

# **STANDING UP FOR SHAREHOLDERS:**

**TREATMENT OF SHAREHOLDERS AND EQUITY CLAIMS IN  
CANADIAN CORPORATE INSOLVENCY PROCEEDINGS**

**INSOLVENCY INSTITUTE OF CANADA**

**LAW STUDENT WRITING AWARD PROGRAM 2016**

Word Count = 3,000 (exclusive of footnotes and headings)

**Andrew Harmes  
Osgoode Hall Law School  
andrewharmes27@gmail.com**

<b>I. INTRODUCTION.....</b>	<b>1</b>
<b>II. BACKGROUND: TREATMENT OF SHAREHOLDERS IN INSOLVENCY.....</b>	<b>2</b>
<b>A. Pre-2009 Framework: Basic Subordination Under the Common Law.....</b>	<b>2</b>
<b>B. 2009 Legislative Amendments: Strict Subordination .....</b>	<b>3</b>
<b>III. THE SUBORDINATION OF SHAREHOLDER MISREPRESENTATION</b>	
<b>CLAIMS: RETHINKING FAIR AND REASONABLE .....</b>	<b>5</b>
<b>A. Pre-2009 Treatment: Blue Range.....</b>	<b>5</b>
<b>B. Post-2009 Amendments: Policy Considerations Relating to Statutory</b>	
<b>Subordination With no Carve Out for Securities Law Claims.....</b>	<b>7</b>
<b>C. Does Strict Subordination Make Sense? .....</b>	<b>10</b>
<b>IV. POTENTIAL FOR LEGAL REFORM .....</b>	<b>12</b>
<b>V. CONCLUSION .....</b>	<b>13</b>

## I. INTRODUCTION

Thanks to the subordination of equity claims, shareholders of distressed corporations are relegated to the ‘bottom rung’ of insolvency law’s priority ladder.<sup>1</sup> Courts and policy-makers have decided that debt should rank ahead of equity in firm insolvency, and accordingly, have prohibited equity investors from sharing in a corporation’s assets until all creditor claims have been met in full. Put simply, shareholders get paid only once everyone else has been paid.

While the subordination of equity claims is not all that controversial, with it being a fundamental tenet of insolvency law that creditors are to prevail when in competition with equity contributors,<sup>2</sup> it is this paper’s position that Canada’s version of subordination bears the risk of over-rigidity, and as such, raises important issues of investor protection. Specifically, this paper considers the status of shareholder claims arising from violations of securities law. Unlike comparable jurisdictions, Canadian law makes no exception for misled shareholders, leaving claims under securities law’s civil liability provisions behind creditors in rank. Such treatment, this paper argues, undermines Canada’s investor protection regime. While shareholders must accept the risk of business failure where their bet goes bad in the normal course, it is overly harsh to also require that they bear the entire consequence of securities law violations. The latter is not a risk assumed in the shareholder bargain, and to deny recourse weakens the effectiveness of Canada’s disclosure requirements — something that causes Canada’s investor protection regime, as a whole, to suffer.

This paper begins with a background of shareholder claims in insolvency, describing the evolution of common law and statutory treatment. Part III specifically addresses shareholder securities law claims, using the lack of carve-out to frame the general thesis that Canada’s version of shareholder subordination is excessively punitive to equity investors.

---

<sup>1</sup> *Re Canadian Airlines Corp*, 2000 ABQB 442 at para 143, 265 AR 201.

<sup>2</sup> See e.g. Robin B Schwill, “A Forest for a Tree: A Case Comment on Sino-Forest”, (2013) 28 BFLR 507 at 509 (“It has been a longstanding fundamental tenet of insolvency law that a person who contributes capital to a business (i.e., equity) cannot prove their claim in bankruptcy in competition with the creditors of the business”).

## II. BACKGROUND: TREATMENT OF SHAREHOLDERS IN INSOLVENCY

### *A. Pre-2009 Framework: Basic Subordination Under the Common Law*

As a corporation approaches insolvency, there exists a basic tension between debt and equity holders.<sup>3</sup> In the normal course of operations, when a corporation is solvent, the potential of creditors' and shareholders' interests conflicting is not usually an issue. The corporation is paying its suppliers and financiers according to bargained for terms, with any surplus being available for distribution to shareholders as dividends.<sup>4</sup> However, when in financial distress and assets are no longer sufficient to satisfy liabilities, the relationship becomes something of a 'zero sum game.'<sup>5</sup> It has been the longstanding view of Canadian insolvency law that choice, as between debt and equity holders, favours debtors.

