IS THE THIRD TIME THE CHARM

The Supreme Court of Canada's opportunity to clarify the question of equitable subordination under the *CCAA*

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TABLE OF CONTENTS

I. INTRODUCTION

The doctrine of equitable subordination has twice been considered by the Supreme Court of Canada, in 1993 and 2013. In both instances the court choose not to apply the doctrine or clarify whether it existed under Canadian insolvency law.[1] On March 9th, 2017 the Supreme Court granted an application for leave to appeal[2] from the Ontario Court of Appeal's decision in *US Steel Canada Inc (Re)*.[3] The Canadian debtor company, U.S. Steel Canada Inc. ("USSC") is in proceedings under the *Companies' Creditors Arrangement Act* ("*CCAA*").[4] The former employees of USSC have sought an order from the *CCAA* judge to subordinate the claims of United States Steel Corporation, the American parent of USSC, based on the principle of equitable subordination.[5] The doctrine of equitable subordination is provided by statute in the U.S.,[6] and is most often applied in circumstances where a claimant who is not at arm's length from the debtor, has exploited its controlling position in the debtor's business to provide itself with a benefit or advantage over other creditors.[7]

Chief Justice Strathy for the Court of Appeal concluded, after applying the principles of statutory interpretation to the *CCAA*, that *CCAA* judges do not have authority under the *CCAA* to apply the doctrine of equitable subordination.[8] Prior to this decision, Canadian courts had been inconsistent in their application of this doctrine developed in U.S. law.[9] While equitable

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[1] *Canada Deposit Insurance Corp v Canadian Commercial Bank*, [1992] 2 SCR 558 at 609; and *Sun Indalex Finance, LLC v United Steelworkers*, 2013 SCC 6 at para 77.
[2] *USW Local 8782 v US Steel Canada Inc*, [2016] CSCR No 480, 2017 CarswellOnt 3573.
[3] 2016 ONCA 662 [*US Steel*].
[4] RSC 1985, c C-36 [*CCAA*].
[5] *US Steel*, *supra* note 3, at para 1.
[6] 11 U.S. Code § 510(c).
[7] Anthony Duggan, Stephanie Den-Ishai,Jannis Sarra, Thomas G.W. Telfer, Roderick J. Wood, *Canadian Bankruptcy and Insolvency Law: Cases, Text, and Materials*, 3d ed (Toronto: Emond Montgomery Publications, 2015) at 452.
[8] *Supra* note 3, at para 101.
[9] *Ibid* at paras 22-26.

subordination is not directly available to creditors in *CCAA* proceedings, there are several other alternative remedies in insolvency proceedings for creditors who have been prejudiced by the inequitable conduct of another creditor.

A critical consideration for the Supreme Court of Canada in deciding whether to overturn the judgement of the Ontario Court of Appeal, is what should be the appropriate interpretation of the *CCAA* judge's authority under section 11 of the *CCAA*. This paper argues that *CCAA* judges have the discretion to order equitable subordination as the doctrine is consistent with the *CCAA*. The Supreme Court has the opportunity to clarify this jurisdiction, and address concerns that the order may be applied too broadly by setting a high threshold for when the doctrine would be appropriate.

II. CURRENT CANADIAN LAW

In 2016 the Ontario Court of Appeal held that *CCAA* judges do not have jurisdiction to grant equitable subordination.[10] Superior courts have previously been inconsistent in their opinions on the availability of the doctrine. One court rejected the doctrine because it would "create chaos",[11] while another court did apply it in a bankruptcy case.[12] Such a variance of interpretation has persisted because neither the legislature, nor the Supreme Court of Canada, has clarified whether the doctrine exists in Canada.[13] The Supreme Court did, however, acknowledge that the American test for equitable subordination as set out in *Re Mobile Steel*,[14] is as follows: (i) the claimant must have engaged in some type of inequitable conduct, (ii) the misconduct must have resulted in the injury to the creditors or conferred an unfair advantage on the claimant, and (iii)

