Intercorporate Debt and Equitable Subordination: One Case Forward and One Case Back

Jeremy Opolsky[*]

This article explores the perplexing status of the doctrine of equitable subordination in Canada. Equitable subordination — the subordination of a claim on the basis of a creditor's misconduct — has an uncertain place in Canadian insolvency law. More than 30 years after Canadian courts first considered whether the United States ("US") doctrine of equitable subordination has a home in Canada, there is no clear answer. This question has come before the Supreme Court of Canada twice. Both times the high Court has passed on answering. Recent cases have gone both ways on whether the doctrine exists in Canada. If the doctrine is available, even fewer cases have examined the conditions for its application.

Yet, answers on equitable subordination are increasingly relevant, especially in the context of intercorporate group debt. In two recent Canadian cases, *Target* and *US Steel*, creditors have sought to equitably subordinate the debts of the Canadian subsidiary's US parent or affiliates.[1] Because of the continuing uncertainty surrounding the doctrine, creditors continue to

* Jeremy Opolsky is an associate at Torys LLP. The author is admitted to the bars of Ontario and New York. The views expressed in this article are those of the author only and do not necessarily represent the views of his firm or his firm's clients. Many thanks to Jonathan Silver and Winston Gee, student-at-law and summer student respectively, for their invaluable research and editing assistance. Thank you also to Scott Bomhof, Andrew Gray and Alison Bauer for their thoughtful and probative edits to this article. Any errors remain, of course, those of the author alone.

1 *Re US Steel Canada Inc*, Court File No CV-14-10695-00CL (Ont SCJ) [*US Steel*]; *Re Target Canada Co*, Court File No CV-15-10832-00CL (Ont SCJ) [*Target*].

seek to subordinate the claims of corporate affiliates. This uncertainty is the focus of this article.

The first section of this article looks broadly at the use of equitable subordination to challenge intercorporate debt, highlighting the *Target* and *US Steel* cases. The second section looks at the law of equitable subordination, providing a summary of the doctrine in the US and its origins in Canada. The third section looks at recent cases, *ie*, those cases in the past 10 years, of equitable subordination in Canada and the relevant issues raised therein. These issues include whether the doctrine of equitable subordination is available in Canada at all, whether it requires a showing of inequitable conduct, and, if so, what is sufficient misconduct to warrant an application of the doctrine. This section draws on comparable US case law to explore the relevant issues.

I. INTERCORPORATE DEBT: THE CHALLENGE OF EQUITABLE SUBORDINATION

Intercorporate debt is a reality of modern corporate groups. Corporations lend to their subsidiaries and affiliates to help these businesses begin, in the ordinary course, as intercompany loans and cash management, or when such corporations are in financial distress. The latter situation is not unusual. As the US Court of Appeals for the Seventh Circuit's apt narrative describes:

> [a] business is ailing. Revenues are down, profits gone. Rather than let it die, the owners decide to try reviving it. Doing so will require an infusion of new funds. The owners drum up the needed funds but face a choice: which legal form should the owners use, equity or debt?[2]

As the Seventh Circuit went on to note, a company will often choose to finance its subsidiary or affiliate in the form of debt. This decision "will provide the firm with needed funds while limiting the owners' risk that the company will go

2 *In re Lifschultz Fast Freight*, 132 F 3d 339 at 341 (7th Cir 1997) [*Lifschultz Fast Freight*].

bankrupt and the new funds will end up in the wallets of the unsecured creditors".[3] This question can become highly relevant if the debtor company becomes insolvent and files for creditor protection. Instead of holding solely equity interests, which recover at the end of the queue only after all of the creditors have been paid in full, the debtor's parent or affiliate may hold large debt claims that could share with, or if secured take precedence over, the claims of arm's length creditors.

Unsecured creditors of the debtor can object to the idea of the debtor's estate being distributed, in whole or in part, to its parent corporation as a result of its debt claims. Such creditors often seek to challenge the debt of these insiders utilizing two different, but related, doctrines. The first is the doctrine of recharacterization, which looks to ascertain the "true nature" of the claim and whether a debt claim should be recharacterized as equity.[4] This doctrine has been widely adopted not only in relation to insolvency, but also in relation to tax and criminal law.[5] It is now effectively embedded in Canada's insolvency statutes.[6]

The second doctrine is equitable subordination. Under this doctrine, the otherwise valid debt claims of a creditor may be subordinated to the claims of a debtor's other creditors. [7] For the claim to be subordinated, it must have arisen from some inequitable conduct of the creditor that has resulted in loss to the debtor's other creditors or that has conferred an unfair advantage on the impugned creditor. This doctrine originated in the United States under the

3 *Ibid* at 342-43.

4 *Canada Deposit Insurance Corp v Canadian Commercial Bank*, [1992] 3 SCR 558, 1992 CarswellAlta 298 [*CCB* cited to CarswellAlta]; *Re Central Capital Corp* (1996), 132 DLR (4th) 223 (Ont CA).

5 See, *eg*, *Bimman v Neiman*, 2015 ONSC 2313; *Joy Estate v 1156653 Ontario Ltd* (2007), 38 BLR (4th) 69 (Ont SCJ); *Big Comfy Corp v R*, [2002] 3 CTC 2151 (TCC [General Procedure]).

6 *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 s. 45 [*CCAA*]; *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*].

7 *CCB*, *supra* note 4 at para 89.

common law and then was codified into the United States *Bankruptcy Code*.[8]

In the context of challenges to intercorporate debt, recharacterization and equitable subordination often arise in similar circumstances. However, the differences between the doctrines are important. Recharacterization looks at whether a claim is indeed founded in debt and, if a challenge is successful, will treat a claim as equity. It requires no inequitable conduct or proof of harm by the claimant — it is a doctrine of interpretation and not based on equitable principles. Equitable subordination takes the claim's status as debt or secured debt as given and then, based on equitable principles, seeks to subordinate it to other unsecured claims.[9] Equitable subordination is inherently a doctrine of "simple fairness"[10] and is intended to be used "sparingly".[11]

In *Target* and *US Steel*, creditors raised both recharacterization and equitable subordination in their challenges to the claims submitted by the debtors' affiliate and parent respectively.

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8 US *Bankruptcy Code*,11 USC § 101 *et sesqui.*

9 *Matter of Mobile Steel C*, 563 F 2d 692 at 702 (5th Cir 1977) [*Mobile Steel*]. "It is important to remember that the issue is not whether the advances 'actually' were loans, but whether equity requires that they be regarded as if they were something else." See also, Janis P Sarra, "Corporate Group Insolvencies: Seeing the Forest and the Trees" (2008) 24 *BFLR* 63, explaining the difference between equitable subordination, piercing the corporate veil and recharacterization.

10 *Re General Chemical Canada Ltd*, (2006), 22 CBR (5th) 298, 2006 CarswellOnt 4675 (Ont SCJ [Commercial List]) at para 92 [*General Chemical*].

11 *Ibid*. See also, *Lifschultz Fast Freight*, *supra* note 2 at 341 ("Equitable subordination is a 'drastic' and 'unusual' remedy.")

