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Statutory Debt Subordination and Creditor Protection: The North American Experience

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The interpretation and reach of section 563A of the *Corporations Act*, dealing with debt priority issues, remains uncertain. The *Sons of Gwalia litigation* in the Full Federal Court (2006) has exposed legal uncertainty concerning issues of shareholder debt subordination during corporate insolvency. The case also raises important policy issues on the optimum allocation of risk between equity and debt capital and the potential primacy of consumer protection laws over long-established priorities in insolvency law. These core issues await High Court or legislative resolution. If a satisfactory resolution is not achieved by the recent High Court appeal in Sons of Gwalia (2006), it seems likely that some form of legislative amendment may be necessary. The purpose of this paper is to examine the legal and policy position of the subordination of shareholder claims during insolvency in the North American jurisprudence. It is hoped that consideration of the North American experience on the subordination of shareholder claims for damages arising out of misrepresentation inducing the acquisition or retention of shares may be of assistance in resolving the current difficulties experienced in Australian insolvency law.

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Introduction

The grant of special leave in *Sons of Gwalia v Margaretic*[1] has provided an opportunity for the High Court to rule upon the proper interpretation and operation of s 563A of the *Corporations Act 2001* (Cth), a key provision concerned with debt subordination and creditor protection. The base issue, eagerly awaiting judicial resolution by capital

[1] *Sons of Gwalia Ltd v Margaretic* [2006] HCATrans 321.

markets[2] and insolvency practitioners[3] having 'attracted some excitement within the commercial community',[4] concerns the extent to which shareholders' claims for statutory misrepresentation and misleading conduct against the company are to be subordinated, if at all, to unsecured creditors' claims during insolvency.

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The judicial uncertainty on the reach of s 563A has arisen from the legacy of the *Sons of Gwalia* litigation, to date, in the Federal Courts.[5] In Australia, at present, the issue of statutory debt subordination of shareholder claims arising from corporate misconduct is at a crossroads. In deciding on the appeal in Sons of Gwalia, the High Court has the Option of upholding the status quo by confirming the decision under appeal (which provides differential treatment of subscriber and transferee shareholders)[6] with its 'logical inconsistency'[7] or holding the shareholder's claim to be caught by s 563A of the *Corporations Act*. This latter option would impose a strict subordination upon shareholder claims that, as will be discussed below, bears strong similarities to the "absolute priority rule", a cardinal feature of the US *Bankruptcy Code*, which completely subordinates shareholder claims against the company until all non-shareholder claims are satisfied. As will be discussed below, Canada will soon introduce a similar rule into its corporate insolvency statutes.

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The aim of this paper is to undertake a comparative examination of statutory debt subordination rules with reference to the American and Canadian experience in this area of the law.[8] Before turning attention to international developments, Part one of the paper presents an overview of the current state of the law in Australia with reference to the *Sons of Gwalia* litigation and the anomalous treatment of subscriber and transferee

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[2] For example, see letter to the editor of the Australian Financial Review, 7 March 2006, by David Michell (Technical Director) of The Finance and Treasury Association, representing professionals responsible for corporate fundraising.

[3] See Administrators Reports to creditors in n 4 and 9.

[4] Finkelstein J in *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* [2006] FCAFC 17 at [1]. As testament, American investors have taken a $100 million court action against JP Morgan Chase as a result of the 2004 collapse of gold mining company Sons of Gwalia. Shareholders in Australia are awaiting the outcome of the High Court hearing over their claim for some $25 million as a result of the company's collapse. See further, Korporaal G, "US investors sue JP Morgan over Gwalia" The Australian (16 December 2006). The latter figure appears to be a vast understatement. The Report to Creditors of Sons of Gwalia Ltd by Ferrier Hodgson (24 November 2006) states: "To date there have been 5,304 shareholder claims in the Administration asserting aggregate damages of $242 million. These claims will be subject to the outcome of the Shareholder Test Case [in the High Court] …"

[5] *Sons of Gwalia Ltd (admin appt) v Margaretic* (2005) 55 ACSR 365; 24 ACLC 244; [2005] FCA 1305; *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* (2006) 56 ACSR 585; [2006] FCAFC 17. At the time of writing the High Court had reserved its decision on the appeal.

[6] Discussed below under Part 1.

[7] *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* (2006) 56 ACSR 585; [2006] FCAFC 17 at [134] per Jacobson J.

[8] This paper builds upon an earlier publication dealing with policy issues flowing from the *Sons of Gwalia* litigation. See Hargovan A and Harris J, "Sons of Gwalia: policy issues raised by the subordination of shareholder claims" (2006) 7 *Insolvency Law Bulletin* 1.

shareholders. Part two discusses the legislative history and policy considerations underpinning the subordination of investor fraud claims in insolvency, reflected in section 510(b) of the US *Bankruptcy Code*. Leading American decisions on the interpretation and operation of s 510(b) are critically examined in an attempt shed light on possible statutory reforms here to strengthen shareholder subordination. In ou submission, there is much to be gained from an understanding of the nearly 30 years of experience of statutory subordination in the United States. In part three we examine Canadian insolvency law. Canadian law will be discussed because of the common influence of British insolvency law that Canada and Australia have, and also because Canada has recently announced reforms to introduce provisions similar to s 510(b) of the US *Bankruptcy Code*. We will discuss why these reforms were seen as necessary in an attempt to determine whether Australia needs to similarly strengthen its laws on this issue.

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Despite the ambiguity in s 510(b) and its imperfect operation, the paper concludes in Part four by offering a potential roadmap to the Australian treatment of defrauded shareholder claims with reference to the North American experience.

1. The Australian Position

Previously, the authors have critiqued the reasoning and outcomes in the *Sons of Gwalia* litigation and have examined some of the legal issues arising from the decisions, including implications for unsecured creditors and the efficient administration of the insolvency regime.[9] The following is therefore only a brief overview of the current legal position in Australian insolvency law.

The legal issues arising from the *Sons of Gwalia* litigation have thrown the judicial spotlight on the scope of the subordination provision contained in s 563A of the *Corporations Act 2001* (Cth), for purposes of creditor protection, which provides:

> Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.

At first blush, it would appear that the language in s 563A is broad enough to subordinate the claims of defrauded shareholders against the company to those of othe unsecured creditors. This conclusion would appear to be supported by the leading High

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[9] Harris J and Hargovan A, "Sons of Gwalia: navigating the line between membership and creditor rights in corporate insolvencies" (2007) 25 *C&SLJ* 7. As to the potential implications of the Full Federal Court decision in *Sons of Gwalia* for the administration of the insolvency regime, see The Report to Creditors' Committee on ION Ltd shareholder claims by Allens Arthur Robinson (8 March 2006) which states: "To date approximately 3000 proofs of debt, totaling in excess of $100 million, had been lodged by shareholders of ION … the process of adjudicating the shareholder claims is likely to take some time and will involve the incurrence of not insignificant costs in the administration of the ION DOCA [Deed of Company Arrangement], given the large volume of claims and the complexity of the numerous issues raised about which the Deed Administrators are required to make a determination." See further, n 4.

