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COMMERCIAL INSOLVENCY REPORTER

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• EQUITY CLAIMS AND THE REFORM OF INSOLVENCY LEGISLATION •

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A 2009 decision of the Alberta Court of Queen’s Bench in *EarthFirst Canada Inc.*¹ has brought attention again to the issue of the characterizations and rankings of equity and equity-type claims in the insolvency context. In *EarthFirst*, Madam Justice Romaine

considered the status of claims of the holders of flow-through common shares in the insolvency context, in particular claims of the shareholders arising from rights to indemnification given by the company. Justice Romaine concluded that the characterization

of the claims was difficult, but that the claims were, at their core, equity claims and therefore subordinate to the claims of the company's creditors. In reaching her conclusion she considered (but could not apply) amendments to the *Companies' Creditors Arrangement Act* [CCAA] that were about to come into force. These amendments were intended to provide clarity and greater certainty: clarifying that equity claims are subordinate to debt claims and providing guidance to assist courts in characterizing claims as equity or debt.² As the relevant amendments are now in force, the *EarthFirst* decision provides an appropriate context for reviewing the origin and purpose of this aspect of insolvency law reform.

THE *EARTHFIRST* DECISION AND THE TREATMENT OF EQUITY CLAIMS

EarthFirst was a developer of renewable wind energy. EarthFirst's capital structure included flow-through common shares. Flow-through common shares are securities that are issued to help finance project development activities. The securities have the features of common shares, but are supplemented by a flow-through feature that allows the issuer to transfer (or "renounce") expenses related to project development activities to the holders of the securities. These expenses can then be applied against the earnings of the holder to reduce taxable income. If project development expenses are not renounced, the shareholder may lose part of the value of the original investment.

When EarthFirst issued its flow-through common shares, it agreed with the shareholders to incur and renounce certain project development expenses or, alternatively, to indemnify the shareholders in respect of the tax consequences of failing to do so:

Pursuant to the Subscription Agreement, the Corporation will covenant and agree: (i) to incur on or before December 31, 2008, and renounce to the Flow-Through Subscriber effective on or before December 31, 2007, CEE in an amount equal to the aggregate purchase price paid by such Flow-Through Subscriber, and (ii) that if the Corporation does not renounce to such Flow-Through Subscriber, effective on or before December 31, 2007, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provisions of the Tax Act, the Corporation shall indemnify the Flow-Through Subscriber as to, and forthwith pay in settlement thereof to such Flow-Through Subscriber, an amount equal to the amount of any tax payable or that may become payable under the Tax Act (and under any corresponding provincial legislation) by the Flow-Through Subscriber as a consequence of such failure or reduction.

[Emphasis added.]³

On November 4, 2008, EarthFirst commenced proceedings under the CCAA. As part of the CCAA proceedings, EarthFirst sought a purchaser for its Dokie I wind power project, whose development was a condition of allowing the company to meet its obligation to renounce project development expenses. Because the sale and continued development of the Dokie I project was uncertain, it was possible that EarthFirst would be unable to meet its obligation to renounce project development expenses. This would give rise to claims in respect of the rights to indemnification promised by EarthFirst. EarthFirst therefore sought a declaration from the Court as to the status of the rights to indemnification that the holders of the flow-through common shares could have.⁴

Justice Romaine had to consider whether the rights to indemnification that the holders of the flow-through common shares could have were debt claims or equity claims. She found that those claims were at their core equity claims. She noted that equity claims may have some features of a debt, and that in some instances equity may be transformed and become debt, making the characterization of the claims difficult. In respect of the flow-through shares of EarthFirst, the rights to indemnification were merely "sweeteners" associated with the sale of those securities. She also noted that the claims derived from the status of the claimants as subscribers for the flow-through common shares, and that the purpose of the claims was to recoup a portion of what had originally been invested by the holders of the flow-through shares — in essence, a claim for the return of the equity investment. Justice Romaine held that the renunciation of project development expenses was merely an incidental aspect of the flow-through shares, secondary to the common share features of the securities.⁵ She noted the difficulty in this case of characterizing the claims, acknowledging that "this type of indemnity skirts close to the line that courts are attempting to draw with respect to the characterization and ranking of equity and equity-type investments in the insolvency context."⁶

In concluding that the claims of the holders of EarthFirst's flow-through common shares must rank behind the claims of creditors, Romaine J. noted that the position of the shareholders was analogous to the position of similarly situated shareholders in *National Bank of Canada v. Merit Energy Inc.*,⁷ making the difficult line-drawing exercise easier for the court in *EarthFirst*. In *Merit Energy*, Mr. Justice LoVecchio had also considered claims for indemnification made by the holders of flow-through common shares, and he held that they were also equity claims:

The second claim of the Flow-Through Shareholders has some of the features of a debt and the Subscription and Renunciation Agreements provide for a specific remedy in the event Merit fails to comply with its undertaking to make and renounce the CEE expenditures.