1. Target[12]

Target Corporation ("Target US") is a large, successful US retailer. In 2011, it began its expansion into Canada. Its indirect Canadian subsidiary, Target Canada Co ("Target Canada") entered into leases for 137 retail premises, in addition to acquiring three retail locations. Its Canadian expansion, however, did not meet with the same success and ended in a well-publicized failure. In January 2015, Target Canada and several of its affiliates ("the Canadian debtors") filed for protection under the *CCAA*. It liquidated its assets, including its real property interests.

During the ramp up of its business, the Canadian debtors were reliant on their US affiliates for financing, including financing for its real estate investments. As such, by January 2015, the Canadian debtors had significant levels of intercorporate debt. In all, there were 29 intercorporate debt claims. Twenty-two of these claims were between Canadian debtors themselves. Of these claims, three were the most significant. The first was a claim of a subsidiary of Target US for $3.07 billion against Target Canada. Target US agreed to subordinate this claim in favour of the other Canadian creditors.[13]

The second and third claims revolved around Target Canada's real estate interests. For tax reasons, Target Canada entered into a sublease/leaseback arrangement with different Canadian Debtors, first Target Canada Property LP ("Prop LP") and then Target Canada Property LLC ("Prop LLC"). Prop LP and Prop LLC were Canadian debtors, but they were not subsidiaries of Target Canada. Any eventual recoveries of Prop LP and Prop LLC would not flow to creditors of Target Canada.[14]

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12 *Target*, *supra* note 1. The author is the solicitor of record for a landlord creditor of Target Canada. The views expressed herein are his own and do not necessarily reflect the views of his client.

13 *Ibid* (Twelfth Report of the Monitor (Monitor's Intercompany Claims Report), 31 August 2015).

14 *Ibid* at 51.

Prop LP and Prop LLC were responsible for $1.4 billion in leasehold improvements to Target Canada's stores. Originally Prop LP, and then subsequently Prop LLC, subleased the stores from Target Canada before the improvements and then leased the stores back once the stores were ready for their customers.[15] In February 2015, Target terminated its leasing arrangements with Prop LLC, triggering an early termination payment under their agreements. As a result, Prop LLC filed a $1.91 billion claim against Target Canada. Prop LP filed a claim of $1.45 billion against Prop LLC, arising from the transfer of the subleases from Prop LP to Prop LLC.

In May 2015, a group of creditors filed a motion seeking the appointment of a committee of creditors to represent the interests of the suppliers of goods and services to Target Canada. They indicated that the committee's main objective would be the subordination or extinguishment of the claim of Prop LLC against Target Canada and all intercompany claims.[16]

Partially as a result of this motion, the claims procedure order required the monitor to produce a report on the intercompany claims. It did so, finding the above three claims to be valid and finding no issues with their quantum. However, the report did not expressly consider or address equitable issues, such as the doctrine of equitable subordination.[17] The issue remains before the court.

2. US Steel

In October 2007, US Steel Corporation ("USS") acquired the assets of Stelco Inc and its subsidiaries, consisting largely of two principal facilities in Lake Erie and in Hamilton. The facilities are operated by its Canadian subsidiary, US Steel Canada ("USSC"). When USS purchased the assets of Stelco

15 *Target*, *supra* note 1 (Twelfth Report of the Monitor (Monitor's Intercompany Claims Report), 31 August 2015, at 54-58).

16 *Ibid* at 71.

17 *Ibid* at 10.

Inc, it gave a series of undertakings to the Canadian government as to the state of USSC's future operations. These undertakings were with respect to its production levels, its employment levels, and with respect to the degree of Canadian control and management over USSC. From the date of USCC's acquisition to 2014, USS provided significant financing to USSC.[18]

In September 2014, USSC filed for protection under the *CCAA*. USS and its subsidiaries filed 14 proofs of claim in the *CCAA* process. The scope of the claims were broad and included secured and unsecured claims of both a contingent and non-contingent nature, including trade claims paid by USS, unsecured claims for intercompany invoices, a claim for interest arising from term and revolving loan agreements, and contingent claims related to various guarantees provided by USS on behalf of USSC. In the aggregate, these claims were secured claims in the amount of US $122 million, unsecured claims in the amounts of US $127 million and $1.84 billion, and a contingent secured claim in the amount of $78 million.[19]

The court-appointed monitor filed a report on the claims USS filed. It recommended that USS bring a motion for court approval of its claim, subject to the court's determination of any objections. Accordingly, USS filed its claims and three parties filed relevant objections: the Province of Ontario, the United Steels Workers ("USW"), and two individual retirees (the "retirees"). Each objecting party submitted that the USS claims should be recharacterized as equity and/or that USS's security should be invalidated as fraudulent preferences or fraudulent assignments. While concerns of preferences, assignments, and characterization are important questions for the determination of intercorporate debt, they lie outside of the scope of this article.

18 *US Steel*, *supra* note 1 (Seventh Report of the Monitor, 9 March 2015, para 9).

19 *Re US Steel Canada Inc*, 2015 ONSC 5103 at para 9 [*US Steel Decision*].

In addition, the USW argued that USS's claims should be subordinated on three bases. First, the USW alleged that that USS had acted in an oppressive manner toward the USW's members, in that USS had failed (i) to comply with its undertakings to the federal and provincial governments; (ii) to make a good faith effort to run USSC as a viable business; (iii) to maintain the viability of the USW pension plan; and (iv) to avoid incurring debt to USS that would seriously dilute USW's recovery. Second, the USW alleged that USSC had breached its fiduciary duties owed to pension plan beneficiaries as the pension administrator by, among other things, diverting production from the Canadian facilities to the US facilities. Third, the USW alleged that the USS controlled USSC to further its own interest and should be equitably subordinated to the claims of USSC's other creditors.

The retirees also argued that the claims of USS should be dismissed or subordinated to the claims of other creditors on the basis of USS's actions as the controlling shareholder of USSC. Although not expressly framed as such, the *CCAA* judge considered the claim to be an application of the doctrine of equitable subordination.[20] Ontario made no comparable claim for the subordination of USS's claims. In August 2015, the *CCAA* judge decided that the doctrine of equitable subordination was not available. The decision is discussed at more length below.

II. EQUITABLE SUBORDINATION IN US AND CANADA

The doctrine of equitable subordination developed in the US without statutory imprimatur. Rather, US courts determined that bankruptcy courts, as courts of equity, had the authority to subordinate a creditor's claim because of the inequitable conduct of that creditor. For the first 40 years of the doctrine, courts developed principles that underlay the application of equitable subordination. In 1978, the new bankruptcy statute

20 *Ibid* at para 34.

codified equitable subordination. When Canadian courts first began to consider the availability of equitable subordination in Canada, they did so in reference to the doctrine in the US, expressly citing US jurisprudence.[21] Canada finds itself in a similar place to the pre-codification era in the US, as the courts struggle to determine whether the doctrine is applicable without a statutory basis. In the 1992 case of *Canada Deposit Insurance Corp v Canadian Commercial Bank*[22] (referred to below as *CCB*), the Supreme Court of Canada first addressed equitable subordination. The Court referenced the US definition and test for the doctrine. Nonetheless, the Court declined to determine whether the doctrine was applicable in Canada.