Court decision on the operation of the predecessor to s 563A, *Webb Distributors (Aust) Pty Ltd v Victoria*,[10] where the majority held:[11]

> "in the present case, the members seek to prove in the liquidation damages which amount to the purchase price of their shares, which is a sum directly related to their shareholding. Moreover, they sue as members… and they seek to recover damages because the shares are not what they were represented to be. Accordingly, the claim falls within the area in which s 360(1)(k) [the predecessor of s 563A] seeks to regulate: the protection of creditors by maintaining the capital of the company."

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Webb, in turn, relied on the House of Lords' decision in *Houdsworth v City of Glasgow Bank*[12] which held that a person who subscribed for shares from the company could not recover damages from the company in an action for deceit for the misrepresentation which induced him to take the shares without first rescinding the allotment. There are two explanations for this decision:[13]

> "The first is that to permit recovery by the shareholder would be inconsistent with his statutory contract with the company and the other shareholders under which his subscription money is to be applied towards the discharge of the company's debts. The second explanation is that the share capital of the company is a fund and is available for creditors and therefore claims by a member must be subordinated to those of creditors."

However, the success of a misled investor in having his status confirmed as a creditor by reason of his damages claim against an insolvent company in the *Sons of Gwalia* litigation, and his claim being held to rank equally with other unsecured creditors, throws doubt on our understanding of traditional principles of insolvency law. The Full Federal Court in *Sons of Gwalia* distinguished *Webb's* case and confined its ratio to subscribing shareholders.[14] Mr Margaretic, the investor, alleged[15] that he was misled into purchasing shares in the Sons of

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[10] (1993) 179 CLR 15.

[11] (1993) 179 CLR 15 at 35 per Mason CJ, Deane, Dawson and Toohey JJ.

[12] (1880) 5 App Cas 317.

[13] *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* (2006) 56 ACSR 585; [2006] FCAFC 17 at [12] per Finkelstein J.

[14] For academic critque, see Harris and Hargovan, n 9. Cf *Johnston v McGrath* (2005) 195 FLR 101; 24 ACLC 140; [2005] NSWSC 1183 (where Gzell J said, in obiter, that the rule in *Houldsworth*, subsequently adopted by the High Court in *Webb*, applies equally to subscribes and transferees).

[15] It should be noted that there has been no case (thus far) where a shareholder has successfully proved that they purchased shares because of improper disclosure by a company that then became insolvent. Such a claim was denied in *Johnston v McGrath* (2005) 195 FLR 101; 24 ACLC 140; [2005] NSWSC 1183. Causation in securities fraud cases are difficult to prove in Australia, at least partially because of the absence of the "fraud on the market" doctrine that operates in the United States and greatly facilitates the proof of causation. However, a recent decision (*Riley (as trustee of Ker Trust) v Jubilee Mines NL* (2006) 59 ACSR 252; [2006] WASC 19) has allowed a former shareholder to claim damages resulting from the sale of shares in a (solvent) mining company for a low price due to inadequate disclosure by the company. For

Gwalia mining company on the secondary market because of incorrect statements made, and inadequate by, the company. Consequently, as a transferee shareholder, it was reasoned in the *Sons of Gwalia* litigation that Mr Margaretic's claim under the misleading and deceptive statutory provisions[16] did not arise in his capacity as a member.[17] Based on this conclusion, it followed that the debt would not be postponed by s 563A and that Mr Margaretic's claim stands *pari passu* with other unsecured creditors.

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The determination of the appropriate reach of the principle in *Webb's* case, and the proper construction of s 563A will inevitably raise broader policy considerations on the allocation between holder of equity and debt capital of the risk of enterprise failure. This issue needs to be addressed, either by the High Court or Parliament, to provide clarity and certainty in our insolvency framework. A failure to adequately balance this risk will result in price volatility in the supply of capital to corporations (due to increased risks and uncertainty), with potentially harmful and long lasting impacts on the Australian economy.

An examination of relevant aspects of North American insolvency laws and the treatment of claims by defrauded investors in insolvency proceedings, similar to that of Mr Margaretic, may provide useful guidance in the formulation and potential resolution of policy tensions. The imperative to address such issues arises for two other significant reasons, namely, to provide certainty into the legal framework of our financial market[18] and certainty to the growing volume of mass class-action claims by shareholders.[19] Accordingly, Parts two and three of the paper focuses attention on the operation of statutory subordination in the United States and recent Canadian law reform measures in this area.

2. The US Position

Traditionally, until bankruptcy law reform in 1977, US courts treated defrauded investors in bankruptcy cases no differently from general creditors in reliance upon an influential non-bankruptcy case.[20] In 1937, the United States Supreme

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discussion of this decision see: Hargovan A and Harris J, "Taking continuous disclosure seriously: a landmark decision in *Jubilee Mines*" (2006) 58 *Keeping Good Companies* 648.

[16] *Corporations Act 2001* (Cth), s 1041H; *Australian Securities and Investments Commission Act 2001* (Cth), s 12DA; *Trade Practices Act 1974* (Cth), s 52.

[17] Finkelstein J, in *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* (2006) 56 ACSR 585; [2006] FCAFC 17, approved the House of Lords approach to this issue in *Soden v British & Commonwealth Holdings Plc* [1998] AC 298. For a review of this case and critique, see Harris and Hargovan, n 9.

[18] See n 2.

[19] See Mills, M and Betts, J "The Rise of Shareholder Class Actions in Australia" Freehills (May 2005) available at http://www.freehills.com.au (viewed January 2007). Spender P, "Securities Class Actions: A View from the Land of the Great White Shareholder" [2002] Common Law World Review 123.

[20] For judicial discussion o the early treatment of investor claims in bankruptcy, see *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002).

Court in *Oppenheimer v Harriman Nat'l Bank & Trust Co*[21] reversed a lower court ruling and refused to subordinate a shareholder's claim following the collapse of a bank. The absence of a statutory basis to support a creditor's priority scheme was influential in the upholding of a shareholder's rescission claim. The subsequent refusal by the Supreme Court to review two cases challenging whether its ruling extended to bankruptcy cases meant that lower courts, thereafter, relied on *Oppenheimer* and allowed investor participation on a par with general creditors.

Genesis and Policy Objectives: s 510(b)

The Bankruptcy Code provides for several types of subordination,[22] of which section 510(b) is relevant for purposes of this paper. This provision, which effectively precludes a defrauded shareholder's claim for damages from enjoying a higher priority status from the debtor's estate, states that:

> "[A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such security … shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claims has the same priority as common stock.