[10] *US Steel*, *supra* note 3, at para 101.
[11] *AEVO Co v D&A Macleod Co* (1991), 4 OR (3d) 368 (Gen Div) at 372.
[12] *Oppenheim v J J Lacey Insurance Limited*, 2009 NLTD 148 at para 54 [*Oppenheim*].
[13] *Supra* note 3, at para 26.
[14] 563 F 2d 692 at 699-700 (5th Cir 1977) [*Re Mobile Steel*].

equitably subordinating the claim must not be inconsistent with the provisions of the bankruptcy statute.[15]

The court in *US Steel* denied jurisdiction to grant equitable subordination under the *CCAA*,[16] after applying the framework for determining the availability of statutory remedies under the *CCAA* from the Supreme Court of Canada's decision in *Century Services v Canada (Attorney General)*.[17] In particular, Chief Justice Strathy emphasized paragraph 70 of *Century Services*:

> Appropriateness under the *CCAA* is assessed by inquiring whether the order sought advances the policy objectives underlying the *CCAA*. The question is whether the order will usefully further the efforts to achieve the remedial purpose of the *CCAA*—avoiding the social and economic losses resulting from liquidation of an insolvent company.

In deciding that the doctrine does not fall within the scheme of the statute, the court stated that the *CCCA* focused on the validity of the claims of creditors against the debtor, and only sections 2(1), 6(8), 22.1 and 36.1 of the Act deal with conflicts between creditors.[18]

Whether or not the *CCAA* judge has jurisdiction to order equitable subordination depends on an interpretation of section 11 of the *CCAA.* Section 11 grants courts the authority to "make any order", so long as it is appropriate in the circumstances and is not precluded by any restriction in the Act.[19] The court in *US Steel* states that while section 11 has been interpreted to give broad powers to *CCAA* judges, this discretion must be exercised in a manner which is "in furtherance of the *CCAA*'s purpose".[20] The Court of Appeal concluded that the scheme of the *CCAA* is to implement plans of arrangement or compromise and is not a scheme for resolving priorities, so

[15] *Re Mobile Steel, supra* note 14, at 700.
[16] *US Steel, supra* note 3, at para 82.
[17] 2010 SCC 60 at para 65 [*Century Services*].
[18] *Supra* note 3, at para 69.
[19] *Ibid* at para 76.
[20] *Ibid* at para 80.

consequently statutory interpretation of the Act does provide authority for applying the doctrine of equitable subordination.[21]

III. ALTERNATIVES TO EQUITABLE SUBORDINATION

While the decision by the Court of Appeal in *US Steel* shut the door to the remedy of equitable subordination in *CCAA* proceedings, there remains other mechanisms in Canadian insolvency, corporate, and commercial law which can in many circumstances, address the concerns of creditors who have argued for equitable subordination.[22] These alternatives have made courts question whether there is even a need for the doctrine of equitable subordination.[23] As noted above, the doctrine of equitable subordination in the United States has traditionally been applied in instances where an insider has used its "power to control its own advantage or to the other creditor's detriment".[24] Below are means by which a creditor can seek to ensure that its claims are not prejudiced by the inequitable conduct of an insider-creditor. These remedies will also be compared to equitable subordination.

A. *Characterization of Claims*

If the non-arm's length creditor alleges that it has a secured claim, then another creditor can seek to subordinate that claim by challenging the security interest under the provisions of the provincial *Personal Property Security Act* ("*PPSA*").[25] Such PPSA challenges can be made to the validity, perfection, or relative priority of the party's alleged secured interest.[26]