... The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares. In essence, what happens in a flow-through share offering (as sanctioned by the Income Tax Act) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes) by the amount of the deductions utilized by the purchaser.

While the Flow-Through Shareholders paid a premium for the shares (albeit to get the deductions), in my view the debt features associated with the CEE indemnity from Merit do not “transform” that part of the relationship from a shareholder relationship into a debt relationship. That part of the relationship remains “incidental” to being a shareholder.

In summary, the Flow-Through Shareholders’ claims, regardless of the basis chosen to support them, are in substance claims for the return of their equity investment and accordingly cannot rank with Merit’s unsecured creditors.⁸

In addition to relying on this reasoning from *Merit Energy*, Romaine J. considered amendments to the *CCAA* that had been passed by Parliament but not proclaimed into force at the time the *EarthFirst* decision was made. Those amendments to the *CCAA* (as discussed below) explicitly address the status of equity claims in insolvency proceedings. Among other things, the amendments prohibit the payment of dividends in respect of equity claims until all other claims are satisfied, and they define equity claims very broadly to capture all claims relating to equity interests, including, therefore, claims relating to the flow-through common shares.

While Romaine J. could not apply these amendments to the claims of the holders of *EarthFirst*’s flow-through common shares, the reference to them suggests that, had the amendments been in force, they would have been determinative of the issue. The amendments, if they could have been applied, would therefore have made the line-drawing exercise for equity claims much easier because the claims at issue were captured by the

amended *CCAA*. The amendments to the *CCAA*, and the related amendments to the *BIA*, were intended to have this effect to make it easier to deal with equity claims in insolvency proceedings, and to bring certainty to this area of the common law.

THE STATUS OF THE COMMON LAW REGARDING EQUITY CLAIMS

In *Merit Energy*, LoVecchio J. had reviewed the status of the common law as it relates to characterizing equity claims in the insolvency context. The position of equity claims relative to debt claims is clear: they rank behind claims of creditors in insolvency, but characterizing a claim as equity or debt is often a difficult interpretative exercise, as Romaine J. acknowledged in *EarthFirst*.⁹

The Supreme Court of Canada addressed the characterization issue in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*.¹⁰ In that case, the Supreme Court had to determine whether an agreement to participate in a portion of a bank’s loan portfolio was an equity investment or a loan. The Supreme Court noted that the characterization exercise was a matter of interpreting the agreements in question to see what the parties reasonably intended, and that the exercise could be a difficult one. Writing for the Court, Mr. Justice Iacobucci stated that “the characterization issue facing this Court must be decided by determining the intention of the parties to the supporting agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention.”¹¹ In *CDIC*, the agreements included characteristics associated with both debt and equity financings, but in substance the agreement was a loan agreement. Reaching this conclusion was not a straightforward matter, as reflected in the Court’s reasoning:

Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in stance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an

agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. 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.¹²

[Emphasis in the original]

In *Re Central Capital Corporation*,¹³ the Court of Appeal for Ontario had to characterize a claim arising from the right of retraction in respect of certain preference shares: did the holders of those preference shares have a provable claim under the *BIA* in respect of the right to require the company to redeem the preference shares? Although the relationship of the holders of the preference shares had characteristics of both debt and equity, the Court of Appeal held that, in substance, the holders of the preference shares had equity claims with respect to their right of retraction, which provides for the return of capital, not for the repayment of a loan.

As Romaine J. noted in *EarthFirst*, an equity claim may also be transformed into a debt claim, and whether or when this happens is a matter of characterization. Some of the claims of issue in *Merit Energy*, and claims at issue in an earlier decision of Romaine J. in *Blue Range Resource Corporation*,¹⁴ were claims by shareholders for damages based on misrepresentations made when their shares were acquired. The courts in both cases held that the fact that the shareholders may have claims in tort does not transform those claims into debt claims — the claims remained equity claims because they were derived from the claimants' status as shareholders and in connection with the equity investment. In *Blue Range*, Romaine J. held that the claim of the shareholder (Big Bear) was in substance an equity claim:

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. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment.¹⁵

This analysis and the conclusion accord with the policy rationale that underlies the ranking of equity and debt claims in the insolvency context, identified by Romaine J. in *Blue Range*: even defrauded shareholder claimants are presumed to have bargained for equity-type profits, and assumed equity-type risks, whereas creditors are presumed to have dealt with the company on the basis that their claims were in priority to such shareholder claims.