The US Congress[23] and judiciary[24] have acknowledged the seminal article[25] written by law professors John Slain and Homer Kripke as providing the origins and policy consideration underpinning section 510(b). In that article, Slain and Kripke were critical of the favourable treatment that bankruptcy courts afforded to shareholder fraud victims. They argued that it was unfair to allow shareholders to make rescission claims in respect of securities fraud by the debtor company so as to compete with the claims of other unsecured creditors. Their thesis rested on the bargain and reliance interests formed by creditors and shareholders.

As part of their discussion on risk allocation and business insolvency, Slain and Kripke observed that the absolute priority rule allocates the risk of insolvency to shareholders and prevents them from seeking to recover their investments

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[21] 310 U.S 206, 215, 81 L. Ed. 1042, 57 S.Ct. 719 (1937)

[22] Section 510(a) allows for subordination pursuant to an agreement between creditors and equitable subordination is provided for in s 510(c). Equitable subordination permits a bankruptcy court to use its equitable powers to "subordinate for purposes of distribution all or part of an allowed claim to all or pat of another allowed claim or all or part of an allowed interest to all or part of another allowed interest." This remedial action has been used infrequently. See further, Collier on Bankruptcy 510.05[1]. For judicial application, see *Benjamin v Diamond (In re Mobile Steel Corp)* 563 F.2d 692 (5th Cir 1977)

[23] See Commission on the Bankruptcy Laws of the United States, HR Doc No 93-137 (1973).

[24] See the leading decisions in *Re Telegroup Inc* 281 F 3d 133 (3rd Cir 2002) and *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002).

[25] John Slain and Homer Kripke, The Interface Between Securities Regulation and Bankruptcy – Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors (1973) 48 NYU L Rev. 261.

before provable creditor claims have been satisfied in full.[26] The following rationale for the absolute priority rule was offered:[27]

> "In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for the payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency …"

Thus, they argued, there is no obvious reason for reallocating the risk of business insolvency from shareholders.[28] The authors justified their thesis on the bases that unsecured creditors generally relied upon the equity cushion that shareholder funds provided to the company to assist in repaying commercial debts.

As regards the risk of illegality in securities issuance, Slain and Kripke also argued for this risk to be born by shareholders. The authors pointed out shareholders, as investors, should justifiably bear the risk of fraudulent or misleading conduct in relation to securities as they had the most to gain from the company's success. Investors share in the profits of the business, a benefit not accorded to creditors. Accordingly, the authors found it 'difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered."[29]

Equal treatment to shareholder fraud claims, in their opinion, gives investors the best of both worlds: a claim to the upside in the event that the company prospers and participation with creditors if it fails. This outcome, according to Slain and Kripke, was unfair. According to them, shareholders should bear an enhanced risk of insolvency because of the unique right to share in profits. Furthermore, giving shareholder claims the same priority as creditor claims would dilute the capital reserves available to repay general creditors and, reasoned Slain and Kripke, would eliminate the safety of the equity cushion.

At the core of the Slain and Kripke thesis was a policy decision "to prevent disappointed shareholders from recovering the value of their investment by filing bankruptcy claims predicated on the issuer's unlawful conduct at the time of issuance, when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments."[30] Slain and Kripke therefore concluded that shareholder claims alleging illegality in the issuance of stock should be subordinated to the claims of other general unsecured creditors.

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[26] Slain and Kripke, n 25 at 261.

[27] Slain and Kripke, n 25 at 286-287.

[28] Slain and Kripke, n 25 at 287.

[29] Slain and Kripke, n 25 at 288.

[30] Slain and Kripke, n 25 at 267-268. This policy position was quoted in *Re Telegroup Inc* 281 F 3d 133 (3rd Cir 2002) at 140-141; *Re Pre-Press Graphics Co Inc* (2004) 307 B.R.65 (ND Ill 2004) at 75.

Congress found Slain and Kripke's theory of risk allocation 'compelling'.[31] Through law reform measures that introduced the Bankruptcy Code in November 1978, the subordination principle articulated by Slain and Kripke was introduced into US statutory law via section 510(b). Since then, Slain and Kripke's thesis has played a pivotal role in the judicial interpretation of the policy basis of s 510(b).[32] Courts have routinely acknowledged the adoption by Congress of Slain and Kripke's theory of risk allocation, as exemplified by the following passage from the leading decision of the United States Court of Appeal for the 3rd Circuit in *Re Telegroup Inc*:[33]

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> "Section 510(b) … represents a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy …Congress enacted section 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding."

The policy objective of disfavouring investors in bankruptcy proceedings, however, was not without criticism. Professor Davis, in an article published soon after the introduction of statutory subordination,[34] provides a trenchant argument against the subordination of shareholder claims. He favoured a rule that allowed defrauded shareholder claimants to participate in bankruptcy proceedings on par with other unsecured creditors. Such an approach, reasoned Davis, 'produces allocations that are better for public policy and fairer than the allocations produced by the subordination doctrine.'[35] Davis' thesis is based on the following contentions:

- that shareholders do not consent to fraud or misrepresentation in securities issues and therefore are as equally innocent as unsecured creditors[36]

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[31] *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1177.

[32] See, for example,*Re Pre-Press Graphics Co Inc* (2004) 307 B.R. 65 (ND Ill 2004) at 74: "In enacting s 510(b), Congress relied heavily on a law review article drafted in 1973 by John J. Slain and Homer Kripke … this court's review of the legislative history of s 510(b) will begin with that article." For similar judicial approaches, see *Re Telegroup Inc* 281 F 3d 133 (3rd Cir 2002) at 139; *Re Granite Partners* 208 B.R at 336 (Bankr. S.D.N.Y. 1997).

[33] 281 F 3d 133 (3rd Cir 2002) at 141-142. For recent judicial pronouncements of a similar nature, see *Re Med Diversified Inc* 461 F.3d 251 (2nd Circ, 2006); *In re American Wagering Inc* (9th Circ, 2006) 465 F.3d 1048.

[34] Davis, K "The Status of Defrauded Securityholders in Corporate Bankruptcy" [1983] Duke LJ 1.

[35] Davis, K n 34 at 4. For a hint of judicial sympathy for this view, see *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1179: "[Davis'] trenchant analysis is not without force, but our task here is only to discern Congress's intent. We do not sit as a super-legislature to weigh the wisdom of legislation."

[36] Davis, K n 34 at 62.

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- both shareholders and creditors benefit from the financial success of the corporation (thus attacking the Slain and Kripke argument that shareholders bargain for the gains from the success of the corporation)[37]
- investor confidence in the capital market would be improved by allowing shareholders to share bankruptcy distributions for securities fraud claims[38]

It is therefore, according to Davis, to give greater protection than creditors.