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[21] *US Steel*, *supra* note 3, at para 101.
[22] Thomas G.W. Telfer, "Transplanting Equitable Subordination: The New 'Free-Wheeling' Equitable Discretion in Canadian Insolvency Law?" (2002) 36 Can Bus LJ, 36 at 23.
[23] *Unisource Canada Inc (cob Barber-Ellis Fine Papers) v Hong Kong Bank of Canada*, [1998] OJ No 5586 at para 134 [*Unisource Canada*].
[24] *Re Fabricators Inc.*, 926 F 2d 1458 at 1467 (5th Cir 1991).
[25] *Personal Property Security Act*, RSO 1990, c P-10 [*PPSA*].
[26] Richard H. McLaren, *Secured Transactions in Personal Property in Canada*, 3rd ed (Toronto: Carswell, 1989) at 8-11.

Following the 2009 amendments to the *CCAA*, a creditor can alternatively seek an order re-characterizing a creditor's claim as an "equity claim" resulting from an "equity interest".[27] This will effectively subordinate the claim, since subsection 6(8) of the *CCAA* states that equity claims cannot be paid in an arrangement until all not equity claims are paid in full.[28] To decide if the claim in substance is debt or equity, courts look beyond the express intention of the parties in the transaction document and consider how the transaction was implemented and the economic reality of the surrounding circumstances.[29]

This type of challenge is a fact-based inquiry into the nature of the transaction,[30] as opposed to an investigation of alleged inequitable conduct. This is important as the facts of a case may prevent this from being an effective alternative to equitable subordination. For example, the applicants in *US Steel* first attempted to re-characterize the claims of the debtor's parent,[31] but were unsuccessful. They then sought to have the claims equitably subordinated.

B. *Preferences and Transfers at Undervalue*

Another way in which the claims of creditors are protected against abusive action by the debtor, or a related party, is through the 'preferences and transfers at undervalue' sections of the *Bankruptcy and Insolvency Act* ("*BIA*") and *CCAA*.[32] These provisions prevent a non-arm's length party from using their influence over the debtor to gain an unfair advantage, in the form of a payment or transfer at undervalue. Sections 137 and 140 of the *BIA* also protect creditors by postponing the claims of not at arm's length creditors and the wages of officers and directors.[33]

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[27] *CCCAA*, *supra* note 4, s 2(1) definitions for "equity claim" and "equity interest".
[28] *CCAA*, *supra* note 4, s 6(8).
[29] *US Steel Canada Inc (Re)*, 2016 ONSC 569 at para 168.
[30] *Ibid* at para 143.
[31] *Ibid* at para 333.
[32] *Supra* note 4, s 36.1(1) and *Bankruptcy and Insolvency Act*, RSC 1985, c B-3, ss 38, 95-101 [*BIA*].
[33] *BIA*, *supra* note 32, ss 137, 140.

While these provisions are helpful in preventing transfers or payments to creditors who are related to the debtor, they differ from equitable subordination by not addressing the legal priority of these creditors' claims.

C. *Subordination under Other Statutes*

There are provisions of the *BIA* and *PPSA* which may be used to subordinate creditors' claims. Section 183 of the *BIA* grants courts equitable jurisdiction,[34] and the Trial Division of the Newfoundland and Labrador Supreme Court referenced this jurisdiction when it allowed equitable subordination during a bankruptcy.[35] The Ontario Court of Justice, meanwhile, has stated that any departure from the scheme of distribution in the *BIA* and *PPSA* should be restricted to situations where there is evidence of fraud or misrepresentation.[36]

The *PPSA*s of Ontario and BC provide that a party's security interest may be subordinated in a security agreement "or otherwise".[37] Ontario courts have narrowly interpreted "or otherwise" to include oral agreements to subordinate a claim,[38] but state that commercial certainty requires courts to be cautious in applying section 38.[39] In BC, however, a creditor who mistakenly did not include the debtor's inventory when it registered its secured interest, convinced the Court of Appeal that "or otherwise" should be applied to subordinate the perfected security interest of another party who acted inequitably.[40]