Although originally left unaddressed by both the *Companies Creditors' Arrangement Act* ("CCAA")<sup>6</sup> and the *Bankruptcy and Insolvency Act* ("BIA"),<sup>7</sup> the common law filled the void and crafted a basic rule that saw equity subordinated.<sup>8</sup> This meant that under insolvency's hierarchy of interests, shareholders would only receive a distribution where all other ordinary creditors had been paid in full. In effect, shareholders were given the unenviable rank of 'super unsecured.'<sup>9</sup>

---

<sup>3</sup> Jason Harris & Anil Hargovan, "The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective", in Janis P Sarra, ed, *Annual Review of Insolvency Law 2007* (Toronto: Carswell, 2008) 699 at 702-3.

<sup>4</sup> *Ibid* at 703.

<sup>5</sup> Stephanie Ben-Ishai, "Debt or Equity? A Puzzle for Canadian Bankruptcy Law" (2012) 53 CBLJ 416 at 418 ("[I]f the shareholders recouped their capital investment, the returns of the creditors would be diminished and if the company's assets are divided amongst the creditors, the shareholders' investments will be lost"); see also, Harris & Hargovan, *supra* note 3 at 706 ("[I]nsolvency brings with it a deficiency of assets that necessitates choice on how to distribute the assets of the company amongst its various claimants").

<sup>6</sup> *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 [CCAA] (As the insolvency statute of choice for major Canadian restructuring and now liquidation proceedings as well, the CCAA is the primary focus of this article).

<sup>7</sup> *Bankruptcy and Insolvency Act*, RSC 1985 c B-3 [

<sup>8</sup> See e.g. *Canada Deposit Insurance Corp v Canadian Commercial Bank*, [1992] 3 SCR 558 at para 47, 97 DLR (4th) 385 [*Canada Deposit Insurance Corp*]; see also *Re Central Capital Corp*, [1996] O.J. No. 359 at para 149, 132 D.L.R. (4th) 223 [*Central Capital*]; see also *Re Nelson Financial Group*, 2010 ONSC 6229 at para 25, 71 CBR (5th) 153 [*Nelson*].

<sup>9</sup> Luc Morin, "L'insolvabilité en contexte international et l'attitude des tribunaux canadiens", (2007) 28 Ottawa L Rev 129 at 131 (see English version online: <[http://www.fasken.com/files/Publication/b67d44b2-6625-4e55-a9b3-113ee303d883/Presentation/PublicationAttachment/ec8fe2c5-a502-4fe0-ae7f-060edbf461e1/Shareholders\\_and\\_corporate\\_insolvency.pdf](http://www.fasken.com/files/Publication/b67d44b2-6625-4e55-a9b3-113ee303d883/Presentation/PublicationAttachment/ec8fe2c5-a502-4fe0-ae7f-060edbf461e1/Shareholders_and_corporate_insolvency.pdf)>.)

The basis underlying this approach, in the words of Justice Morawetz, “flows from the fundamentally different nature of debt and equity.”<sup>10</sup> Debt holders as creditors are relatively low risk takers who have fixed claims limited to repayment of the amount owing to them plus interest.<sup>11</sup> Shareholders meanwhile are tied to firm performance, and have unlimited potential upside in their investment as they stand to benefit from any increase in share value that results from the companies’ wealth generating activities.<sup>12</sup> Based on this differing risk participation, courts consistently held that shareholders rank behind creditors in insolvency.<sup>13</sup>

### ***B. 2009 Legislative Amendments: Strict Subordination***

Despite common law subordination being applied on many occasions, a call for explicit statutory language emerged. The impetus for reform was twofold: (i) the increasing difficulty in distinguishing between debt and equity claims, and (ii) the view that Canada’s insolvency framework did not sufficiently subordinate “shareholder damage claims.”<sup>14</sup>

The challenge of distinguishing between debt and equity claims arose with the rising popularity of hybrid securities which combined elements of both.<sup>15</sup> With no statutory definition of equity claim, in applying common law subordination, courts were left to their own devices to make this distinction. The Supreme Court in *Canada Deposit Insurance Corp v Canadian Commercial*

---

<sup>10</sup> *Re Sino-Forest Corp*, 2012 ONSC 4377 at para 24, 92 CBR (5th) 99.

<sup>11</sup> See e.g. *Central Capital Corp*, *supra* note 8 at para 42; see also “Update on Shareholder and Equity-Related Claims in Insolvency Proceedings”, (2003) INSOL International Technical Series No 28 at 12 (This applies equally to both trade creditors as well as holders of debt securities, both of whom have negotiated for a predetermined return and have claims limited to this contracted for amount).

<sup>12</sup> *Nelson*, *supra* note 8 at paras 25-6.

<sup>13</sup> *Ibid*, at 25 (“[O]n the insolvency of a company, the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of shareholders in an insolvency”).

<sup>14</sup> Schwill, *supra* note 2 at 516; see also Senate, *Standing Senate Committee on Banking, Trade and Commerce, A Review of the Bankruptcy and Insolvency Act and the Companies’ Creditors Arrangement Act* (November 2003) at 158 [*Senate Report*].