The first subsection below first looks at the development of the doctrine in the US, both before and after its codification in the US *Bankruptcy Code*. The second part of this section looks at the early treatment of this doctrine in Canada, the Supreme Court's decision in *CCB* and the subsequent treatment in Canadian courts.

1. The Origin of the Doctrine in the US

A discussion of the doctrine of equitable subordination in Canada must begin with the context of the US jurisprudence. The Canadian jurisprudence has always rooted itself with reference to the doctrine in US law. However, Justice Pepall, then of the Ontario Superior Court of Justice, has cautioned against the "danger associated with taking a doctrine divorced from its legal home and applying it" in Canada without a deep knowledge of "the origin, development and legal system from which it originated".[23]

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21 *Laronge Realty Ltd v Golconda* (1986), 7 BCLR (2d) 90, 1986 CarswellBC 496 (BCCA) at paras 26-27 [*Laronge*] (*citing Pepper v Litton*, 308 US 295 (1939)).

22 *CCB*, *supra* note 4.

23 *Re I Waxman & Sons Ltd* (2008), 89 OR (3d) 427, 2008 CarswellOnt 1245 (Ont SCJ [Commercial List]) at para 33 [*Waxman*].

i. Pre-statutory history of equitable subordination: origins in equity

At its origin, the principle of equitable subordination was inferred from the equitable jurisdiction of the bankruptcy court. The US Supreme Court affirmed and applied the doctrine in *Pepper v Litton*, a 1939 case decided under the *Bankruptcy Act of 1898*.[24] The Supreme Court described the basis of its jurisdiction as the court's wide, equitable powers: "a bankruptcy court is a court of equity at least in the sense that in exercise of the jurisdiction conferred upon it by the *Act*, it applies the principles and rules of equity jurisprudence". As such, it found that a bankruptcy court may "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankruptcy estate".[25] In *Pepper*, the dominant and controlling shareholder of the debtor corporation had caused the debtor corporation to recognize a significant wage liability to the shareholder in order to defeat an arm's length creditor of the debtor holding an unliquidated claim. The Court emphasized the particular applicability of subordination to a corporation's insiders: the court's duty to look at the equities of a claim was "especially clear when the claim seeking allowance accrues to the benefit of an officer, director or stockholder".[26]

In *Taylor v Standard Gas & Electric Co*, a similar case decided in the same year, the US Supreme Court determined that the claim of a parent against its wholly-owned subsidiary would be subordinated to the preferred stockholders.[27] The inequitable activities forming the basis of this subordination were the parent's breach of its fiduciary duties and "abuses in management", including the payments of large dividends to

24 *Pepper v Litton*, 308 US 295 (1939) [*Pepper*].
25 *Ibid* at 304, 308.
26 *Ibid* at 306.
27 *Taylor v Standard Gas & Electric Co*, 306 US 307 (1939) [*Taylor*].

preferred shareholders in order to prevent them from exercising any control over the company.[28]

In both *Pepper* and *Taylor*, the US Supreme Court's analysis was based on a consideration of equity: the Court did not articulate any structured test to apply the newly formed doctrine. In 1946, the US Supreme Court affirmed that bankruptcy courts could subordinate claims in order "to prevent the consummation of a course of conduct by [a] claimant which ... would be fraudulent or otherwise inequitable".[29]

In the seminal case of *Mobile Steel* (1977), the US Court of Appeals for the Fifth Circuit finally articulated a three part test for the application of equitable subordination:

> [T]hree conditions must be satisfied before exercise of the power of equitable subordination is appropriate.
>
> (i) The claimant must have engaged in some type of inequitable conduct.
>
> (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
>
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the *Bankruptcy Act*.[30]

This test has been widely adopted throughout different US jurisdictions.[31] The US Supreme Court, in its most recent treatment of equitable subordination, referenced the *Mobile Steel* factors, although it fell short of expressly endorsing them.[32]

28 *Ibid* at 323.

29 *Heiser v Woodruff*, 327 US 726 at 733 (1946).

30 *Mobile Steel*, *supra* note 9 at 699-700 (citations omitted).

31 *In re Baker & Getty Fin Servs, Inc*, 974 F 2d 712 at 717-18 (6th Cir 1992): "Most courts have uniformly followed and applied the Mobile Steel test".

32 *United States v Noland*, 517 US 535 at 538-39 (1996) [*Noland*].

The doctrine of equitable subordination is a narrow remedy and is usually only applied[33] to corporate insiders.[34] When considering a transaction with a corporate insider, courts have held that the transaction "must be subject to rigorous scrutiny". If the initial challenge to the transaction raises questions, the burden shifts to the insider to prove that the transaction is not inherently inequitable.[35] Claims for the equitable subordination of non-insider creditors, *ie*, those creditors that dealt at arm's length with the debtor, face a higher onus.[36] The Court of Appeals for the Seventh Circuit has remarked that instances of such cases are "few and far between".[37]

ii. Section 510(c): rooting equitable subordination in the US Bankruptcy Code

After years of only common law authority, the *Bankruptcy Code of 1978* introduced a statutory provision dealing directly with equitable subordination. Section 510(c) provides that after notice and a hearing, the court may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest".[38]

33 *Lifschultz Fast Freight*, *supra* note 2 at 343. *Kham & Nate's Shoes No 2, Inc v First Bank of Whiting*, 908 F 2d 1351 at 1356 (7th Cir 1990) [*Kham & Nate's Shoes No. 2*] ("Equitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy.").

34 The US *Bankruptcy Code*, 11 USC, § 101(31) defines an insider of a corporation to include: "(i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, office or person in control of the debtor" or an "affiliate, or insider of an affiliate".

35 *Matter of Herby's Foods, Inc*, 2 F 3d 128 (5th Cir 1993) (citing *Mobile Steel*, *supra* note 9 at 699-700).

36 *Anaconda-Ericcson, Inc v Hessen (In re Teltronics Serv, Inc)*, 29 BR 139 at 169 (Bankr EDNY 1983); *ABF Capital Mgmt v Kidder Peabody & Co (In re Granite Partners)*, 210 BR 508 at 515 (Bankr SDNY 1997).

37 *Kham & Nate's Shoes No. 2*, *supra* note 33 at 1356.

38 US *Bankruptcy Code*, 11 USC § 510(c)(1).

Although equitable subordination is now expressly recognized by statute, application of the doctrine continues to draw heavily on the same body of common law as it did before its codification in 1978. Section 510(c) provides "no explicit criteria for equitable subordination".[39] Rather, the courts have interpreted the words of the provision — the reference to the existing "principles of equitable subordination" — and legislative history to imply that the introduction of § 510(c) did little to change the foundations of the doctrine or restrict its application.[40] Indeed, the report of the House of Representatives on § 510(c) stated that the section was "intended to codify case law, such as *Pepper v. Litton* and *Taylor v. Standard Gas and Electric Co* and was not intended to limit the court's power in any way".[41]

2. Equitable Subordination in Canada

The doctrine of equitable subordination has had a trying history in Canada. As discussed below, there is no definitive pronouncement on whether equitable subordination is available under either the *BIA* or the *CCAA*, nor a definitive exploration of the limits of the doctrine. This lack of clarity makes it difficult to evaluate the potential success of actions for equitable subordination against intercorporate debt.

