which CCAA arrangements are fundamentally similar, the rights of the debtor vis-à-vis its creditors is altered under the proposal but not the rights of the creditors *inter se* [6].

[43] Subordination clauses are fully enforceable in a bankruptcy or insolvency context [7]. Giving effect to a subordination clause as HII proposed does not make a plan unfair or unreasonable [8] as the fair and reasonable criterion for court sanction of a CCAA plan of arrangement does not require equal treatment of all creditors [9].

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

6 *Merisel Canada Inc. vs 2862565 Canada Inc.,* 2002 R.J.Q. 671 (QCCA)..

7 Re *Maxwell Communications Corp,* [1994] 1 All.E.R. 737 (Ch.D.) pp. 13-14, 21; *Bank of Montréal vs Dynex*; (1997) 145 D.L.R. (4th) 499 (Alta Q.B.) confirmed on other grounds 182 D.L.R. 4th 640 (Alta C.A.) and [2002] 1 S.C.R. 146.

8 *Bank of Montréal vs. Dynex*, ibid.

9 *Air Canada*, (2004) 2 C.B.R. (5th) 4 at para 2. and 11 (Farley, J.).

[44] Subordination clauses not containing express language addressing the effect of the subordination in a bankruptcy are given effect in a bankruptcy, nonetheless [10].

[45] Subordinate creditors have been ordered to turnover to senior creditors monies received in an insolvency based on general subordination language – i.e. absent a turnover clause [11].

[46] Significantly, in *Stelco* [12], the Ontario Court of Appeal confirmed Farley, J. that a debtor may group subordinate with senior debt in classification. The creditors are classified according to their rights vis-à-vis the debtor [13]. Both Stichting and Taberna are unsecured note or debenture debt. It is their rights *inter se* which differ.

[47] It is noteworthy that on the facts of the *Stelco* case, there was a turnover clause which was characterized as reinforcing the subordination [14], which in turn reinforces Mr. Safestein's testimony before the undersigned that the general language is sufficient.

[48] The Ontario Court of Appeal has stated that classification that would jeopardize plans of arrangement should not be favoured [15]. In *Stelco* as here, junior debt was grouped with senior debt since the junior debt was "out of the money" and accordingly would vote against the plan, as did Taberna in the present case. If placed in their own class, the Taberna noteholders could either defeat the plan, or not be bound by the plan so that the Debtor would be unable to arrange all of its debts. The debt of all the other creditors, senior to Taberna would be arranged but that of Taberna would not be arranged since they would not be bound by the plan.

[49] Mr. Partee and Mr. Saferstein explained that in US bankruptcy law, the cram down provisions of the US Bankruptcy Code could allow the Court to sanction a plan and bind a creditor in a separate class who had voted against the plan. However, this possibility does not exist under the CCAA so that the "cram down" must exist at the voting level by grouping subordinate debt with senior debt. Otherwise, junior debt would have a veto or an option of not being bound which is what Farley, J. characterized as the "tyranny of the minority" [16].

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10 *Air Canada*, ibid.
11 *Merisel Canada Inc. vs. 2862565 Canada Inc.,* op.cit.
12 *Re Stelco*, (2005) 15 C.B.R. (5th) 297 (Ont S.C.); affirmed (2005) 15 C.B.R. (5th) 307 (Ont. C.A.).
13 See s. 22 CCAA concerning criteria for classification.
14 Re *Stelco*, 2007 ONCA 483; , para.483; para. 41-45.
15 Re *Stelco*, (2005), C.A.,op.cit. para. 36.
16 Re *Stelco*, (2005), op.cit., para. 15.

[50] In the second round of *Stelco* litigation, the Ontario Court of Appeal again confirmed the trial judge (this time, Wilton-Siegel, J.) in giving effect to the subordination (*albeit* containing a turnover) but emphasizing the principle applicable here that a plan vote and implementation do not alter the rights of creditors *inter se.*

[51] Accordingly, applying principles of Canadian insolvency law to the subordination in the present cause, Taberna remains subordinate in the insolvency and this absent the specific bankruptcy language and a turnover clause.

[52] Unfortunately for Taberna, the extrinsic evidence adduced is not helpful to its case.

[53] The testimony of Mr. Miles, the officer of HII involved in the business negotiation of the 2011 Taberna Indentures, at best, might support an argument that the new language was intended to eliminate subordination in the event that HII went into a bankruptcy liquidation [17]. However, the present regime is that of a plan of arrangement under the CCAA. There is no proof that there was a meeting of the minds that subordination ended within an insolvency filing.

[54] The email exchanges of draft wording between the attorneys charged with preparing the 2011 Taberna Indentures are not proof of any meeting of the minds either. Initially, a draft was sent by Taberna's lawyer eliminating the whole subordination section from the 2006 Taberna Indentures. HII counsel replied with a request that the omitted subordination language be reinserted into the document. The end-result was the present wording. After HII consulted Dutch and Canadian counsel, the present wording was accepted. Taberna's counsel at trial invokes this exchange as part of its argument that it was agreed that there would be no turnover obligation in the event of an insolvency. However, the position of Canadian and Dutch counsel is equally consistent with the position of the Canadian case law summarized above that the general subordination language was sufficient to continue the status of Taberna debt as fully subordinated notwithstanding an insolvency filing and notwithstanding the absence of specific turnover language. Taberna counsel may have sought an advantage for Taberna in the drafting but no meeting of the minds to change the basic subordination concept has been demonstrated.