<sup>15</sup> See e.g. Ben-Ishai, *supra* note 5 at 416.

*Bank*<sup>16</sup> adopted what Stephanie Ben-Ishai describes as the “contextual, intention based approach,”<sup>17</sup> saying that where debt and equity elements co-exist, courts are to search for the main thrust of the transaction.<sup>18</sup> Although this approach was subsequently refined, results have been described as “not necessarily consistent,” thus giving rise to demands for a firm line to be drawn between the two.<sup>19</sup>

As for the view that insolvency law did not sufficiently subordinate ‘shareholder damage claims,’ focus here was on claims of misrepresentation in the capital market.<sup>20</sup> Canada’s Standing Senate Committee on Banking, Trade and Commerce reviewed both the *BIA* and *CCAA*, and published a report (the “Senate Report”) which stated that there was no “facility in place” to deal with shareholder misrepresentation claims, giving issuers “no choice but to file in the US where there is a vehicle to deal with these claims.”<sup>21</sup> To make Canada a more favourable jurisdiction, it was recommended that shareholder damage claims be encompassed within a broader scheme of statutory subordination.<sup>22</sup>

---

<sup>16</sup> *Canada Deposit Insurance Corp*, *supra* note 8 (In this case, Canadian Commercial Bank (“CCB”) obtained emergency financial assistance from a group of lending institutions under an agreement that provided the lenders warrants to buy up to 75 percent of the struggling firm’s common shares. CCB became insolvent despite the assistance, and therefore the classification would determine whether or not the lenders would be entitled to stand *pari passu* with the unsecured creditors, or whether they would be subordinated as equity claimants).

<sup>17</sup> Ben-Ishai, *supra* note 5 at 420.

<sup>18</sup> *Canada Deposit Insurance Corp*, *supra* note 8 at para 55 (“When a court is searching for the *substance* of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement”).

<sup>19</sup> See “Update on Shareholder and Equity-Related Claims in Insolvency Proceedings”, *supra* note 15 at 6 (The article references the decisions of *Re Waxman & Sons Ltd*, 89 OR (3d) 427 and *Re Blue Range Resources Corp*, 2000 ABQB 4, 259 AR 30 [*Blue Range*] as being illustrative of the inconsistencies in application).

<sup>20</sup> The concern that shareholder damage claims were not sufficiently addressed arose in the context of large corporate scandals in the early 2000’s involving companies such as Enron and Worldcom.

<sup>21</sup> *Senate Report*, *supra* note 12 at 158.

<sup>22</sup> *Ibid*, at 159 (The Senate Report determined that shareholders, by accepting equity rather than debt, have naturally accepted a lower priority ranking and therefore must *always* step aside in insolvency proceedings. It was recommended that: “The *Bankruptcy and Insolvency Act* be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not participate in the proceeds of a restructuring or bankruptcy until other creditors of the debtor have been paid in full”).

The Senate Report's recommendations for statutory subordination were ultimately adopted with the enactment of Bill C-12,<sup>23</sup> amending both the *CCAA* and the *BIA* and the manner in which the two statutes treated equity claims. With respect to the *CCAA*, the first amendment to note was the codification of subordination of equity claims generally with the introduction of Section 6(8).<sup>24</sup> Also important was the inclusion of a broad definition describing an equity claim as including a (a) claim for a dividend, (b) return of capital, (c) redemption or retraction obligation, or (d) monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission of a purchase or sale of an equity interest.<sup>25</sup>

### **III. THE SUBORDINATION OF SHAREHOLDER MISREPRESENTATION CLAIMS: RETHINKING FAIR AND REASONABLE**

#### ***A. Pre-2009 Treatment: Blue Range***

Although the Senate Report was of the view that no framework was in place to address shareholder damage claims, the case of *Re Blue Range Resources*<sup>26</sup> dealt directly with the issue, and according to Janis Sarra, was suggestive of “fairly rigid subordination.”<sup>27</sup> Applying the ‘contextual, intention based approach’ described above, *Blue Range* held that the shareholder tort claim of fraudulent misrepresentation was properly characterized as an equity claim. While not a claim for the return of capital in the direct sense, the misrepresentation claim was said to be based entirely upon the claimant’s status as shareholder, and was in substance a return of what

---

<sup>23</sup> Bill C-12, An Act to amend the Bankruptcy and Insolvency Act, the Companies’ Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2nd Sess, 39th Parl, 2007 (assented to 14 December 2007), SC 2007, c 36 (The amendments came into force on September 18, 2009 <<https://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br02261.html>>).

<sup>24</sup> *CCAA*, *supra* note 6, s 6(8) (“No compromise or arrangement that provides for the payment of an equity claim is to be sanctioned by the court unless it provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid”).