There are a series of excellent articles detailing the full history of equitable subordination in Canada.[42] There is no need to repeat these lengthy explorations here. However, for the purposes of context, this section provides a brief history of the difficult birth of equitable subordination in Canada.

39 *Noland*, *supra* note 32 at 539 (1996).
40 *Ibid*.
41 HR Rep No 95-595 at 359 (1977).
42 See, *eg*, Michael J MacNaughton and Sam P Rappos, "Equitable Subordination in Canadian Insolvency Law", in Janis P Sarra, ed, *Annual Review of Insolvency Law 2008* (Toronto: Thomson Carswell, 2009); Thomas G W Telfer, "Transplanting Equitable Subordination: The New Free-Wheeling Equitable Discretion in Canadian Insolvency Law?" (2002) 36 *Can Bus LJ* 36.

i. Statutory basis for equitable subordination

Neither the *BIA* nor the *CCAA* have an express reference to equitable subordination, *ie*, an equivalent to § 510(c) of the US *Bankruptcy Code*. However, like the US *Bankruptcy Act of 1898* in force when equitable subordination was first developed, the *BIA* confirms the equitable jurisdiction of courts acting in bankruptcy. Section 183(1) of the *BIA* provides that relevant courts of inherent jurisdiction exercise "jurisdiction at law and in equity as will enable them to exercise original, auxiliary and ancillary jurisdiction in bankruptcy and in other proceedings authorized".[43] The *CCAA* has no similar express provision of equitable authority; however, in addition to the courts' general equitable jurisdiction,[44] the inherent jurisdiction of a *CCAA* court may be sufficiently broad to allow it to exercise the same equitable powers as a court under the *BIA*.[45]

The *BIA* and the *CCAA* do differ in a significant respect for the purposes of equitable subordination. The *BIA* has statutory provisions with respect to the ranking of claims and the postponement — which is essentially subordination — of certain claims. The *BIA* provides for the payment of claims in the following order: super priority or secured claims, preferred claims, and then the payment of all remaining surplus to all remaining general unsecured creditors on a *pari passu* basis.[46] Equity claims take last; equity claimants can recover money from the estate only after all non-equity claims have been satisfied.[47] The *BIA* provides for the subordination of certain claims by silent partners who have invested for a share of the profits of a trade or business carried out by the bankrupt,[48] and for the claims of officers and directors of the bankrupt.[49] In

43 *BIA*, *supra* note 6, s 183.
44 See, *eg*, Ontario *Courts of Justice Act*, RSO 1990, c C.43, s 11(2).
45 *Century Services Inc v Canada (Attorney General)*, 2010 SCC 60.
46 *BIA*, *supra* note 6, s 136. What constitutes a preferred claim is defined in this section of the legislation.
47 *Ibid*, s 141.
48 *Ibid*, s 139.
49 *Ibid*, s 140. The *BIA* contained additional subordination provisions,

addition, a creditor who enters into a non-arm's length transaction with the bankrupt is subordinated to all other claims of the debtor unless the trustee is of the opinion that the transaction was "proper".[50] These provisions are sufficiently broad that they may cover some of the ground occupied by equitable subordination in the US.

The famously skeletal and flexible *CCAA* includes none of these provisions.[51] Notably, it does not include any provisions detailing the priority of distributions amongst creditors, as this priority is intended to be addressed in a plan of compromise or arrangement.

Despite the continuing uncertainty of the state of equitable subordination in Canadian law, no clarification was provided when the *CCAA* and the *BIA* were recently amended in 2007.[52]

ii. Early consideration of equitable subordination

The first cases to look at equitable subordination refused to apply the doctrine on the facts, but disagreed on its general applicability under Canadian law. In 1986, the British Columbia Court of Appeal found it unnecessary "to reach any firm view as to whether [equitable subordination] is part of Canadian law". Nevertheless, it held:

> I prefer to say no more than it should not be inferred that there is no such jurisdiction available. I would not wish to say anything which would encourage the view that the court does not have a long arm to prevent the kind of grossly unjust results which I think would have been achieved had the appellants succeeded in the position they took.[53]

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including subordination of claims of a present or former spouse and wage claims of relatives. These provisions were repealed in the 2007 legislative amendments to the *BIA*.

50 *Ibid,* s 137.

51 *ATB Financial v Metcalfe & Mansfield Alternative Investments II Corp*, 2008 ONCA 587.

52 See also, The Report of the Standing Senate 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* (Ottawa, November 2003).

53 *Laronge*, *supra* note 21 at paras 28-29.

Five years later, a case in Ontario considered the US doctrine of equitable subordination at length.[54] In *AEVO*, Justice Chadwick held that the Canadian *Bankruptcy Act*,[55] the predecessor to the *BIA*, exhaustively sets out the order of priority for distributions to creditors and thus effectively precluded the application of equitable subordination:

> I cannot agree that the doctrine of equitable subordination has any application in Canadian law.
>
> The *Bankruptcy Act* itself provides how claims are to be identified and how the estate is to be distributed.
>
> To incorporate the doctrine of equitable subordination into the *Bankruptcy Act* would create chaos and lead to challenges of security agreements based on the conduct of the secured creditor.
>
> If the Parliament of Canada felt that this doctrine had some application I am confident that in their wisdom they would have incorporated similar provisions into our statute.[56]

Justice Chadwick confirmed his findings in a case the following year, noting that "I concluded that the doctrine of subordination was not included into the *Bankruptcy Act*. [...] There was no room in the interpretation of the Act for that equitable doctrine."[57]

iii. Canadian Commercial Bank: the uncertainty continues

In 1992, the Supreme Court of Canada finally weighed in on the issue of equitable subordination in *Canada Deposit Insurance Corp v Canadian Commercial Bank*.[58] In *CCB*, the Canadian Commercial Bank, facing a solvency crisis due to non-performing loans, signed support agreements with the Government of Canada, the Government of Alberta, the

54 *AEVO Co v D & A Macleod Co (Bkcy)* (1991), 4 OR (3d) 368 (Bktcy) [*AEVO*].
55 *Bankruptcy Act*, RSC 1985, c B-3.
56 *AEVO*, *supra* note 54.
57 *Matticks v B & M Construction Inc (Trustee of)* (1992), 11 OR (3d) 156, 1992 CarswellOnt 193 (Ont Bktcy) at para 11.
58 *CCB*, *supra* note 4.

Canadian Deposit Insurance Corporation, and a group of chartered Canadian banks (the "participants"). The support agreements involved both a Participation Agreement, through which the participants purchased the portion of the portfolio loans that were thought to be non-recoverable, and an Equity Agreement, which granted warrants in Canadian Commercial Bank to each participant. Despite the assistance of the participants, Canadian Commercial Bank nonetheless continued to deteriorate and an order was made to wind up the bank under the *Winding-Up Act*.[59] The liquidator applied to the court to determine the validity and potential subordination of the participants' claims, in essence asking whether the participants could rank *pari passu* with the unsecured creditors of Canadian Commercial Bank.