Operation of s 510(b)

The US bankruptcy courts determine whether s 510(b) applies to a particular claim, either as part of a motion to subordinate[39] or as part of the court's authority to confirm reorganisation plans.[40] If the court holds in the affirmative, it has no discretion but to apply the mandatory provision and subordinate the claim.[41]

Until recent judicial developments, discussed below, US courts have consistently limited the operation of s510(b) to claims alleging fraud in the inducement to *purchase or sell* a debtor's securities. Early cases limited the scope of s 510(b) to claims directly "arising from" a purchase or sale of a security.[42] A literal interpretation of the statute sustains this result. Traditionally, this meant that shareholder claims based on post-issuance conduct did not fall within the ambit of s 510(b).

However, despite the existence of s 510(b) for almost three decades, the courts are still grappling with the language and policy objectives of the subordination principle.[43] Judicial tension in the interpretation and proper scope of section 510(b) is best exemplified in the narrower decisions in *Re Amarex Inc*[44], *Re Angeles Corp*[45] and *Re Montgomery Ward Holding Corp*[46] (rejecting

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[37] Davis, K n 34 at 63.

[38] Davis, K n 34 at 65-66

[39] See, for example, the bankruptcy trustee's motion to subordinate investors' fraudulent inducement and fraudulent retention claims in *Re Granite Partners LP* 208 B.R. 332 (Bankr. S.D.N.Y. 1997).

[40] See, for example, the court's confirmation of the debtors' First Amended Joint Plan of Reorganisation in *Merrimac Paper Co v Harrison (In re Merrimac Paper Co)* 303 B.R. 710 (Bankr. D. Mass. 2003).

[41] Collier on Bankruptcy: 510.04[7].

[42] For example, *Re Amarex Inc* 78 B.R 605 at 609 (Bankr. W.D. Okla. 1987): "The legislative history expressly focuses on the initial illegality and thus the automatic subordination should extend no farther.". See also the later decision in *Re Montgomery Ward Holding Corp*, 272 B.R 836 at 842 (Bank.D.Del 2001): "[T]he plain language of the statute limits automatic subordination to claims that directly concern the stock transaction itself."

[43] Section 510(b) has been described as a 'confusing area of the law'. See further, Schmid, M J "A Congressional Montage of Two Systems of Law-Mandatory Subordination Under the Code" American Bankruptcy Institute Law Review, Spring 2005, 361.

[44] 78 B.R. 605 (W.D. Okla. 1987).

[45] 177 B.R 920 (Bankr. C.D. Cal. 1995).

subordination claims based on post-issuance wrongful conduct) and the wider decisions in *Re Telegroup Inc*[47] *and Re Geneva Steel*[48] accepting such claims.

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Despite generally adopting a common methodology in discerning Congressional intent, the courts reach different conclusions on the issue of mandatory subordination arising from post-investment fraud or illegality that causes an investor to hold rather than sell their securities.

A discussion on the divergent judicial approaches adopted in these cases is necessary to demonstrate the current tension, ambiguity (particularly the words "arising from")[49] and broad reach of s 510(b) in US bankruptcy law.

The decisions in *Amarex,*[50] *Angeles* and *Montgomery* are authority for the proposition that s 510(b) is limited in its application to claims of fraud in the purchase or sale of securities. Based on a literal interpretation of s 510(b), these cases held that the legislative history did not extend s 510(b)'s mandatory subordination beyond the initial illegality. Thus, in *Amarex*, the court declined to subordinate a claim for damages arising from a breach of a partnership agreement because the wrongful conduct occurred after the issuance and sale of the partnership units. In the court's view, the congressional purpose in enacting section 510(b) was to "shift to the shareholders the risk of fraud in the issuance and sale of a security – no more."[51] Similarly, in *Angeles*, the court held that subordination claims for breach of fiduciary duty do not arise from the purchase or sale of limited partnership interests where the wrongful conduct occurred after the sale of those interests. Likewise, the court in *Angeles* justified its conclusion with reference to the legislative history of section 510(b) and concluded:[52]

> "If Congress had wanted to subordinate all claims of security holders to an equity position, regardless of the source of the claim, Congress would have worded Section 510(b) to say: "All claims made by security holders, regardless of the source of that claim, shall be subordinate to an equity class …". However Bankruptcy Code Section 510(b) does not say this.

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46 272 B.R. 836 (Bankr. D. Del. 2001).

47 281 F 3d 133 (3rd Cir 2002).

48 281 F.3d 1173 (10th Cir 2002).

49 *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1178-1179: "We conclude … that the language of section 510(b) is ambiguous … [and] cannot discern the scope of section 510(b) by examining only the text of the statute."

50 Due to the decision in *Geneva Steel*, discussed below, *Amarex* is no longer good law in the Tenth Circuit.

51 78 B.R. 605 (W.D. Okla. 1987) at 608.

52 177 B.R 920 (Bankr. C.D. Cal. 1995) at 927. Based on similar reasoning, *Montgomery* held that a claim arises from the purchase or sale of a security only if there is an allegation of fraud in the purchase, sale or issuance of the instrument.

A paradigm shift

In more recent times, there has been a trend towards a broader interpretation of s 510(b). This broader interpretation has been most prominently stated by the US Court of Appeals for the 3rd Circuit[53] in *Telegroup* and by the Court of Appeals for the 10th Circuit in *Geneva Steel*.[54] These decisions capture post-issuance fraud claims within s 510(b) and therefore represent a paradigm shift from the cases discussed above and the traditional understanding of the meaning of the words in that section. The term 'arising from', as used in s 510(b), was held in both cases to require some 'nexus or causal relationship' between the claim and the claimant's purchase of debtor's securities, but that nexus is not so limited as to require illegality in the purchase itself.

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The litigation in *Telegroup* arose from stock purchase agreements which required the debtor, Telegroup, to register its stock and ensure that the shares were freely tradable by a nominated date. Telegroup failed to register the stock by the required date and, allegedly, failed to use its best efforts to do so as originally required. Some 8 months after the stock was supposed to be registered, Telegroup filed a voluntary Chapter 11 bankruptcy petition. The shareholders sought damages. They argued that had Telegroup performed its contractual obligation, they would have sold their shares as soon as the debtor's stock became freely available, thereby avoiding the losses incurred when the stock subsequently declined in value. Telegroup objected to the shareholders claims, arguing for a wider construction of s 510(b) in an effort to subordinate the claims. The shareholders argued for a narrower construction, in reliance upon *Amarex and Angeles*, and advanced the proposition that only claims for fraud or other illegality that occurred at the time of the purchase or sale should be subordinated.