[55] Taberna counsel's argument that the modification to the subordination was the consideration for Taberna forbearing the HII covenant default is not supported by the evidence. It is axiomatic that unsecured creditors generally benefit from their debtor continuing in business and avoiding forced liquidation. Particularly in this case, Taberna received letters of credit aggregating

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[17] Deposition of James Miles, February 21, 2013, pp. 29 to 30, and page 34.

approximately $2 Million. Payment under the letters of credit was not subordinated. Taberna also received fee compensation in the six figures as additional consideration for entering into the Exchange Agreement and the 2011 Taberna Indentures. Payment to Taberna under the letters of credit is explicitly stated in the 2011 Taberna Indentures not to be subject to the subordination. Clearly, if the bargain had been that subordination would cease on bankruptcy or insolvency filing, then the parties could have easily so stated as they did for the payment under the letters of credit.

[56] Most significantly, and in itself fatal to Taberna's position is the fact that Stichting was not a party to the negotiations leading up to the 2011 Taberna Indentures nor to the documents themselves.

[57] Section 1.10 of both the 2006 and 2011 Taberna Indentures provides as follows:

> **"SECTION 1.10** ***Benefits of Indenture***
>
> Nothing in this Indenture or in the Securities, express or implied, shall give to any Person, other than the parties hereto and their successors and assigns, the holders of Senior Debt and the Holders of the Securities any benefit or any legal or equitable right, remedy or claim under this Indenture."

[58] Accordingly, and in virtue of Section 1.10, Stichting can rely on the terms of the Taberna Indentures and claim the benefit thereof.

[59] Moreover, Section 12.7 of the 2006 Indentures (equivalent to Section 12.6 in the 2011 Taberna Indentures) provides as follows:

> **"SECTION 12.7** ***No Waiver of Subordination Provisions***
>
> *(a)* No right of any present or future holder of any Senior Debt to enforce subordination as herein provided shall at any time in any way be prejudiced or impaired by any act or failure to act on the part of the Company or by any act or failure to act, in good faith, by any such holder, or by any noncompliance by the Company with the terms, provisions and covenants of this Indenture, regardless of any knowledge thereof that any such holder may have or be otherwise charged with.
>
> *(b)* Without in any way limiting the generality of paragraph (a) of this Section 12.7, the holders of Senior Debt may, at any time and from to time, without the consent of or notice to the Trustee or the Holders of the Securities, without incurring responsibility to such Holders of the Securities and without impairing or releasing the subordination provided in this Article XII or the obligations

> hereunder of such Holders of the Securities to the holders of Senior Debt, do any one or more of the following: (i) change the manner, place or terms of payment or extend the time of payment of, or renew or alter, Senior Debt, or otherwise amend or supplement in any manner Senior Debt or any instrument evidencing the same or any agreement under which Senior Debt is outstanding, (ii) sell, exchange, release or otherwise deal with any property pledged, mortgaged or otherwise securing Senior Debt, (iii) release any Person liable in any manner for the payment of Senior Debt and (iv) exercise or refrain from exercising any rights against the Company and any other Person."

[60] Accordingly, Stichting senior rights existing at the time of the 2011 Taberna Indentures could not be waived or altered by HII dealing with Taberna alone, the whole in virute of the 2006 Taberna Indentures. Stichting's agreement was necessary.

[61] This is clear on the basis of the afore-mentioned provisions and is underscored by the application of the principles of the Québec Civil Code dealing with the stipulation in favour of a third-party beneficiary to a contract (see Article 1444 and following of the Québec Civil Code).

[62] There is no evidence of any revocation of the stipulation in favour of Senior Debt agreed to by Stichting. Indeed, the stipulations in their favour (Article 1.10) are reiterated in the 2011 Taberna Indentures.

[63] In view of all of the foregoing, any debt under the 2011 Taberna Indentures is subordinate to the Stichting debt and based on the clear terms of the 2011 Taberna Indentures cannot receive payment unless and until Senior Debt including Stichting debt is paid in full.

[64] Taberna's argument that the plan implementation changed the foregoing, is simply not correct. As stated above, the plan of arrangement does not alter the rights of creditors *inter se* [18]. Moreover, the process undertaken of seeking a judgment on the matter and writing into the plan that Taberna's claim would be dealt with on the basis of the Court order to be issued pursuant to such legal proceedings was not only a valid manner of dealing with the issue, but was a commercially practical manner of allowing the plan to move forward for the benefit of HII and all of the creditors and other stakeholders. Such an approach attains the policy objectives of the CCAA and was lauded by the Ontario Court of Appeal in *Stelco* [19], in similar circumstance to this case.