The Supreme Court determined that the participants' claims were valid and would not be subordinated. Justice Iacobucci considered the doctrine of equitable subordination, as established in US law, expressly citing the three-factor test set out in *Mobile Steel*. Nonetheless, he declined to answer the question of whether the principle of equitable subordination was available, for two reasons. First, the issue was not argued at any of the levels of court below and he lacked the insights such courts below could have provided.[60] Second, Justice Iacobucci concluded that, even if equitable subordination were to apply in Canada, the facts of this case did not meet the three-factor equitable subordination test from *Mobile Steel*. The facts did not give "rise to the 'inequitable conduct' and ensuing 'detriment' necessary to trigger its application".[61]

Nonetheless, Justice Iacobucci left the question open for future consideration, holding that it was not necessary in the circumstances of the case to determine the "question of whether a comparable equitable doctrine should exist in Canadian law"

59 *The Winding-Up Act*, RSC 1985, c W-11.
60 *CCB*, *supra* note 4 at para 91.
61 *Ibid* at para 92.

and he "expressly refrain[ed] from doing so".[62] The question was therefore left "open for another day".[63]

This issue has indeed remained open. The year following *CCB*, the Ontario Court of Appeal merely echoed Justice Iacobucci's *dicta*, noting that it was "unnecessary to decide the question of the existence of the doctrine of equitable subordination in Canada [...] and we refrain from doing so".[64] In the decade after *CCB*, no case has expressly applied the principle of equitable subordination in a final order,[65] although a few cases applied it by analogy or in the alternative.[66]

62 *Ibid* at para 91.

63 *Ibid* at para 97.

64 *Olympia & York Developments Ltd v Royal Trust Co* (1993), 103 DLR (4th) 129, 1993 CarswellOnt 200 (Ont CA) at para 59.

65 In *CC Petroleum Ltd v Allen* (2002), 35 CBR (4th) 22 (Ont SCJ [Commercial List]), the trial judge determined that equitable subordination of the secured claims of certain insiders, including the directors of the bankrupt, the beneficial shareholders of the bankrupt (the wives of the directors) and part-time employees of the bankrupt, was appropriate. However, on appeal, the Ontario Court of Appeal noted that "[i]t is an open question whether the trial judge had jurisdiction to subordinate the female appellants' secured claim to the unsecured claims." *CC Petroleum Ltd v Allen* (2003), 36 BLR (3d) 244, 2003 CanLII 48445 (Ont CA) at para 18. The issue was moot at the time and the Court of Appeal held that "[g]iven the uncertain state of the law on this point, that portion of the judgment should be deleted as it is unnecessary".

66 See *Re Pine Valley Mining Corp*, 2007 BCSC 926 at para 42 [*Pine Valley*]. Some courts have come close to expressly applying the principle. Some case law notes that the Ontario Court of Appeal in *Bulut v Brampton (City)* (2000), 185 DLR (4th) 278, 2000 CarswellOnt 1063 [*Bulut*] applied equitable subordination. See, *eg*, *Re Christian Brothers of Ireland in Canada* (2004), 69 OR (3d) 507, 2004 CarswellOnt 574 (Ont SCJ [Commercial List]) at para 101. It did not. As Justice MacPherson noted for the majority, there was a "crucial difference" between equitable subordination and the question at issue before the Court of Appeal, which looked only at a traditional common law assessment of the priority of two creditors. *Bulut, supra* note 66, paras 88-89. *In Re Blue Range Resource Corp*, 2000 ABQB 4 [*Blue Range Resource*], the Court looked to the principles of equitable subordination, but in essence, recharacterized the rescission claim of defrauded shareholders as an

However, courts did not shut the door on its possible application. In *Christian Brothers of Ireland in Canada*, Justice Blair, then of the Ontario Superior Court of Justice, went so far as to call the application of the doctrine "attractive" and found no jurisdictional hurdles to invoking the doctrine, although he found that it was not appropriate for application on the facts of that case.[67]

The next section of this article looks at the more recent case law on equitable subordination, in which the doctrine has been successfully applied. Nonetheless, the overall uncertainty about its applicability, and the appropriate conditions for its application, continues.

III. CURRENT DEVELOPMENTS IN EQUITABLE SUBORDINATION

The past decade has seen the continuing evolution of the doctrine of equitable subordination, bookended by the clearest application of equitable subordination in Canada and the clearest rejection since Justice Chadwick's renunciation of the doctrine in *AEVO*. This section looks at

equity interest as opposed to a debt claim, thus subordinating the shareholders to other creditors. The closest that the doctrine has come to being applied is in the case of *S-Marque Inc v Homburg Industries Ltd*, [1998] NSJ No 550 (NSSC), where the Court decided it was not necessary to apply equitable subordination, but held that, if necessary it could apply. S-Marque sought to equitably subordinate a secured creditor from having recourse to the proceeds of certain transactions, the validity of which it was challenging. The Court held that the secured creditor's security was not valid and, as an unsecured creditor, it had no right to share in the proceeds of S-Marque's action. Nonetheless, if the Court was wrong, equitable subordination should apply because the transactions were being declared void as a result of the inequitable conduct of the secured creditor (or its related parties). This was consistent with the intent of s 137 of the *BIA*, to subordinate the claims of creditors who have entered into a reviewable transaction with respect to that transaction and it was thus consistent with the *BIA* to extend this principle to related parties.

67 *Re Christian Brothers of Ireland in Canada*, *supra* note 66 at paras 104-106.

developments in the doctrine of equitable subordination in the last 10 years, looking in particular at three questions raised in these cases that are relevant to the challenge of intercorporate debt. First, is equitable subordination a viable doctrine in Canada? Second, if it is, must inequitable conduct be shown for the application of equitable subordination? Third, what misconduct is sufficiently inequitable to qualify a creditor's claim to be subordinated?

1. The Availability of Equitable Subordination is Still an Open Question

Does the doctrine of equitable subordination exist in Canadian insolvency law? The answer to this question is a critical threshold issue to determine whether equitable subordination can be applied against intercorporate liabilities. One would have hoped and expected that this question would have been conclusively answered 24 years after the Supreme Court first noted that the question remained open for determination, but it has not.

In the past decade, courts appear split on whether the doctrine is fully available or completely unavailable, or — to carry the tradition forward — courts simply continue to buck the question. This section looks at each of these positions in turn.