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[34] *BIA*, *supra* note 32, s 183.
[35] *Oppenheim*, *supra* note 12, at para 54.
[36] *Unisource Canada*, *supra* note 23, at para 134.
[37] *PPSA*, *supra* note 25, s 38. See also *Personal Property Security Act*, RSBC 1990, s 40(1).
[38] *Royal Bank v Tenneco Can Inc*, [1990] OJ No 96 at para 24.
[39] Sun Life Assurance Co of Canada v Royal Bank, [1995] OJ No 3622 at para 23.
[40] *Furmanek v Community Futures Development Corp of Howe Sound*, [1998] BCJ No 153 (BCCA) at para 19.

D. *Oppression Remedy*

The oppression remedy under section 241 of the *Canadian Business Corporations Act* ("*CBCA*")[41] is another mechanism by which creditors can protect themselves against inequitable behaviour. Creditors are among the listed parties of subsection 241(2) of the Act, and can employ the remedy to protect themselves against oppressive behaviour of the debtor corporation or "any of its affiliates",[42] which includes directors and controlling parent corporations.

In *Ernst & Young Inc v Essar Global Fund Ltd et al*,[43] a group of creditors successfully obtained the oppression remedy in a *CCAA* proceeding. The oppression remedy was used to stop a complex transaction in which a critical asset of the debtor's business was sold to a newly created corporation held by the debtor's parent company. Through was a change of control provision in the contract of sale the parent company would have been able to effectively veto any restructuring in which it was not an applicant.[44] Therefore, the sale was disapproved. This sales transaction was oppressive because it allowed the parent company to continue to effectively control the debtor's business, despite the fact that the parent's equity had been wiped out during the restructuring.[45]

Creditors, where they have been unfairly prejudiced, have also sought the oppression remedy against the directors of the debtor, including where the director fails to collect its receivables,[46] or where the director siphoned off the company's assets during the insolvency to pay himself excessive compensation.[47]

Equitable subordination and the oppression remedy can both be sought by prejudiced creditors; the former is brought against another creditor, the latter is brought against the debtor's

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[41] RSC 1985, c C-44 [*CBCA*].
[42] *CBCA*, *supra* note 41, s 241(2).
[43] 2017 ONSC 1366.
[44] *Ibid* at para 75.
[45] *Ibid* at para 73.
[46] *Waiser v Deahy Medical Assessments Inc.*, [2016] OJ No 224.
[47] *Prime Computer of Canada Ltd v Jeffrey*, [1991] OJ No 2317 at para 9.

company. In theory this procedural difference should neither prevent prejudiced creditors from being able to bring actions, nor change the outcome. The result should be the same if the non-arm's length creditor's claim is subordinated, or if the debtor is forced to set aside or alter the transaction which gave rise to the non-arm's length creditor's claim. A difference with equitable subordination is that it could foreseeably be sought against an arm's length creditor. The oppression remedy, however, is arguably a more favourable remedy, because subsection 241(3) of the *CBCA* grants courts the broad discretion to make "any interim or final order it thinks fit",[48] while equitable subordination only deals with changing the relative priority of a creditor's claim.

E. *The Role of the Monitor*

If the monitor adequately fulfills its role, then arguably there is less of a need for a remedy of equitable subordination. The monitor plays an important role in *CCAA* proceedings, acting "on behalf of the court to provide information and monitoring for the benefit of all parties".[49] The monitor owes a fiduciary duty to the stakeholders (including creditors), they must act independently and treat all parties reasonably and fairly.[50] In inter-creditor disputes, such as those under which the remedy of equitable subordination is sought, the monitor must not be an advocate of any particular party,[51] but does have a duty to ensure that no creditor has an advantage over another.[52] In their statutorily mandated reports to the court,[53] the monitor can include its opinion on how any proposed arrangement might be a beneficial or detrimental resolution of the inter-creditor dispute. The monitor, however, is usually limited to presenting its opinion. The *CCAA* judge ultimately retains the full authority to grant orders or approve plans of arrangement.