While in *Merit Energy* and *Blue Range* the shareholders' claims were characterized as equity claims, the Court came to a different conclusion in *Re I. Waxman & Sons Limited*.¹⁶ In that case, the claimant had obtained a judgment in an oppression action in his capacity as a shareholder. However, the Court concluded that this claim, which began in equity, was properly characterized as a debt claim: "By virtue of the judgment, the money award becomes debt and is properly the subject of a proof of claim in bankruptcy. In this regard, the facts in this case are unlike those in [*Blue Range*] or [*Merit Energy*]. Those cases involved causes of action that had been asserted in court proceedings but in neither case had judgment been rendered."¹⁷

More recently, an inter-company claim in *Smurfit-Stone Container Canada Inc.* had to be characterized as part of a *CCAA* proceeding.¹⁸ A loan had been advanced between affiliates, the terms of which required that, on an insolvency, the loan would be repayable in shares of the borrower. The borrower argued that the parties intended the investment to be an equity investment in the event of an insolvency, and therefore the claim should be characterized as an equity claim. The Court rejected this argument, finding that the intention of the parties, as revealed by the agreement between them, was that the investment was a loan, albeit one repayable in equity in certain circumstances.¹⁹

REFORM OF INSOLVENCY LAW

As the cases discussed above indicate, the characterization of claims as debt claims or equity claims can be difficult, resulting in uncertainty. This led to the reform of insolvency law and the amendments to the *CCAA* that Romaine J. referred to in *EarthFirst*, and to parallel amendments to the *BIA*.

The need for reform, and the suggested scope of the reform, was addressed in 2002 by the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals in the *Report of the Joint Task Force on Business Insolvency Reform*.²⁰ The Joint Task Force recommended that insolvency legislation be amended to address the circumstances that arise in the cases discussed above, and to provide that "all claims against a debtor in an

insolvency proceeding that arise under or relate to an instrument that is in the form of equity, including claims for payment of dividends, redemption or retraction or repurchase of shares and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor.²¹ The list of specific claims in the proposal captures the kinds of claims that were at issue in *Central Capital*, *Merit Energy*, *Blue Range* and *EarthFirst*. The principled rationale for the proposed reform was consistent with the principles identified by Romaine J. in *Blue Range* and applied by the Court in that case: equity investors bargain for claims of lower priority than debt claims. Clarifying this in amendments to the *CCAA* and *BIA* would provide greater certainty.

The Standing Senate Committee on Banking, Trade and Commerce came to the same conclusion in a 2003 report. The Committee recommended that insolvency legislation should be amended to clarify the subordination of equity claims: “their claims should be afforded lower ranking than secured and unsecured creditors, and the law — in the interests of fairness and predictability — should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full.”²²

The recommended reform to insolvency law was ultimately passed into law as amendments to the *CCAA* and *BIA*. The amendments addressing the status of equity claims were presented in Bill C-12 in 2007, and came into force on September 18, 2009.²³

The amendments to the *CCAA* and *BIA* effected through Bill C-12 clearly subordinate equity claims. The amendments exclude the entire class of creditors having “equity claims” from the right to vote on a plan or proposal unless the court orders otherwise, and they prohibit the court from approving a plan or proposal that provides for the payment of an equity claim, unless all other claims are to be paid in full before the equity claims are paid.²⁴ The amendments, in addition, provide that equity claims based on misrepresentations (*i.e.*, the claims in *Merit Energy* and *Blue Range*) may be compromised in a plan or proposal, and will be discharged in a bankruptcy.²⁵

The amendments define “equity claim” very broadly to include any claim relating to an “equity interest,” defined as a share in a corporation, including a warrant, option or other right to acquire a share, or in the case of an income trust an income trust unit or an option, warrant or other right to acquire a unit in the income trust. An “equity claim” is defined in the amendments as follows:

a claim that is in respect of an equity interest, including a claim for, among others,

- (a) a dividend or similar payment,
- (b) a return of capital,
- (c) a redemption or retraction obligation,
- (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
- (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d)²⁶

The stated purpose of the amendments is consistent with the recommendations and proposals that preceded them. Industry Canada’s clause-by-clause analysis of the amendments notes, in reference to the provision in the *CCAA* restricting the voting rights of creditors with equity claims, that “[t]he amendment is one of several made with the intention of classifying that equity claims are to be subordinate to other claims. Equity claims are ownership interests, and as such, should be subject to the risks of insolvency.”²⁷ In order to achieve that intended purpose, the amendments have defined equity claims as broadly as possible to include any claim that relates to an equity interest, including but not limited to the kinds of claims dealt with in cases such as *Central Capital*, *Merit Energy*, and *Blue Range*.