The Court of Appeals for the 3rd Circuit resolved the competing arguments in favour of Telegroup by examining the scope of section 510(b) and giving it a broad interpretation.[55] After examining the text of the statute and finding it ambiguous, the court turned to the legislative history and underlying policies, discussed above, for guidance and concluded:[56]

> "… section 510(b)'s language alone provides little guidance in delineating the precise scope of the required nexus …. It is, in our view, more natural, as a textual matter, to read "arising from" as requiring some nexus or causal

[53] It should be noted that the US Court of Appeals for the 3rd Circuit includes the influential state of Delaware.

[54] There is also a wealth of district court and bankruptcy court decisions across all circuits that supports the broad interpretation of s 510(b): see for example *Re Pre-Press Graphics Co Inc* (2004) 307 B.R. 65 (ND Ill 2004); *Re WorldCom Inc* 329 BR 10 (SDNY 2005); *Re Enron Corp* 341 BR 141 (SDNY 2006).

[55] For trenchant criticism of the judicial approach in *re Telegroup*, see Schmid, M J, n 43 at 366: "The Third Circuit erred in its broad reading of section 510(b) in Telegroup. Not the plain language, the legislative history, nor its policy rationales support the court's interpretation."

[56] 281 F 3d 133 (3rd Cir 2002) at 138.

> relationship between the claims and the purchase of the securities, but not as limiting the nexus to claims alleging illegality in the purchase itself … the text of section 510(b) is reasonably read to encompass the claims in this case, since the claims would not have arisen but for the purchase of Telegroup's stock …"

The Court of Appeals in *Telegroup* fortified its conclusion by relying on a variety of official reports and, significantly, the Slain and Kripke article[57] with its emphasis on the theory of risk allocation between creditors and shareholders (discussed above). The court opined that the legislative history, by adopting the Slain and Kripke argument, sheds light on the policies animating section 510(b).[58] Although Slain and Kripke's article was primarily concerned with actionable conduct occurring in the issuance of the debtor's securities, as opposed to post-issuance conduct,[59] the court in *Telegroup* stressed that the examples raised in the article were "illustrative, not exhaustive" of claims that must be subordinated.[60] From a policy standpoint, *Telegroup* held:[61]

> "Congress intended to prevent disaffected equity investors from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy … because [the] claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that section 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. "

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The court in *Telegroup* reasoned it would be senseless to allow shareholders to gain parity with unsecured creditors simply because their claims were predicated on post-issuance conduct. According to *Telegroup*, to hold otherwise would offend Congressional policy of preventing shareholders from using fraud claims to "bootstrap their way to gain parity with, or preference over, general unsecured creditors."[62]

Similarly, the Court of Appeals for the 10th Circuit in *Geneva Steel* applied a broad interpretation of the term 'arising from' and subordinated the claims of a bondholder arising from the debtor's post-investment fraud which induced the bondholder to retain, rather than sell, its securities. After reviewing the legislative history of section 510(b) and ascertaining Congress intent, the court in *Geneva Steel* reasoned:[63]

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[57] Slain and Kripke, n 25.

[58] 281 F 3d 133 (3rd Cir 2002) at 140

[59] *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1179: "…it is …true that neither Congress nor Slain and Kripke discussed or even mentioned fraudulent retention claims."

[60] 281 F 3d 133 (3rd Cir 2002) at 140. Cf Stark, R "Reexamining the subordination of investor fraud claims in bankruptcy" (1998) 72 Am Bankr LJ 497 at 508: "[T]he House Report's reference to rescission claims suggests that Congress, like Slain and Kripke, did not focus on fraud in the retention claims when drafting section 510(b) This seems correct based on the plain language of the section …"

[61] 281 F 3d 133 (3rd Cir 2002) at 142.

[62] 281 F 3d 133 (3rd Cir 2002) at 141.

[63] 281 F.3d 1173 (10th Cir 2002) at 1179.

> [The claimant's] claim, at its essence, accuses Geneva of manipulating information concerning his investment. He acquired and held that investment with the belief that its value would increase, though he no doubt recognized that for any number of issues it might not; indeed, he recognized that it might even lose value. In contrast, a mere creditor of [the debtor] could expect nothing more than to recoup the value of goods or services supplied to the company. Yet now, *having watched his investment gamble turn sour, [the claimant] would shift his losses to those same creditors. We think this effort clashes with the legislative policies that section 510(b) purports to advance.* [emphasis added]

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The court was concerned that if the claimant were to succeed it could undermine the operation of the absolute priority rule (discussed above).[64] The court stated:[65]

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> "When an investor seeks pari passu treatment with the other creditors, he disregards the absolute priority rule and attempts to establish a contrary principle that threatens to swallow up this fundamental rule of bankruptcy law."

Telegroup has received a mixed judicial reception, although the balance of judicial authority supports this broad interpretation.[66] There is, however, some criticism of this analysis.[67] Critics argue that the court's broad construction of s 510(b) is inconsistent with the plain meaning of the words that comprise the section; which while apparently enforcing a policy embraced by Congress, does not follow the actual law enacted by Congress.[68] The accuracy of these criticisms will need to await judicial resolution. However, despite any judicial tension as to whether s 510(b) should be broadly or narrowly construed, at least the US Bankruptcy Code provides 'a clear mandate'[69] that shareholder claimants will not be allowed to elevate their interests from the level of equity to general claims.

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[64] The court relied heavily upon the earlier decision in *Re Granite Partners* 208 B.R 332 (Bankr. S.D.N.Y. 1997).

[65] 281 F.3d 1173 (10th Cir 2002) at 1180-1181.

[66] See, for example, within the 3rd Circuit: *Re International Wireless Communications Holdings Inc* 68 Fed. Appx. 275 (3d Cir. 2003); *Re Alta+Cast LLC*, 301 B.R 150 (Bankr. D. Del. 2003). The decision has also been followed in US Court of Appeals for the 9th Circuit (*Re American Wagering Inc* 465 F.3d 1048 (9th Cir. Nev. 2006)) and by lowers courts in the 2nd Circuit ((*Re Med Diversified Inc* 461 F.3d 251 (2d Cir. N.Y. 2006)), the 7th Circuit (*Re Pre-Press Graphics Co Inc* (2004) 307 B.R. 65 (ND Ill 2004)) and the 11th Circuit (*Re Vista Eyecare Inc* 283 B.R. 613 (Bankr. N.D. Ga. 2002)).

[67] Although the *re Telegroup* decision is the controlling authority in Delaware, Schmid n 43 argues that judicial approaches adopted in *In re DirecTV Latin America* 2004 WL 302303 and *in In re Mobile Tool International Inc* 306 B.R 778 (Bankr. D. Del. 2004) indicate a rejection sub silencio of the Third Circuit's application of section 510(b).