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[48] *CBCA*, *supra* note 41, s 241(3).
[49] *United Used Auto & Truck Parts Ltd (Re)*, [2000] BCJ No 409 at para 18.
[50] *Re Winalta Inc*, 2011 ABQB 399 at para 67 [*Re Winalta*].
[51] Kevin P. McElcheran, *Commercial Insolvency in Canada* (Markham, Ont.: LexisNexis Butterworths, 2005) at 236.
[52] *Re Winalta*, *supra* note 50, at para 77.
[53] *CCAA*, *supra* note 4, ss 23(h)-(i).

IV. THE FUTURE OF EQUITABLE SUBORDINATION

A. *How broad is the Authority under Section 11?*

Ultimately whether a CCAA court has jurisdiction to grant equitable subordination turns on the interpretation of section 11 of the *CCAA*.[54] The Ontario Court of Appeal in *US Steel* stated that the court's authority under section 11 is limited to orders which are "consistent with the purpose of the *CCAA*", and concluded that equitable subordination was inconsistent with the *CCAA*.[55] This arguably restricts the broad power afforded to CCAA courts, and consequently the Supreme Court of Canada will have to determine if it agrees with this slightly narrower interpretation.

The argument that a *CCAA* judge has jurisdiction to grant equitable subordination would be based on existing jurisprudence prior to *US Steel*, which broadly interpreted *CCAA* authority.[56] As noted by Chief Justice Strathy in *US Steel*, the success of the *CCAA* in achieving its statutory purpose is contingent on the court's ability to exercise discretion under section 11 and design creative solutions which do not have express statutory authority.[57] Flexibility is particularly important for large and complex restructurings,[58] where there are more interests to balance and the stakes are higher. In addition, Justice Deschamps in *Century Services* stated that the amendments to the wording of section 11 appear to indicate that Parliament endorses the broad interpretation of *CCAA* authority developed by jurisprudence.[59]

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[54] *CCAA*, *supra* note 4, s 11.
[55] *US Steel*, *supra* note 3, at para 101.
[56] *Century Services*, *supra* note 17, at para 68.
[57] *Supra* note 3, at para 102.
[58] *Supra* note 17, at paras 19-21.
[59] *Ibid* at para 68.

The fact that there are varying remedies which address the inequitable conduct of an insider creditor, suggests that it would be consistent with the *CCAA* to allow another remedy such as equitable subordination. Furthermore, maintaining a broad interpretation of what orders are consistent with the *CCAA* is important to protect the flexible nature of the Act. Thus, arguably, section 11 should be interpreted to allow courts the authority to order equitable subordination.

B. *Is There a Gap in the Legislative Scheme?*

Chief Justice Strathy in *US Steel* stated that there is no gap in the legislative scheme to be filled by equitable subordination through the court exercising its inherent or equitable jurisdiction.[60] Consequently, it is worth analyzing whether Canadian law already provides functional equivalents to equitable subordination.[61] While there are other legal alternatives, they are all distinguishable from equitable subordination in terms of their availability and/or usefulness.

As noted above, a challenge to the characterization of a claim can effectively have the same result as equitable subordination, but the former is a challenge to the factual nature of the transaction, while the later considers if the actions of the creditor were equitable. The preferential or undervalue transactions provisions cannot change the priority of creditors' claims, but instead address preventing transactions which provide an 'unfair' advantage to one creditor. It is doubtful whether equitable subordination is available under another statute. The oppression remedy is likely the most similar to equitable subordination. It is arguably even more favourable for creditors since they can obtain "any order".[62] Collectively these remedies, in many circumstances, make the

[60] *US Steel*, *supra* note 3, at para 104.
[61] Thomas G.W. Telfer, *supra* note 22, at 18.
[62] *CBCA*, *supra* note 41, s 241(3).