First, the agnosticism of several courts has continued post-*CCB*, including at the Supreme Court of Canada itself. In its most recent treatment of equitable subordination, which is the only reference since *CCB*, Justice Deschamps for the majority of the Court declined to decide the issue, stating instead that *CCB* "did not endorse it, leaving it for future determination. I do not need to endorse it here either".[68] Similarly, Justice Pepall noted that the Court had "left open the question of whether such a doctrine should be recognized in Canada" and that the

68 *Re Indalex Ltd*, 2013 SCC 6 at para 77 [*Indalex*] (internal citations omitted).

case before her again did "not establish the need for such a doctrine".[69]

Second, some courts appear to have given up on the viability of the doctrine of equitable subordination. In *Nguyen*, the British Columbia Supreme Court held that "this US doctrine does not appear to have gained purchase in this jurisdiction".[70] A similar opinion was articulated in Ontario by Justice Campbell, holding that the "doctrine of equitable subordination is limited and questionable at best in Canadian law".[71] As discussed at greater lengths below, Justice Wilton-Siegel found in *United Steel* that courts lacked the jurisdiction to equitably subordinate claims.[72]

Third, a few courts have been more optimistic about the use of equitable subordination, whether or not the doctrine applied on the facts of the case. Justice Mesbur held in *General Chemical Canada* that, despite the fact that "equitable subordination had been used sparingly by Canadian courts", the "equitable jurisdiction of the bankruptcy court is likely broad enough to permit this".[73]

Most promising for the doctrine of equitable subordination is its first real application in 2009 by the Newfoundland and Labrador Supreme Court (Trial Division) in *Lloyd's Non-Marine Underwriters v JJ Lacey Insurance Ltd*.[74] Given its significance, it is worth examining the factual details in more depth.

69 *Waxman*, *supra* note 23 at para 34. See also *Romspen Investment Corp v Edgeworth Properties*, 2012 ONSC 4693 (Ont SCJ [Commercial List]); *674921 BC Ltd v Advanced Wing Technologies Corp*, 2006 BCCA 49.

70 *Re Nguyen*, 2012 BCSC 1756 at para 48. The trustee had argued that the doctrine of equitable subordination "does not exist under the law of British Columbia" (para 36).

71 *New Solutions Financial Corp v 952339 Ontario Ltd* (2007), 29 CBR (5th) 222, 2007 CarswellOnt 46 (Ont SCJ [Commercial List]).

72 *US Steel Decision*, *supra* note 19 at para 50.

73 *General Chemical*, *supra* note 10 at paras 90, 92.

74 *Lloyd's Non-Marine Underwriters v JJ Lacey Insurance Ltd*, 2009 NLTD 148 [*Lloyd's*].

Mr Gillingham was the controlling mind of JJ Lacey Insurance Limited ("Lacey"), which had acted as an insurance broker and agent on behalf of Lloyd's Non-Marine Underwriters ("Lloyd's") in Newfoundland. In 1992, Lloyd's indicated to Mr Gillingham that it would be discontinuing its business in Newfoundland and Labrador. As a result, Mr Gillingham decided to establish a new insurance company, Hiland Insurance Company Limited ("Hiland"). While Hiland was being formed, Lacey continued to sell insurance policies that ostensibly bound Lloyd's but did not inform Lloyd's of the policies. During this period, Lacey retained the premiums and, with one exception, satisfied insurance claims from those proceeds.[75] Once Hiland was formed, Lacey transferred some of the premiums to Hiland, as well as the impugned Lloyd's policies, without the permission of Lloyd's or the insureds. Hiland was later investigated by the Newfoundland and Labrador Superintendent of Insurance, which revoked Hiland's license and put Hiland into liquidation. Lacey then filed for bankruptcy under the *BIA*.

In bankruptcy, both Lloyd's and Hiland filed claims against Lacey's estate. Hiland's claims against Lacey were unsecured and Lloyd's argued that these claims should be equitably subordinated to the claim of Lloyd's.[76] The Court found that Lacey had used Hiland as a "corporate vehicle to further wrongful acts" and Hiland had been used "as a façade to conceal" the premiums collected and policies written in Lloyd's name.[77] However, the Court did not have sufficient evidence about the nature of Hiland's claims against Lacey to disallow

75 In the sole exception, when the insured made a claim on his policy, the illegitimate policy was cancelled and a policy was properly written on Lloyd's forms, which was backdated before the claim. The claim was then submitted to Lloyd's for payment.

76 Hiland also claimed that the premiums transferred by Lacey to Hiland were held in trust by Hiland. These claims were not subject to an equitable subordination analysis.

77 *Lloyd's*, *supra* note 74 at para 27.

them. As such, the Court turned its attention to equitable subordination.

The Court considered the three-factor *Mobile Steel* test and found that each factor was met. First, Hiland was culpable in inequitable conduct, as it had accepted the premium revenue that Lacey had "illegally appropriated" from Lloyd's.[78] Second, this conduct injured Lloyd's and "conferred an unfair advantage on Hiland".[79] Finally, the Court concluded that subordinating Hiland's unsecured claim to Lloyd's unsecured claim would not be inconsistent with the provisions of the *BIA*, as general unsecured creditors are to be paid rateably.

Finally, the Court concluded that equitable subordination was indeed available relief under Canadian law, and thus would apply in this case. The Court acknowledged that equitable subordination was inherently subjective and that "there is difficulty in limiting the scope of equitable subordination".[80] However, the Court could not abstain from using equitable subordination "simply because such conduct is generally difficult to define".[81]

2. Is Inequitable Conduct Necessary and if Necessary, What is it?

Since *CCB,* Canadian courts have generally proceeded on the basis that each of the three *Mobile Steel* factors must be met to apply equitable subordination. Key among these factors — the "equity" in equitable subordination — is the requirement of inequitable conduct. This section looks at recent developments in Canadian law relating to this principle that are relevant to intercorporate debt. First, it looks at whether inequitable conduct is required for equitable subordination in Canada.

78 *Ibid* at para 51.
79 *Ibid.*
80 *Ibid* at para 54.
81 *Ibid.*

Second, it looks at what conduct is sufficient to satisfy this element.

i. Is inequitable conduct a necessary element of equitable subordination?

Must there be inequitable conduct for equitable subordination? The *Mobile Steel* test expressly requires such conduct; the first element of the test requires that the claimant has "engaged in some type of inequitable conduct".[82] Inequitable conduct encompasses not only the first element of the *Mobile Steel* test, but also the second, specifically, that the conduct has caused harm. Furthermore, the principles of equitable subordination articulated by US courts are largely based, in some manner, on inequitable conduct.[83] Canadian courts have largely followed suit, rejecting claims for equitable subordination in recent cases where no misconduct was shown.[84] Despite the fact that *CCB* endorsed the *Mobile Steel* test, a couple of post-*CCB* cases have considered whether inequitable conduct is a necessary condition in Canada. These cases do not acknowledge the nuanced approach the US courts have taken to this issue: exceptions to the broad requirement of inequitable conduct are narrow and rare.

In *Waxman,* Justice Pepall considered whether equitable subordination requires inequitable conduct, citing jurisprudence from the US Court of Appeals for the Seventh Circuit that appears to suggest that it does not.[85] Justice Pepall

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82 *Mobile Steel*, *supra* note 9 at 700.

83 *Ibid* at 700-702; Richard C Solow, "The very limited no-fault equitable subordination theory; why section 510(c) requires misconduct in nearly all cases" (2013), 22 *J Bankr L & Prac* 1, art 4 ("Each 'principle of equitable subordination' derived from case law involves creditor misconduct in some way.").

84 See, *eg*, *National Bank of Canada v Merit Energy Ltd*, 2001 ABQB 583 at para 67 [*National Bank*]. LoVecchio J emphasizes that equitable subordination is an "extraordinary remedy that ought to be employed only where there is some misconduct on the part of the claimant". See also, *General Chemical*, *supra* note 10, para 92.