<sup>25</sup> *Ibid*, s 2(1).

<sup>26</sup> *Blue Range*, *supra* note 19 (The case involved a successful hostile takeover bid in which the target (Blue Range Resource Corp or “Blue Range Resource”) was found to have publicly misrepresented their financial state. The target turned out to be in dire financial condition and in need of immediate creditor protection. Upon causing the target to file for *CCAA* protection, the purchaser (Big Bear Exploration Ltd or “Big Bear”) took the position that their tort claim for fraudulent misrepresentation should rank equally with unsecured creditors).

<sup>27</sup> Janis Sarra, “From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings” (2007) 16 *IIR* 198 at 158.

had been invested in that capacity.<sup>28</sup> Notably, since the CCAA did not yet address where shareholder claims were to rank, the court had to also determine the ultimate question of priority. Deciding that the misrepresentation claim should rank last, the court made the following observations: first, creditors conduct business with corporations legitimately expecting to be given priority over shareholders in insolvency; and second, the same risk-assumption rationale underlying general subordination of shareholder insolvency claims, also applies in the case of misleading disclosure.<sup>29</sup>

The reasoning in *Blue Range* generally follows that which was articulated in a highly influential 1973 article by respected US law professors John Slain and Homer Kripke.<sup>30</sup> At that time in the US, dissatisfied investors were able to stand *pari passu* with general unsecured creditors by rescinding their share purchase agreement where the transaction violated securities laws.<sup>31</sup> Slain and Kripke viewed such treatment as unfair and suggested two primary reasons for subordinating the defrauded shareholder.

First, while both investors and creditors assumed the risk of business failure in the normal course, only shareholders should be exposed to the risk of illegal securities issuance. Slain and Kripke saw shareholders as “conscious risk-takers” who invest consenting to a higher degree of exposure for the opportunity to share in profits.<sup>32</sup> There existed, in Slain and Kripke’s opinion, “no obvious reason...for reallocating that risk” in the case of misleading conduct since

---

<sup>28</sup> For the misrepresentation claim’s connection to the purchaser’s status as shareholder, see *Blue Range*, *supra* note 19 at 22 (“Big Bear had no cause of action until it acquired shares of Blue Range...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”); for the claim’s characterization as a return of capital, see *Ibid*, at 23, 25 (“It is true that Big Bear does not claim rescission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the “true” value of Blue Range shares and their “misrepresented” value — in other words, money back from what Big Bear “paid” by way of consideration...A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range [Resources] ...The nature of the claim is in substance a claim by a shareholder for a return of what it invested *qua* shareholder”).

<sup>29</sup> *Ibid*, at paras 33-4.

<sup>30</sup> John J Slain & 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.

<sup>31</sup> See e.g. Kenneth B Davis Jr, “The Status of Defrauded Securityholders in Corporate Bankruptcy” (1983) 1 Duke LJ 1 at 9-11.

<sup>32</sup> Slain & Kripke, *supra* note 30 at 261.

shareholders invest knowing they will be subordinated in insolvency.<sup>33</sup> Further, Slain and Kripke argued that subordination was necessary because credit is provided to corporations in reliance upon the ‘equity cushion.’ Since debt is senior to equity in insolvency, creditors view shareholders’ contribution as capital that enables the business to absorb losses without compromising its ability to pay creditors.<sup>34</sup> This equity cushion was said to impact lenders’ willingness to grant credit. Securities law claims therefore had to be subordinated to protect this equity cushion and the expectations of creditors.

### **B. Post-2009 Amendments: Policy Considerations Relating to Statutory Subordination With no Carve Out for Securities Law Claims**

With the 2009 amendments, Canadian insolvency legislation adopted the position of both *Blue Range* and Slain and Kripke respecting misled shareholders. The CCAA’s definition of ‘equity claim’ includes “monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission...of a purchase or sale of an equity interest,” with no distinction for claims arising out of securities law.<sup>35</sup>

The issue with such strict subordination is that much of the rationale relied on by Slain and Kripke is not as persuasive today. Much has changed in securities law and policy, so that strict subordination encompassing misled shareholder claims, can no longer be justifiable either on the basis of creditor reliance, or that this is a risk assumed by shareholders as part of their bargain.

Regarding creditor reliance on the equity cushion, the nature of debt and equity investments is quite different today. Although Slain and Kripke were writing in 1973, the reliance rationale for favouring creditors over defrauded shareholders was originally developed by American courts before the twentieth century.<sup>36</sup> At that time, shareholders were typically small groups of entrepreneurs or insiders, and the capital they provided was regarded as the principal basis for a

---

<sup>33</sup> *Ibid* at 287 (Also, it was said that equal treatment of shareholder fraud claims would create a ‘best of both worlds’ scenario where they participate in the firm’s success during times of prosperity, while also standing level with creditors in certain cases of failure. See also Harris & Hargovan, *supra* note 3 at 711).