doctrine mostly redundant. However, as outlined above, it is possible for there to be situations where a creditor acts egregiously and the issue could only be resolved by equitable subordination.[63]

C. *Normative Basis for the Doctrine*

The decision of whether there should be equitable subordination depends on striking the right balance between having legal certainty, and maintaining some flexibility to tailor the most circumstantially appropriate solution. There is a legitimate concern that if the Supreme Court of Canada provides courts with the jurisdiction to grant equitable subordination, they may use the remedy too broadly, undermining the contractual legal rights of creditors based on an "intuitive sense of ad hoc fairness".[64] This concern is clearly expressed by Justice Mesbur in *Harbert Distressed Investment Fund, LP v General Chemical Canada Ltd*, when she states that equitable subordination should be used sparingly by Canadian courts and should not be used to "adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the Court perceives the result as inequitable".[65] The court added that the focus should be on the nature of the creditor's claims, and not on who the creditors are because otherwise the later will disproportionately favour the "innocent and vulnerable" employees over the "sophisticated and wealthy" lender.[66]

It would be concerning if equitable subordination is applied too broadly, because it requires disregarding an otherwise legally valid transaction.[67] U.S. courts have recognized the need for

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[63] See e.g. *In re Yellowstone Mountain Club, LLC*, Case No. 08-6150-11, Adv. 09-00014 (Partial & Interim Order) (Bankr. D. Mont., May 13, 2009) (Docket No. 289) at 19 ("The only equitable remedy to compensate for Credit Suisse's overreaching and predatory lending practices in this instance is to subordinate Credit Suisse's first lien position").
[64] Thomas G.W. Telfer, *supra* note 22, at 9.
[65] *Harbert Distressed Investment Fund, LP v General Chemical Canada Ltd*, [2006] OJ No 3087 at para 92.
[66] *Ibid*.
[67] *Re Lifschultz Fast Freight*, 132 F 3d 339 (7th Cir 1997) at 347.

limitations on equitable subordination, and have struggled with how to set those limitations.[68] In addition, predictability is important for insolvency regimes, particularly with regards to the priority of claims, since greater uncertainty will discourage creditors and investors, or may cause them to demand higher premiums.[69] Not only might the cost of credit increase, but allowing equitable subordination could reduce legal certainty.

Conversely, however, allowing equitable subordination could provide greater relief to prejudiced creditors. Equitable subordination can be viewed as a judicial desire to overcome the technical restraints of other insolvency remedies.[70] The *CCAA* is a flexible statute which affords courts the discretion to effect creative restructurings. Therefore, it is unclear why a court should not be able to grant the remedy if equity demands such an outcome.

V. CONCLUSION

Continuing to broadly interpret section 11 of the *CCAA* is preferable, so that courts have the authority to order equitable subordination. While the above analysis supports the position that a *CCAA* judge has jurisdiction to grant the order, it is important, and the Supreme Court of Canada now has the opportunity, to clarify this position and establish a high threshold for when the doctrine would be appropriate and necessary. In doing so, the range of alternative remedies, and the need for predictability and legal certainty in the priority of creditors' claims, need to be carefully considered.

Regardless of whether the Supreme Court of Canada grants the appeal in *US Steel*, it would be beneficial if the legislature amends the *CCAA* to expressly state whether orders of equitable

[68] *Re Lifschultz Fast Freight*, *supra* note 67, at 347.
[69] The World Bank, *Creditors Rights and Insolvency Standard* (Revised 2011) at 38, online: The World Bank <http://siteresources.worldbank.org/INTGILD/Resources/ICRStandard_Jan2011_withC1617.pdf>.
[70] Robert C Clark, "The Duties of the Corporate Debtor to Its Creditors" (1977) 90 Harv L Rev 505 at 532.

subordination are allowed. If the legislature decides to adopt the doctrine, it could look to U.S. law for guidance on how equitable subordination may be effected and what limitations might be applied.