85 *Re Virtual Network Services Corporation*, 902 F 2d 1246 (7th Cir

addressed the submission that the Supreme Court in *CCB* had an "outdated and incomplete" understanding of equitable subordination, but dismissed the argument, noting that the Supreme Court had these cases before it but decided not to address them.[86] However, *Waxman* did not examine the actual state of US law. Moreover, in an earlier Canadian case, *Blue Range Resource*, the Court held that inequitable conduct was not a necessary element: "it appears that more recent American cases do not restrict the use of equitable subordination to cases of claimant misconduct".[87] In reference to Canadian case law, *Blue Range Resource* held that the cases "appear to have accepted the erroneous proposition that inequitable conduct is required in all cases under the American doctrine".[88]

Whether or not inequitable conduct must be shown for subordination is an important question, especially for the subordination of insider claims such as intercorporate debt. The transactions of insiders are subject to close scrutiny because "such parties usually have greater opportunities" for inequitable conduct, but "not because the relationship itself is somehow a ground for subordination".[89] Removing the requirement of inequitable conduct shifts the test closer to solely a consideration of who the creditor is as opposed to what the creditor has done. This shift would appear to contradict the well-established wisdom that equitable subordination should look at claims and not creditors:

> Equitable subordination is not 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". The court must therefore be careful not to approach the question on the basis of who the competing creditors are, ie, the "innocent and vulnerable" employees, as opposed to

1990) [*Virtual Network*]; *Re Envirodyne Industries Inc*, 79 F 3d 579 (7th Cir 1996).

86 *Waxman*, *supra* note 23 at para 34.

87 *Blue Range Resource*, *supra* note 66 at para 50.

88 *Ibid* at para 52.

89 William M Collier, Henry J Sommer & Alan N Resnick, *Collier on Bankruptcy*, 16th ed (New Providence: LexisNexis, 2009) at para 510.05(3)(b).

> the "sophisticated and wealthy" lender, but rather by the nature of their respective claims.[90]

It is generally acknowledged that prior to the introduction of the US *Bankruptcy Code*, equitable subordination required inequitable conduct. However, after the introduction of § 510(c), some US authority held that inequitable conduct is not required in *all* circumstances. The leading cases — referred to in *Blue Range Resource* and *Waxman* — are rulings by the US Court of Appeals for the Seventh Circuit. In *Re Virtual Network Services Corporation*, that Court permitted the subordination of a tax penalty claim without a showing of misconduct by the IRS, holding that section "510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor".[91] In *Re Envirodyne Industries Inc*, the Court permitted the subordination of a claim arising from notes that were issued as a result of a stock redemption, holding again that inequitable conduct was not required.[92] However, since *Virtual Network*, US courts, including the Seventh Circuit, have expressly limited the scope of this "no-fault" form of equitable subordination.[93]

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90 *General Chemical*, *supra* note 10, para 92 (citing *Re First Truck Lines, Inc*, 48 F 3d 210 (6th Cir 1995)). The US Supreme Court referred to the same aphorism in *Noland*, *supra* note 32 at 539.

91 *Virtual Network*, *supra* note 85 at 1250.

92 *Re Envirodyne Industries Inc*, 79 F 3d 579 (7th Cir 1996). In particular, the claim arose from non-interest bearing debt that was issued to former shareholders who failed to tender their shares in a short-form merger.

93 This very question was considered in the most recent equitable subordination case before the US Supreme Court, *Noland*, *supra* note 32 at 542. In this case, the Court was called upon to address whether a post-petition, punitive tax penalty could be subordinated without a finding of inequitable conduct. The Court found that equitable subordination could not apply to categories of claims that were expressly given priority by Congress, like tax claims. It thus held that it did not have to address the broader question of "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated".

The Seventh Circuit itself revisited this question in *Lifschultz Fast Freight*, a case that considered the equitable subordination of intercorporate debt.[94] The debtor, a freight forwarding company, was suffering financial difficulties and problems with its liquidity such that it could not meet its payroll obligations. Corporate insiders, who owned the majority of the debtor, borrowed money personally and lent it through a corporate affiliate to the debtor on a secured basis. Once in bankruptcy, the trustee challenged the insiders' claim, arguing that because the debtor had been undercapitalized at the time of the insiders' loan, the claim should be subordinated to the general creditors. The District Court ordered equitable subordination on the basis that the equitable subordination did not require inequitable conduct — undercapitalization alone was sufficient.[95]

The Seventh Circuit reversed the decision. It reaffirmed the principle that "[t]he rule is that equitable subordination is predicated upon creditor misconduct".[96] *Virtual Network* was "the birth of an exception" and not "the death of a rule".[97] Undercapitalization alone, "without evidence of deception about the debtor's financial condition or other misconduct, cannot justify equitable subordination of an insider's debt claim".[98]

US courts have identified three narrow exceptions to the general rule requiring inequitable conduct: "tax penalties, stock redemption claims, and punitive damages claims".[99] Indeed, not all jurisdictions recognize even these three exceptions,[100] and those that do hold that it should be

94 *Lifschultz Fast Freight*, *supra* note 2.

95 *Ibid*.

96 *Ibid* at 348. See also, *In re Hedged-Investments Associates, Inc*, 380 F 3d 1292 (10th Cir 2004).

97 *Lifschultz Fast Freight*, *supra* note 2 at 348.

98 *Ibid* at 349.

99 *Nat'l Emergency Servs v Williams*, 371 BR 166 at 170 (WD Va 2007).

100 *In Re Hyatt*, 509 BR 707 at 719 (Bankr DNM 2014) ("in the Tenth

available in "extremely limited" circumstances.[101] Exceptions for punitive damage claims or tax penalties are not of any particular relevance for intercorporate debt issues and, as explained below, the limited exception for stock redemptions is no longer necessary under Canadian insolvency law on the basis of recent statutory amendments.

In the pre-amendment Canadian cases considering this question, the most relevant of the US exceptions is the one for stock redemptions. As articulated by the Seventh Circuit, the basis for this exception is that a claim for a stock redemption is a claim "based on equity interests".[102] On a broad level, this exception was the concern in *Waxman* and *Blue Range Resource*: the cases considered the categorical subordination of a claim because they arose from the creditor's status as a former shareholder. In *Waxman*, the claim was founded in a final judgment for, among other things, oppressive action against the claimant *qua* shareholder. In *Blue Range Resource*, the impugned claim was by a shareholder for a return of an investment based upon misleading financial information. *Blue Range Resource* expressly refers to the fact that "stock redemption claims have been subordinated in a number of [US] cases even when there is no inequitable conduct".[103]

Circuit, the only exception to the inequitable conduct requirement for equitable subordination is in the context of tax penalty claims").

101 *United States v State St Bank & Trust Co*, 520 BR 29 at 87 (Bankr D Del 2014) ("I conclude that if no fault equitable subordination can still be pursued in this Circuit, the circumstances allowing it would be extremely limited."); see also *In re Merrimac Paper Co, Inc*, 420 F 3d 53 at 65 (1st Cir 2005) (equitable subordination requires "misconduct on the part of the [creditor] or other special circumstance").