<sup>34</sup> Slain & Kripke, *supra* note 30 at 286; see also Davis, *supra* note 28 at 19.

<sup>35</sup> CCAA, *supra* note 6, s 2(1) (For an example of an interpretation of the new equity-related provisions, see *Re Sino Forest Corp*, 2012 ONCA 816, 114 OR (3d) 304).

<sup>36</sup> Davis, *supra* note 31 at 26.

corporation's credit.<sup>37</sup> This capital was to provide a cushion for the creditor-outsiders should the business venture fail.<sup>38</sup> The position of the contemporary creditor is significantly different.

First, the players have changed. The composition of today's typical shareholder group is a widely dispersed body that generally lack the monitoring power of insiders. Creditor groups meanwhile tend to consist not only of various trade creditors and individual debt security holders, but are also frequently dominated by sophisticated financial institutions that have some monitoring ability.<sup>39</sup> According to Kenneth Davis, "the comparative abilities of the debt and equity classes to protect themselves from fraud...have flipflopped."<sup>40</sup> Second, the idea that a corporation's share capital is the basis for its credit is no longer necessarily true. According to Davis, a corporation's capital structure is far less of a concern for credit providers. Trade creditors focus more on the corporation's reputation as opposed to analyzing its financial condition, while long-term lenders are more likely to base decisions on the corporation's future business prospects and potential for operating profits.<sup>41</sup> And even if a corporation's share capital remained the credit market's principal focus, the subordination of securities law claims is just one class of risk, protection from which is unlikely to weigh heavily in the decisions of prospective lenders.<sup>42</sup>

Even more vulnerable is the idea that shareholders assume the risk of securities violations as *quid pro quo* for taking the upside of a corporation's business activity. This assertion should be re-analyzed in the context of contemporary securities regulation and market disclosure laws.

---

<sup>37</sup> *Ibid.*

<sup>38</sup> *Ibid.*, at 27.

<sup>39</sup> Sarra, *supra* note 27 at 191; see also Davis, *supra* note 31 at 191-2 (While it is true that shareholders and not creditors are the ones who vote on the corporation's directors, this is not always an effective monitoring tool given the typical proportion of shareholder dispersal).

<sup>40</sup> Davis, *supra* note 31 at 29 (Note that Davis was speaking with regards to the US. While the positions of debt and equity holders may not have exactly flipflopped in Canada given that capitalization in the equity market is so dominated by institutional ownership, the point holds that the monitoring capacity of shareholders today is not what it was when shareholders were predominantly insiders).

<sup>41</sup> *Ibid.*, at 29-30 (While Davis says that lenders do certainly consider the corporation's debt-equity ratio, it is argued that this is less of a factor than future business prospects).

<sup>42</sup> Note also that it is possible that any detriment on the availability of debt financing arising from parity of securities law claims, would be offset at least to some extent by the corresponding benefit to equity financing. The full extent to which parity of securities law claims in insolvency will effect the debt market is outside the scope of this paper. Nevertheless, for more, see Davis *supra* note 31 at 34.

Securities regulation has three main priorities: the protection of investors, the promotion of fair and efficient capital markets, and the enhancement of public confidence therein.<sup>43</sup> One of the principal tools through which regulators seek to achieve these goals is the adoption of extensive disclosure requirements. The idea is to eliminate any information asymmetries between insiders and the investing public by requiring reporting issuers to provide timely and accurate information regarding their financial and operational health.<sup>44</sup> There is no guarantee that full, true and plain disclosure automatically leads to fairness as retail investors do not always have the ability to make use of the information, but as a starting point, disclosure requirements are meant to place investors on an equal playing field with respect to information available to assist their investment decisions.<sup>45</sup>

To ensure that continuous disclosure requirements contribute to the enhancement of market integrity, civil liability provisions have been introduced to assist investors in the secondary market. In addition to primary market liability for misrepresentations in a prospectus, investors now have a statutory right of action where securities have been acquired or disposed on the secondary market while there was either an uncorrected error in disclosure or failure to report a material change.<sup>46</sup> Unlike the common law tort action for negligent misrepresentation, under the Ontario provision for example, both primary and secondary market liability provisions create a statutory right of action regardless of reliance.<sup>47</sup> The extension of this right is meant to overcome

---

<sup>43</sup> Janis Sarra, “Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions” in *Canada Steps Up: Task Force to Modernize Securities Legislation in Canada* (Toronto: 2006) 7 at 8.

<sup>44</sup> *Ibid*, at 19-20; see also *Securities Act*, RSO 1990, c S.5, ss 56(1) (In addition to the requirement of full, true and plain disclosure regarding the issuance of securities under a prospectus, Canada’s disclosure regime is supported by continuous disclosure obligations. Reporting issuers must provide periodic disclosure in the form of quarterly financial statements, as well as timely disclosure of material changes that can be expected to impact the reasonable investors investment decisions).