[68] For academic criticism towards the trend to a broader judicial interpretation of section 510(b), see Schmid n 43; Stark n 60. For rejection of Stark's view of the legislative history of section 510(b), see *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1179.

[69] See further, Collier on Bankruptcy 510.04[2].

- In order to demonstrate the strength of the US court's commitment to enforcing the subordination of equity claims under s 510(b), the following represents a sample of claims that have been caught by the provision and subjected to mandatory subordination:Claims by shareholders of a subsidiary of a debtor parent company;[70]
- Claims by underwriters of a securities issue for contractual indemnification in respect of securities issue by debtor where debtor company's shareholders sued for securities fraud;[71]
- Claims by stockbrokers for indemnification against securities fraud actions;[72]
- Claims by shareholders for breach of contract in relation to a merger agreement;[73]
- Claims by former employee for breach of contract to issue shares as upon termination;[74]

Thus, it seems that s 510(b) of the Bankruptcy Code provides for a robust subordination of claims by shareholders. This is due to two features of US insolvency law, namely:

- the blanket accepted of Slain and Kripke's arguments supporting subordination; and
- the broad interpretation given to the phrase "arising from" in s 510(b).

It is clear that the US lawmakers (both in Congress and on the bench) have made a policy choice to provide shareholders with lower priority in insolvency. The position being relatively stable (at least with respect to conduct inducing the purchase or sale of securities) since the introduction of the Bankruptcy Code in 1978, it may be assumed that both investors and creditors have factored subordination into their demand and pricing structures. However, the recent scandals in Enron and Worldcom have reignited the debate in the US concerning the importance of protecting shareholders.[75] The subsequent introduction of the Sarbanes Oxley Act in 2002 allowed the Securities and Exchange Commission to distribute penalties for breach of securities laws to defrauded shareholders under the "fair funds for investors provision" (s 308(a)). This provides:

> **308(a) Civil Penalties Added to Disgorgement Funds for the Relief of Victims.**

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[70] *Re VF Brands Inc* (2002, BC DC Del) 275 BR 725.

[71] *Re Jacom Computer Services* (2002, BC SD NY) 280 BR 570.

[72] *Re De Laurentiis Entertainment Group Inc* (1991, CD Cal) 124 BR 305.

[73] *Re Betacom of Phoenix Inc* (2001, 9th Circ) 240 F3d 823.

[74] *Re Worldwide Direct Inc* (2001, BC DC Del) 268 BR 69.

[75] Particularly given that tens of thousands of employees lost their pensions because their pension funds invested in their company's stock.

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> If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

Whilst there is an obvious tension between the fair funds provisions and the subordination of claims under s 510(b) of the Bankruptcy Code,[76] the relatively few decisions on this issue have decided that Congress has made a conscious choice, in limited circumstances where the fair funds provisions apply, to prefer shareholder protection over bankruptcy priorities.[77]

It is interesting to note that Canada has recently adopted an even stricter form of statutory subordination of shareholder claims than applies under s 510(b), and without the fair funds provisions in its securities laws. We will now discuss how Canadian law subordinates shareholder claims.

3. The Canadian Position

Canadian insolvency law is dealt with as a federal matter and comprises two main statutes: the *Bankruptcy and Insolvency Act 1985* (hereafter BIA) and the *Company Creditors Arrangement Act 1985* (hereafter CCAA). The BIA provides for the liquidation of the assets of insolvent individuals and corporations.[78] The BIA also provides for the reorganisation of the bankrupt's estate by allowing for a proposal to be made to the creditors to settle the bankrupt's debts.[79] However, this procedure is not frequently used in corporate insolvencies due to the more flexible procedures offers in the CCAA.[80]

The CCAA provides solely for the restructuring of large insolvent corporations with debts in excess of $5 million.[81] The CCAA is a corporate rescue statute that was developed during the great depression to promote the reorganisation of corporate debt. As a broad generalization, the procedure is similar to that which operates under Ch 11 of the US Bankruptcy Code, in that the debtor company remains in control of the business but is subject to the supervision of an external

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[76] See Christensen Z, "The Fair Funds for Investors Provision of Sarbanes-Oxley: Is it Unfair to the Creditors of a Bankrupt Debtor?" [2005] U. Ill. L. Rev. 339.

[77] The decisions are discussed in Christensen, above, n 76.

[78] Bankruptcy and Insolvency Act 1985 (RSC) Pt II.

[79] Bankruptcy and Insolvency Act 1985 (RSC) Pt III Div 1.

[80] Towriss S, "Through the Lens of Insolvency: Shareholder Equity in CCAA Restructurings" [2005] *Annual Review of Insolvency Law* 527 at 528.

[81] Company Creditors Arrangements Act 1985 (RSC) s 3.

"monitor". A moratorium is imposed by the court to allow the debtor company to formulate a reorganisation plan that must be approved by creditors and the court.

At present, there are no specific provisions in either statute that subordinate shareholder claims in insolvency.[82] However, this has not prevented Canadian courts from subordinating or, in some cases, completely excluding shareholder rights during corporate insolvencies.

A review of the authorities supports the proposition that where the company is completely insolvent and the shareholders have no chance of obtaining an economic return in the absence of a reorganization (i.e. in a liquidation under the BIA), then the shareholders will not be permitted by the court to hinder or block the wishes of creditors.[83] This prohibition against shareholder interference in corporate insolvencies extends to the exclusion of statutory rights given to shareholders under provincial law. For example, the courts have held that shareholders are not required to vote for a plan of reorganisation under the CCAA that involves the sale of a major asset, even though such a right is conferred by provincial corporate law statutes.[84]

The Canadian position is best put by the leading insolvency judge (Justice Farley-now retired) in the following terms:[85]

> shareholders would have to appreciate that, when viewed as to the hierarchy of interests to receive value in a liquidation or liquidation related transaction, they are at the bottom.

That said, the court will take into account the affect of the reorganisation plan on shareholders, but this is part of the court's consideration of other non-creditor stakeholders,[86] including the community at large and does not denote a direct duty to weigh up creditor and shareholder interests.

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[82] The common law rule in the UK preventing shareholders from rescinding their shares during insolvency also applies in Canada: see Re Northwestern Trust Co., [1926] S.C.R. 412 (S.C.C.) at 419; Milne v. Durham Hosiery Mills Ltd., [1925] 3 D.L.R. 725 (Ont. C.A.); Trusts & Guarantee Co. v. Smith (1923), 54 O.L.R. 144 (Ont. C.A.); Re National Stadium Ltd. (1924), 55 O.L.R. 199 (Ont. C.A.) (cited in Blue Range at [37]). There is however subordination of equity claims for silent partners in insolvent partnerships: see Bankruptcy and Insolvency Act 1985 (RSC) s 139.