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[18] Re *Stelco,* 2007, op.cit, para. 41-45.
[19] Re *Stelco*, op.cit. no 2, para. 43

[65] Equally, neither Stichting nor the Monitor can validly argue that Taberna renounced its position or waived any right by not contesting the classification. The Motion for Directions was tabled prior to the plan. Everyone involved knew what the issue was. Taberna voted against the plan and awaited its day in court on the Motion to learn how its claim would ultimately be treated. It bought into the same commercially reasonable approach as the other parties in resolving the issue while allowing the plan to move forward. There was no waiver or renunciation by Taberna of its rights.

[66] The Monitor aggressively supported Stichting's position. Mr. Saferstein, the expert produced by the Monitor, provided useful evidence since he brought a bankruptcy perspective into the evidence of US or New York law. There was however an inevitable overlap with Stichting's expert evidence made through Mr. Levine who did not deal with the the bankruptcy law effects of the subordination but solely the effect as between the parties. Accordingly, Stichting will be awarded costs including those of Mr. Levine fixed at US$76,413.00 according to the evidence filed at the hearing. Since no proof was made of the applicable exchange rate, this will be subject to taxation. The Monitor will be awarded one half of its expert's costs which will be subject to taxation since invoices were not filed at the hearing. Also, the Monitor did not testify nor file a report as is customary in order to bring the Court up to date on the state of the CCAA file. In view of the foregoing, no judicial costs of the Monitor will be awarded other than half of its expert fees.

[67] Since HII's position was essentially represented by Stichting and the Monitor, no costs will be awarded to HII.

[68] HII's counsel amended the conclusions of the Motion for Directions at the request of the undersigned to avoid reference to terms defined outside of the conclusions. The other parties did not contest the wording so that the conclusions in this judgment will follow such wording.

FOR ALL OF THE FOREGOING REASONS, THE COURT:

[69] **GRANTS** the Petitioners' *Re-amended Motion for Directions* (the “Motion”);

[70] **DECLARES** that the payment of any and all amounts owing under and pursuant to:

70.1. Taberna Preferred Funding VI, Ltd.’s US $12 million interest pursuant to a Junior Subordinated Indenture dated as of July 26, 2006 (the “2006 USD Indenture”) by and between Homburg Invest Inc. (“HII”) and Wells Fargo Bank, N.A. (“Wells Fargo”) for the

issuance of US $20 million junior subordinated notes due 2036 (the "Original Taberna VI Note");

70.2. The note issued to Taberna Preferred Funding VIII, Ltd. ("Taberna VIII") pursuant to a Junior Subordinated Indenture dated as of February 28, 2011 (the "2011 Taberna VIII Indenture") by and between HII and Wells Fargo (the "2011 Taberna VIII Note"); and

70.3. The notes issued to Taberna Europe CDO I P.L.C. and Taberna Europe CDO II P.L.C. on February 28, 2011 witnessing their respective interest of €20 million and €5 million pursuant to a Junior Subordinated Indenture dated as of February 28, 2011 (collectively with the 2006 USD Indenture and the 2011 Taberna VIII Indenture, the "Taberna Indentures") by and between HII and Wells Fargo for the issuance of €25 million junior subordinated notes due 2036 (the "2011 Taberna Europe Notes");

(the Original Taberna VI Note, the 2011 Taberna VIII Note and the 2011 Taberna Europe Notes are collectively referred to as the "Current Taberna Notes") is subordinated to the full and complete payment of any and all amounts owing in respect of the principal of and any premium and interest on all debt of HII (excluding trade accounts payable or liabilities arising in the ordinary course of business), whether incurred on or prior to the date of the Indentures or thereafter incurred, unless it is expressly provided in the instrument creating or evidencing the same that such obligations are not superior in right of payment to the Current Taberna Notes (the "Senior Debt"), including without limitation Stichting Homburg Bonds' claims against HII pursuant to a Trust Indenture dated as of December 15, 2002, and any related supplemental indentures thereto, and a Trust Indenture dated as of May 31, 2006 as guaranteed by HII pursuant to a Guarantee Agreement dated as of December 15, 2002 (the "Bonds"), unless and until the Senior Debt is fully satisfied;

[71] **ORDERS** that for the purpose of any distribution to occur under the Fourth Joint Amended and Restated Plan of Compromise and Reorganization of HII and Homburg Shareco Inc. dated as of March 27, 2014 (the "Plan"), any distribution to the holders of the Current Taberna Notes by virtue of their status as unsecured creditors and holders of the Current Taberna Notes shall be remitted to the holders of the Senior Debt on a pro-rata basis, including without limitation the Bonds, unless and until the Senior Debt is fully satisfied;

[72] **CONDEMNS** the mis-en-cause Taberna entities to judicial costs in favour of the mis-en-cause Stichting Homburg Bonds including experts' fees of US$76,413.00 subject to taxation but only for conversion to Canadian dollars, and to one half the expert costs of the Monitor regarding the report and testimony of Mr. Jeffrey Saferstein subject to taxation.

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Dates of Hearing: June 10, 11 and 12, 2014