<sup>45</sup> Sarra, “Modernizing Disclosure in Canadian Securities Law” *supra* note 44 at 19-20 (“Information about an issuer drives market moves; hence it has a valuable good”).

<sup>46</sup> *Securities Act*, *supra* note 41 ss 130(1), 138.3(1).

<sup>47</sup> See e.g. “Secondary Market Liability in Canada: A Legal Overview” (November 2012), online: Stikeman Elliott LLP <<http://www.stikeman.com/2011/en/pdf/Secondary-Market-Liability.pdf>>.

the evidentiary hurdles that have previously denied secondary market investors any meaningful remedy where they have suffered losses from inaccurate disclosure.<sup>48</sup>

With both primary and secondary market investors having this right of action, how can it be that shareholders bear the risk of securities law violations? According to Anita Anand, shareholders “bargain in the shadow of securities legislation.”<sup>49</sup> This means that when making investment decisions, shareholders acquire securities with the expectation that they can avail themselves of statutory investor protection mechanisms where a reporting issuer disseminates misleading disclosure. These rights offer better protection than at common law, and are meant to promote investor confidence by providing meaningful recourse. As such, it is unreasonable to say that shareholders accept subordination for this type of claim as part of their bargain with the corporation.

### **C. Does Strict Subordination Make Sense?**

With Slain and Kripke’s original justifications challenged, it is appropriate to re-evaluate and ask whether it is nevertheless the correct legal choice to undermine securities law’s statutory remedies and have shareholders bear the cost of misleading disclosure in firm insolvency.<sup>50</sup>

This paper answers the above in the negative. A misrepresentation claim is not a claim for residual value or return of capital, rather it is a claim for damage to investment value.<sup>51</sup>

Subordinating this type of claim is a poor allocation of risk given recent investor protection trends. There has been significant emphasis in securities law on implementing a disclosure regime that both deters information asymmetries *and* compensates investors who suffer losses relying on misrepresentations.<sup>52</sup> Enhanced disclosure obligations and increased liability

---

<sup>48</sup> For assessment of damages, see *Securities Act*, *supra* note 44, s 138.5 (For example, under Section 138.5(1), if a shareholder on the secondary market has not disposed of the reporting issuer’s security, damages will constitute the difference between the price paid and their trading price following the public correction of the misrepresentation).

<sup>49</sup> Anita I Anand, “Should Shareholders Rank with Unsecured Creditors in Bankruptcy?”, (2008) 24 BFLR 169 at 178.

<sup>50</sup> See Harris & Hargovan, *supra* note 3 at 710 (The question is: “should insolvency subordination rules triumph over non-insolvency securities law rights?”)

<sup>51</sup> Sarra, *supra* note 27 at 187.

<sup>52</sup> See e.g. Sarra, “Modernizing Disclosure in Canadian Securities Law”, *supra* note 44; see also Peter de C Cory & Marilyn L Pilkington, “Critical Issues in Enforcement” in *Canada Steps Up: Task Force to Modernize Securities Legislation in Canada* (Toronto: 2006) 171 at 238.

thereunder has been seen as essential to ensuring fairness and efficiency in the capital market. Subordinating misrepresentation claims in insolvency is a limit to this disclosure regime, and as a result, serves to weaken investor confidence. Neither shareholders nor creditors bargain on the basis of misleading information; given that neither consents to this type of loss, it is difficult to support a legal framework that does not apportion it. Investors must have confidence in available remedies if they are to invest.<sup>53</sup> Strict subordination causes shareholders to suffer disproportionately from securities law violations, and in turn, may cause some reluctance to invest.

Strict subordination is further questionable considering comparable jurisdictions have made very different choices. The harshness of the US's 'absolute priority rule'<sup>54</sup> is mitigated by the fair funds provision of the *Sarbanes-Oxley Act*, which allows equity investors harmed by violations of securities law to recover through the Securities and Exchange Commission ("SEC").<sup>55</sup> The SEC ranks equally with unsecured creditors, therefore providing an indirect exception to shareholder subordination. The fair funds provision represents the policy judgement that shareholders should *not* always and *not* automatically be subordinated to a corporation's creditors. With the 2009 amendments, Canada has gone in the opposite direction — one that is somewhat perplexing considering the Senate Report's intention of aligning with the US treatment of equity claims.<sup>56</sup>

---

<sup>53</sup> Sarra, *supra* note 27 at 181.

<sup>54</sup> *US Bankruptcy Code*, 11 USC § 101 (This is the US codification of subordination of equity claims. Section 510(b) provides that "a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims").