[83] There are several decisions under the CCAA including: *Re Cadillac Fairview Inc* (1995) Carswell Ont 2488 at [8] per Farley J; *Re Canadian Airlines Corp* (2000) 9 BLR (3d) 41 at [76] per Paperny J; *Re Loewen Group Inc* (2001) 22 BLR (3d) 134 at [9] per Farley J; *Re Stelco Inc* (2006) 18 CBR (5th) 173 at [11] per Farley J. For an application of these principles under the BIA see: *Fiber Connections Inc v CVSM Capital Ltd* (2005) 5 BLR (4th) 271.

[84] *Re Loewen Group Inc* (2001) 22 BLR (3d) 134, which, although an Ontario case, considered the equivalent to *Business Corporations Act 1990* (RSO) s 184(3) under the former British Columbia *Company Act 1996* (RSBC) that required shareholder approval to dispose of all or substantially all of the company's business.

[85] *Re Royal Oak Mines Inc* (1999) 14 CBR (4th) 279 at [2] per Farley J

[86] See *Re Algoma Steel Inc* (2001) 30 CBR (4th) 1; *Re Canadian Airlines Corp* (2000) 9 BLR (3d) 41 at [96] per Paperny J.

The court's subordination of shareholder rights during insolvency is further supported by provisions in both federal and provincial corporate law statutes that prohibit shareholders from objecting to a corporate reorganisation that amends the company's articles.[87] This provision was seen as necessary given that reorganisations in insolvency will usually be accompanied by an arrangement with shareholders (usually canceling their shares) under the relevant company law statute.[88]

However, where the shares do have value (i.e. when there is a chance of the shareholders receiving a return after creditors' claims have been satisfied) then they must be accounted for in the reorganisation plan.[89] One method of accounting for shareholder value is to make provision in the reorganisation for a financial payment to the shareholders.[90]

Aside from questions about whether shareholders may vote against the plan of reorganisation, there have been relatively few decisions dealing squarely with the issue of the subordination of shareholder claims.

In *Re Central Capital Corp* (1996) 132 DLR (4th) 223, the Ontario Court of Appeal held that holders of redeemable preference shares could not redeem their contributions once the company was insolvent.[91] Weiler JA stated (at [90]):

> In the case of an insolvency where the debts to creditors clearly exceed the assets of the company, the policy of federal insolvency legislation appears to be clear that shareholders do not have the right to look to the assets of the corporation until the creditors have been paid.

These comments sit comfortably with the policy position adopted in relation to preventing shareholders from blocking reorganisations in insolvency, discussed above.

The leading decision in *Re Blue Range Resource Corp* (2000) 15 CBR (4th) 169, did however deal directly with the subordination of shareholder claims against the insolvent company. This case concerned a shareholder who submitted a proof of debt in the corporate reorganisation (under the CCAA) of Blue Range Resource Corporation. The proof was based upon an unliquidated claim for fraudulent misrepresentation inducing the shareholder's purchase of shares over the secondary market.[92] The moderator rejected the proof and the shareholder sought a declaration from the court that its claim was meritorious (in effect to

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[87] *Canada Business Corporations Act 1985* (RSC) s 191(7). For provincial legislation see for example: *Business Corporations Act 1990* (RSO) s 186(6).

[88] See Houlden & Morawetz, Bankruptcy and Insolvency Analysis (electronic database available on Westlaw) at N§24.

[89] *Re Stelco Inc* (2006) 14 BLR (4th) 260 at [16] per Farley J.

[90] *Re Blue Range Resource Corp* (2000) 15 CBR (4th) 169 at [31] per Romaine J.

[91] This was held on the basis that the *Canada Business Corporations Act 1985* (RSC) s 36(2) prohibited returns of capital during insolvency.

[92] The facts in this case are similar to those in the leading UK decision in *Soden v British & Commonwealth Holdings Plc* [1998] AC 298, although with the opposite result.

enable it to stand alongside unsecured creditors in the restructuring). Romaine J denied the claim on the basis that claims by shareholders (as shareholders) should be subordinated to those of the non-shareholder creditors.

Romaine J stated (at [17]) that:

> It is clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full.

Romaine J accepted that shareholders may have claims against the insolvent company that did not depend upon their status as shareholders in which case they would not be subordinated (at [22]):

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

Romaine J considered that the shareholder's claim was essentially a return of capital (at [23]):

> A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principal that shareholders rank after creditors in respect of any return on their equity investment.

Romaine J justified her refusal to allow the shareholder to stand alongside unsecured creditors on several grounds:

- Creditor priority over shareholder claims was a "fundamental corporate principle". This principle relied upon the popular view that creditors trade with the company on the understanding that:[93]

  a) there is an "equity cushion" that will not be removed during insolvency; and

  b) creditors price their loans to the company on the basis that they will receive priority over equity claims.

- The difficulty and complication that would be imposed on insolvency administrators in adjudicating claims if shareholders were permitted to rank alongside creditors (at [45]).

- Shareholders undertake investment with knowledge that it is a riskier activity than providing credit and should therefore bear the risk of business failure. In this case, the shareholder undertook the takeover bid without a

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[93] Although not cited in the decision, this rationale is consistent with the thesis proposed by Slain & Kripke.

> full due diligence process and therefore should have appreciated the risk of purchasing the shares based on possibly incomplete information.

Romaine J also approved (at [43]) of this quote from a US decision (*Newton National Bank v Newbegin* (1896) 74 F 135 at 140) on shareholder subordination:

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

Her Honour approved generally of the approach taken by US courts on the subordination of shareholder claims (at [54]):

> comments made by the American courts in these cases relating to the policy reasons for subordinating defrauded shareholder claims to those of ordinary creditors are persuasive, as they are rooted in principles of equity that are very similar to the equitable principles used by Canadian courts.

Re Blue Range Resource Corp was followed soon after in *National Bank of Canada v Merit Energy Ltd* (2001) 28 CBR (4th) 228. That case concerned an application for damages pursuant to a statutory cause of action for misrepresentation. The court refused the claim and stated (at [50]):

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

Proposed statutory reforms[94]

Despite the seemingly clear position at common law in Canada regarding shareholder subordination, the lack of clear statutory guidance has generated substantial disquiet from the business community, leading to calls for a statutory subordination provision similar to s 510(b) of the United States Bankruptcy Code. Indeed, several insolvency law review committees over the last decade have commented on submissions made to the effect that some large corporate bankruptcies were being filed in the United States rather than Canada, in part due to the absence of a shareholder subordination provision.[95]

This was the view reported by the *Joint Task Force on Business Insolvency Law Reform* (2002), and the *Standing Senate Committee on Banking, Trade and Commerce* (2003), both of which regarded the introduction of a statutory subordination provision similar to s 510(b) as being necessary.[96] These

[94] This section draws on the authors' earlier article: Hargovan A and Harris J, "Sons of Gwalia: Policy Issues Raised by the Subordination of Shareholder Claims" (2006) 7(1) *INSLB* 1.