CONCLUSION

In referring to the amendments to the *CCAA* in *EarthFirst*, Romaine J. suggests that, had she been able to apply them, the characterization exercise in respect of the claims of the holders of flow-through common shares would have been less difficult because the claims would have fallen squarely within the broad definition of equity claims included in the amendments to the *CCAA*, and therefore would have clearly been subordinate to equity claims in the ways specified by the *CCAA*. It remains to be seen whether the amendments to the *CCAA* and *BIA* will make the characterization of claims as equity or debt less difficult, thereby bringing clarity and certainty to this area of insolvency law.

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¹ [2009] A.J. No. 749, 2009 ABQB 316 (Q.B.) [*EarthFirst*].

² The amendments to the *Companies’ Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [*CCAA*] and the

- 3 *Bankruptcy and Insolvency Act*, R.S.C 1985, c. B-3 [BIA], and the background to the amendments, are described below in the third section of the article.
- 4 This description of the obligation is quoted from the prospectus of EarthFirst, dated November 27, 2007 and accessed through <www.sedar.com>.
- 5 EarthFirst ultimately entered into an agreement to sell the Dokie I project, and the asset purchase agreement included a covenant by the purchaser to make reasonable commercial efforts to complete the steps necessary to allow project development expenses to be renounced to the holders of the flow-through common shares. EarthFirst exited the CCAA proceedings by amalgamating with Maxim Power Corp. in March 2010.
- 6 *EarthFirst*, *supra* note 1 at para. 4.
- 7 *Ibid.*
- 8 *National Bank of Canada v. Merit Energy Ltd.*, [2001] A.J. No. 918, 2001 ABQB 583 (Q.B.) [*Merit Energy*].
- 9 *Ibid.* at paras. 52-55.
- 10 *Ibid.* at paras. 23 to 30.
- 11 [1992] S.C.J. No. 96, [1992] 3 SCR 558 [*CDIC*].
- 12 *CDIC*, *supra* note 10 at para. 51.
- 13 [1996] O.J. No. 359, 27 O.R. (3d) 494 (C.A.) [*Central Capital*].
- 14 [2000] A.J. No. 14, 15 CBR (4th) 169 (Alta. Q.B.) [*Blue Range*].
- 15 *Ibid.* at para. 23.
- 16 [2008] O.J. No. 885 (S.C.J.) [*Waxman*].
- 17 *Ibid.* at para. 25.
- 18 Unreported decision of the Honourable Madam Justice Pepall, Ontario Superior Court of Justice, January 28, 2010, accessed online at <http://www.deloitte.com/view/en_CA/ca/specialsections/insolvencyandstructuringproceedings/smurfitstonecontainercanada/index.htm> [*Smurfit Stone*].
- 19 The court in *Smurfit Stone* went on to find that, although the claim was a debt claim, it was not a claim provable in bankruptcy within the meaning of s. 121 of the BIA, and was therefore not a claim for the purposes of s. 12(1) of the CCAA.
- 20 Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, *Report of the Joint Task Force on Business Insolvency Reform*, March 2002. Some of the background that preceded the amendments is discussed in an excellent article by J. Sarra, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings," 16 *Int. Insolv. Rev.* (2007) 181.
- 21 *Ibid.* proposal #62.
- 22 Senate Standing Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*, November 2003, at 158-159.
- 23 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, 2005*. The legislation had a long history, having been introduced through a prior bill (Bill C-55) that was passed but never proclaimed into force. For the background, see: Legislative Summary, *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, 2005*, accessed online at <www2.parl.gc.ca/Sites/LOP/LegislativeSummaries>.
- 24 CCAA, ss. 6(1), 6(8), 22.1; BIA, ss. 54.1, 54(2)(d), 60(1.7).
- 25 CCAA, s. 9(2)(d); BIA, s. 178(1)(e).
- 26 CCAA, s. 2(1); BIA, s. 2.
- 27 Industry Canada, *Bill C-12: Clause by Clause Analysis*, accessed online at <<http://www.ic.gc.ca/eic/site/bsf-osf.nsf/eng/br01978.html>>. See, also the analysis of the earlier amendments in Bill C-55: Industry Canada, *Bill C-55: Clause by Clause Briefing Book*, accessed online at <<http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/c100833.html>>.