<sup>55</sup> *Sarbanes-Oxley Act*, Pub L No 107-204, 116 Stat 745 (2002) at section 308.

<sup>56</sup> For an Australian perspective, see Harris & Hargovan, *supra* note 3 (In Australia, the landmark decision of *Sons of Gwalia Ltd v Margaretic*, [2007] HCA 1, held that shareholders' securities law damage claims were outside the scope of their subordination provision, and therefore were free to rank equally with general unsecured creditors should they succeed. According to Sarra, *supra* note 27 at 217, the basis for this finding was as much a recognition of the important public policy objectives that securities law is meant to fulfill, as it was dependent on the specific statutory language of Australia's subordination provision).

#### IV. POTENTIAL FOR LEGAL REFORM

Legal reform is no easy exercise and the 2009 amendments were certainly the result of significant deliberation. However, according to Anand, “key stakeholders on the regulatory side and the buy-side were not included in the consultation process on the issue of subordination of equity shareholders” — a significant omission considering strict subordination’s impact on the investing public.<sup>57</sup>

While the adoption of strict subordination runs counter to investor protection developments in both Canada and the US, another attempt to mirror US law may prove ill-advised.<sup>58</sup> Any attempt to increase the ability of securities regulators to distribute funds to harmed investors will raise constitutional issues. Bankruptcy and insolvency is an explicit federal head of power and securities law is a matter of provincial jurisdiction.<sup>59</sup> Since application of any fair fund-type provision in insolvency would directly undermine the subordination of equity claims under either the *CCAA* or *BIA*, there is a conflict that would potentially engage the doctrine of paramountcy to render this investor restitution power of little use in insolvency.<sup>60</sup>

A better approach might be to return to the law as it existed pre-2009 by bringing judicial discretion back into the fold. The *CCAA* has been said to be a flexible and remedial statute that serves the broad social and economic objectives of *all interested stakeholders*.<sup>61</sup> The simple solution would be to allow courts to do just that by amending Section 6(8) to permit approval of

---

<sup>57</sup> Anand, *supra* note 49 at 185.

<sup>58</sup> Although provinces have enacted forfeiture of funds provisions, Canadian securities regulators do not yet have a comparable mechanism to the US’ fair funds provision. In Ontario for example, the Ontario Securities Commission has the ability to apply to the courts for an order directing investor restitution, but this has rarely been used. Aggrieved investors are instead mostly left to seek compensation from industry-funded bodies such as the Canadian Investor Protection Fund. See e.g. Drew Hasselback & Barbara Schecter, “The OSC has introduced steps to help recover funds for wronged investors, but are they enough?” *National Post* (30 October 2015), online: National Post <<http://business.financialpost.com/news/fp-street/the-osc-has-introduced-steps-to-help-recover-funds-for-wronged-investors-but-are-they-enough>>.

<sup>59</sup> *Constitution Act, 1982*, being Schedule B to the *Canada Act 1982* (UK), 1982, c 11, ss 91(21), 92(2).

<sup>60</sup> Sarra, *supra* note 27 at 213-4; see also Anand, *supra* note 45 at 178.

<sup>61</sup> *Re Indalex Ltd*, 2013 SCC 6 at para 205, [2013] 1 SCR 271.

a plan that provides payment to equity even where all creditor claims are not met in full.<sup>62</sup> This would allow courts the discretion to have misrepresentation claims stand equally with unsecured creditors, something that would apportion the risk of faulty disclosure between equity and debt holders more fairly.<sup>63</sup>

## V. CONCLUSION

The subordination of shareholder insolvency claims is generally a reasonable policy choice. It is in the nature of shareholders investment that they participate in firm success but also bear the risk of firm failure. That said, shareholder claims are not always those of sore losers beaten fair and square at the investment game. In cases of misrepresentation, shareholders invest expecting to avail themselves of civil liability provisions. It cannot therefore be said that misrepresentation is a risk investors should bear as part of their investment bargain. One must ask: at what cost does it stop making sense to create a framework that makes Canada attractive for insolvency proceedings? Is it worth undermining investor confidence? Because Canadian insolvency law, as it currently stands, weakens investor confidence in the legal structures that govern the industry. To put it in the most Canadian way possible, in insolvency, the misled equity investor is in the precarious position of being up the proverbial creek, without a paddle.

---

<sup>62</sup> Sarra, *supra* note 27 at 210-1 (Writing when the amendments were proposed but not yet enacted, Sarra recommended that rather than a rigid rule, discretion could be maintained by adding the words “unless the court determines that it is ‘fair and equitable’ or ‘fair and reasonable’ to order otherwise.” This approach has subsequently been endorsed by Bill Kaplan “Bul River Mineral Corporation: A Question of Equity”, in Janis P Sarra, ed, *Annual Review of Insolvency Law 2015* (Toronto: Carswell, 2016)(Westlaw) at 29.