[95] Noted in Towriss S, "Through the Lens of Insolvency: Shareholder Equity in CCAA Restructurings" [2005] *Annual Review of Insolvency Law* 527 at 528.

[96] *Joint Task Force on Business Insolvency Law Reform*, Final Report (2002) Sch B at p 32; *Standing Senate Committee on Banking, Trade and Commerce*, "Debtors and Creditors Sharing the Burden" (2003) at pp 159-160.

recommendations were included as part of the very substantial amendments made to Canadian insolvency law by Bill C-55 (2005) which was passed by the Canadian federal parliament in November 2005.[97] The change of federal government in Canada in early 2006 has resulted in the Bill remaining unproclaimed. The new conservative government has announced that the Bill will undergo further consultation for the purpose of amending the Bill to address several concerns expressed by the business community.

Much of the controversy surrounding the Bill is directed towards the amendments proposed by the Bill that deal with the priority of employee entitlements and the role and powers of the monitor. The subordination of shareholder claims has been universally accepted in all previous committee reports (noted above).

The reforms proposed by C-55 would amend the BIA by inserting s 140.1 which provides:

> A creditor is not entitled to claim a dividend in respect of a claim arising from the rescission of a purchase or sale of a share or unit of the bankrupt-or in respect of a claim for damages arising from the purchase or sale of a share or unit of the bankrupt-until all claims of the other creditors have been satisfied.

The amendments would also amend s 54 of the BIA by preventing creditors with claims arising from the rescission or purchase of shares from voting at a creditors' meeting.

In relation to corporate debt reorganisations, the reforms contained in Bill C-55 amend the CCAA by inserting a new s 22 which will require creditors with claims arising from the rescission of a purchase or sale of a share or unit in the company to be placed into a separate class of creditors and not be permitted to vote on proposed reorganisations.

During 2006, the Insolvency Institute of Canada made submissions regarding what it perceived were inadequacies with the original Bill C-55. Most of these recommendations do not relate to subordination. The only comment made regarding the subordination of shareholder claims provisions in Bill C-55 were that these did not cover the full range of equity claims that may be made against insolvency companies.[98]

On the 8th December 2006, the Canadian federal government proposed substantial amendments to the original Bill C-55 to address industry concerns. These amendments include new definitions to s 2 of the BIA relating to equity claims and equity interests. The proposed definition of "equity claim" includes claims relating to:

- dividends,

[97] After passing the through the parliament the Bill was renumbered as Bill C-47 (2006), however the Bill is still commonly referred to as Bill C-55.

[98] Insolvency Institute of Canada, *Position Paper on Bill C-55* (Proposal 19). Available from http://www.insolvency.ca/papers/IIC%20Position%20Paper%20re%20Bill%20C-55_Oct%2012.pdf (viewed 29 January 2007).

- capital returns,
- redemption or retraction obligations,
- monetary losses resulting for share ownership, and the purchase, sale or rescission of equity interests, and
- contributions or indemnities in respect of any of the above claims.

The amendments to Bill C-55 will define equity interest as a share, warrant, options or other right to acquire a share in the corporation (although not if the interest arises from a convertible debt instrument).

The December 2006 proposed amendments to Bill C-55 will therefore reword the subordination provisions in the original Bill by removing references to claims arising from the “rescission or purchase” of shares (as used in the proposed s 140.1 above) and insert the new term “equity claim” as defined above. The proposed amendments will retain the original proposal to amend the CCAA by preventing equity claimants from voting at creditors meetings, although this provision will be renumbered to s 22.1 and the court will also be given the power to allow equity claimants to vote. It is submitted that this power will be interpreted in accordance with the existing common law position outlined above (i.e. that only equity claimants whose shares have an economic value will be permitted to vote). At the time of writing these amendments to Bill C-55 had not yet been voted on by the parliament.

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4. Conclusion

This paper has discussed the subordination of shareholder fraud and misrepresentation claims against insolvent companies. Canada and the United States were chosen as points of comparison with Australia because they both have statutory provisions that provide robust subordination. The provision in the United States Bankruptcy Code has generated considerable case law, particularly concerning the meaning of “arising from” the purchase or sale of securities, with recent appellate court decisions interpreting the words to include post issuance conduct by the debtor company. The more recent Canadian provision (if the proposed amendments to Bill C-55 are approved by the Senate) provides arguably the clearest, and most strict form of subordination because of the broad definition of “equity claims”. As noted above, this accords with the common law position of steadfastly refusing to allow shareholders in insolvent companies to block reorganisation attempts or to receive a distribution out of the reorganisation. This refusal by the courts in Canada is consistent with the US position under the “absolute priority rule”. Therefore, the US and Canada provide two interesting examples of different paths reaching the same destination - the priority of debt over equity in insolvency administrations.

The statutory subordination of claims by shareholders serves the purpose of protecting the contractual expectations that consensual creditors have bargained for (i.e. the expectation that they will receive priority over shareholders in insolvency).[99] Critics of mandatory subordination argue that the "equity cushion" thesis by Slain and Kripke is no longer valid (if it ever was) given the absence of substantial minimum capital requirements and the equally innocent status of defrauded shareholders. Of course, this same criticism (if valid) would apply to the illogical distinction between subscribing and transferee shareholders under Australian/UK law.

In deciding on the Sons of Gwalia appeal, the High Court will need to balance two competing policy goals in an effort to rid current law of the 'logical inconsistencies'[100] of granting protective rights to transferee shareholders but not to subscribing shareholders. On one hand, shareholder victims of corporate illegality in issuing securities should be treated equally with all other valid creditors claims during insolvency. On the other hand, shareholders, rather than the general unsecured creditors, should bear the risk of illegality and insolvency and should have their claims subordinated to other claims. Whatever contextual interpretation is given to s 536A, it is submitted that, ultimately, such policy issues will impact on the resolution of this issue rather than general principles of right and wrong.

If the High Court denies the Sons of Gwalia appeal, a legislative solution may be necessary to provide certainty for debt capital markets. This paper has attempted to provide some guidance as to what that legislative solution may look like. Australia can learn much from the experience in North America. In particular, any statutory subordination provision needs to be clear and unambiguous to avoid increasing the amount of litigation and the resultant uncertainty. Of course, drafting clear and unambiguous legislation that will withstand the attacks of ingenious and well resourced corporate lawyers is another matter!

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[99] The subordination would of course also benefit involuntary creditors, but they have not bargained and, ex ante, have no expectations of the likely outcome as they have no awareness of their impending injury.

[100] Jacobson J in *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* [2006] FCAFC 17 at [134].