<sup>63</sup> For a detailed analysis of the different options for implementing a carve-out from subordination for securities law claims, see Sarra, *supra* note 27 at 222-5.

## LEGISLATION

*Bankruptcy and Insolvency Act*, RSC 1985 c B-3.  
*Companies' Creditors Arrangement Act*, RSC 1985, c C-36.  
*Constitution Act, 1982*, being Schedule B to the *Canada Act 1982 (UK)*, 1982, c 11.  
*Sarbanes-Oxley Act*, Pub L No 107-204, 116 Stat 745 (2002).  
*Securities Act*, RSO 1990, c S.5, ss 56(1).  
*US Bankruptcy Code*, 11 USC § 101.

## CANADIAN JURISPRUDENCE

*Canada Deposit Insurance Corp v Canadian Commercial Bank*, [1992] 3 SCR 558, 97 DLR (4th) 385.  
*Re Blue Range Resources Corp*, 2000 ABQB 4, 259 AR 30.  
*Re Central Capital Corp*, [1996] O.J. No. 359, 132 D.L.R. (4th) 223.  
*Re Indalex Ltd*, 2013 SCC 6, [2013] 1 SCR 271.  
*Re Nelson Financial Group*, 2010 ONSC 6229, 71 CBR (5th) 153.  
*Re Sino-Forest Corp*, 2012 ONSC 4377, 92 CBR (5th) 99.  
*Re Sino Forest Corp*, 2012 ONCA 816, 114 OR (3d) 304.  
*Re Waxman & Sons Ltd*, 89 OR (3d) 427.

## FOREIGN JURISPRUDENCE

*Sons of Gwalia Ltd v Margaretic*, [2007] HCA 1.

## SECONDARY MATERIALS: ARTICLES AND BOOKS

Anand, Anita I. "Should Shareholders Rank with Unsecured Creditors in Bankruptcy?", (2008) 24 BFLR 169.  
Ben-Ishai, Stephanie. "Debt or Equity? A Puzzle for Canadian Bankruptcy Law" (2012) 53 CBLJ 416.  
Davis Jr, Kenneth B. "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) 1 Duke LJ 1.  
Harris, Jason & Anil Hargovan. "The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective" in Janis P Sarra, ed, *Annual Review of Insolvency Law 2007* (Toronto: Carswell, 2008) 699.  
Kaplan, Bill. "Bul River Mineral Corporation: A Question of Equity", in Janis P Sarra, ed, *Annual Review of Insolvency Law 2015* (Toronto: Carswell, 2016)(Westlaw).  
Morin, Luc. "L'insolvabilité en contexte international et l'attitude des tribunaux canadiens" (2007) 28 Ottawa L Rev 129 (see English version online: <[http://www.fasken.com/files/Publication/b67d44b2-6625-4e55-a9b3-113ee303d883/Presentation/PublicationAttachment/ec8fe2c5-a502-4fe0-ae7f-060edbf461e1/Shareholders\\_and\\_corporate\\_insolvency.pdf](http://www.fasken.com/files/Publication/b67d44b2-6625-4e55-a9b3-113ee303d883/Presentation/PublicationAttachment/ec8fe2c5-a502-4fe0-ae7f-060edbf461e1/Shareholders_and_corporate_insolvency.pdf)>.)  
Sarra, Janis. "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings" (2007) 16 IIIR 198.  
Schwill, Robin B. "A Forest for a Tree: A Case Comment on Sino-Forest" (2013) 28 BFLR 507.  
Slain, John J & 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.

## **OTHER MATERIALS: REPORTS, ONLINE PAPERS AND MEDIA**

- Cory, Peter de C & Marilyn L Pilkington. "Critical Issues in Enforcement" in *Canada Steps Up: Task Force to Modernize Securities Legislation in Canada* (Toronto: 2006) 171.
- Hasselback, Drew & Barbara Schecter. "The OSC Has Introduced Steps to Help Recover Funds for Wronged Investors, but are they Enough?" *National Post* (30 October 2015), online: *National Post* <<http://business.financialpost.com/news/fp-street/the-osc-has-introduced-steps-to-help-recover-funds-for-wronged-investors-but-are-they-enough>>.
- Sarra, Janis. "Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions" in *Canada Steps Up: Task Force to Modernize Securities Legislation in Canada* (Toronto: 2006) 7.
- Senate, *Standing Senate Committee on Banking, Trade and Commerce, A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act* (November 2003).
- "Secondary Market Liability in Canada: A Legal Overview" (November 2012), online: Stikeman Elliott LLP <<http://www.stikeman.com/2011/en/pdf/Secondary-Market-Liability.pdf>>.
- "Update on Shareholder and Equity-Related Claims in Insolvency Proceedings", (2003) *INSOL International Technical Series* No 28.