102 *Re Envirodyne Industries Inc*, *supra* note 96 at 583.

103 *Blue Range Resource*, *supra* note 66 at para 50. See Telfer, *supra* note 42 at 80, for a generalized criticism of *Blue Range Resource*, *supra* note 66, noting that "a more balanced approach would have explored (1) the decisions that cast doubt upon no-fault subordination as a general rule, (2) the policy implications of a no-fault subordination regime and (3) the fuller reasoning in *Noland* [*supra* note 32], which precluded categorical subordination".

The most recent amendments to the *BIA* and the *CCAA* have now made it unnecessary to consider whether there is a Canadian variant of no-fault equitable subordination for claims, like stock redemptions, that are based in, or related to, equity claims.[104] Section 140.1 of the *BIA* and section 22.1 of the *CCAA* provide for the effective subordination of an "equity claim". In turn, equity claims are broadly defined to include any claim "in respect of an equity interest", including a "monetary loss resulting from the ownership, purchase or sale of an equity interest" or "a redemption or retraction obligation".[105] These sections would have certainly captured the claims subordinated in *Blue Range Resource*.[106]

Before moving on, it is worth noting that both *Waxman* and *Blue Range Resource* do not address the fact that the US *Bankruptcy Code* has multiple avenues of subordination, including, but not limited to, equitable subordination. A debt claim that is related to a security is subordinated under a different section of the US *Bankruptcy Code*, § 510(b). In contrast to the case-by-case equitable subordination of § 510(c), § 510(b) provides for the categorical subordination of any 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".[107] In the US, the claims considered in *Blue Range Resource* would have been subordinated under § 510(b) as a claim for damages resulting from the purchase of a security. The US authority referred to in *Blue Range Resource* of a "claim for damages arising from the purchase or sale of a security of the debtor" refers to this

104 Such claims of course should continue to also be considered under the doctrine of recharacterization.

105 *BIA*, *supra* note 6, s 2, "equity claim"; *CCAA*, *supra* note 6, s 2(1) "equity claim".

106 These amendments would also address the issues fully in *National Bank*, *supra* note 84, which involves the question of the subordination of shareholder claims and underwriter indemnities and cites *Blue Range Resource*, *supra* note 66, extensively.

107 US *Bankruptcy Code*, 11 USC § 510(b).

categorical subordination.[108] Section 510(b) was intended to provide courts with a broader power than available under the general doctrine of equitable subordination.[109] *Blue Range Resource* did not need to rely on US principles of equitable subordination. Even before the recent amendments to the *BIA* and the *CCAA*, Canadian courts "subordinated shareholder equity claims to general creditors' claims in an insolvency" on a categorical basis.[110] Combining this categorical subordination of equity claims with the strict case-by-case considerations of equitable subordination unnecessarily introduced the possibility of omitting the inequitable conduct element from the latter doctrine.

ii. What is "some inequitable conduct"?

As discussed above, a central tenet of the *Mobile Steel* case is the requirement for "some type of inequitable conduct". This element is also potentially the most subjective element of the test: what indeed is inequitable conduct and how much of it is required for an application of equitable subordination? This section explores what Canadian jurisprudence within the past decade can tell us is sufficient, or insufficient, to meet this requirement. Unfortunately, the case law appears to currently present more questions than answers, and the categories of what constitutes inequitable conduct in Canada remain open.

US law has helpfully characterized the relevant categories of inequitable conduct. Common categorizations include: (1) a claimant's use of the debtor as a mere instrumentality; (2) fraud, illegality or breach of fiduciary duties; and (3) undercapitalization.[111] This section looks at the status of each category in Canadian law in turn.

108 *Blue Range Resource*, *supra* note 66 at para 50 (*citing Noland*, *supra* note 32).

109 US, HR No 95-595, 95th Cong, 1st Sess 359 (1977).

110 *Re Sino-Forest Corporation*, 2012 ONCA 816 at para 30.

111 *Matter of Fabricators, Inc*, 926 F 2d 1458 (5th Cir 1991). The Fifth Circuit later defined the inequitable conduct as subject to "three general paradigms: (1) when a fiduciary of the debtor misuses his

A. Inequitable conduct: mere instrumentality or alter-ego

First, the claimant's alleged use of the debtor as a "mere instrumentality" is the basis of inequitable conduct that has been most actively explored in recent Canadian jurisprudence. Because of the implicit requirements of domination and control, this grouping of inequitable conduct is potentially highly relevant to the equitable subordination of claims of insiders within a corporate group.[112] In both *Lloyd's* and *General Chemical*, claims of equitable subordination were founded in arguments that the claimant had controlled the debtor for its own benefit.[113] The claims were successful in the former but failed in the latter.

The facts of *Lloyd's* are set out in detail above. Mr Gillingham was the operating mind of both Lacey, the insurance brokerage, and Hilband, the newly established insurance company. The Court found that they should be treated "as one entity" and that Lacey and Gillingham used "Hilband as a corporate vehicle to further wrongful acts".[114] Lacey and Gillinghman had used Hilband solely for their own benefit, namely, by illegally appropriating Lloyd's insurance premium revenue and funneling that revenue to Hilband. As such, Hilband, together with Gillingham and Lacey "clearly engaged in a form of inequitable conduct".[115]

The allegations of inequitable conduct in *General Chemical* centred on a secured loan made to the debtor by the

position to the disadvantage of other creditors; (2) when a third party controls the debtor to the disadvantage of other creditors; and (3) when a third party actually defrauds other creditors". *United States Abatement Corp v Mobil Exploring & Producing US, Inc (In re United States Abatement Corp)*, 39 F 3d 556 at 561 (5th Cir 1994).

112 Collier, Sommer & Resnick, *supra* note 89 at para 510.5(3)(a) (courts may find inequitable conduct where the claimant exercises "domination and control" over the debtor).

113 *General Chemical*, *supra* note 10.

114 *Lloyd's*, *supra* note 74 at paras 27, 29.

115 *Ibid* at para 51.

controlling shareholder of the debtor's parent. The administrator of the debtor's pension plan challenged a recovery from the estate to the secured creditor, arguing that the secured claim should be subordinated to its own secured position.[116] The administrator argued that the proceeds of the secured debt were not used to the benefit of the debtor but rather for the sole purpose of paying off the corporate parent's obligations under separate interim financing loans. The implication was that the monies were advanced to benefit the secured creditor itself due to its controlling stake in the parent. The Court rejected this argument, finding that the debtor did in fact benefit from the loans.[117]

In both *Lloyd's* and *General Chemical*, each court left open the question of whether the debtor's actions as the mere instrumentality or alter-ego of the creditor is a sufficient basis to satisfy the requirement of inequitable conduct. In *Lloyd's* it is impossible to disaggregate the instrumentality analysis from the analysis of fraud and illegality. In *General Chemical*, the factual findings did not exist to require the Court to opine on this issue.

B. Inequitable conduct: fraud, illegality or breach of fiduciary duty

The second category of inequitable conduct — fraud, illegality or breach of fiduciary duties — has most often been described in recent Canadian law in its absence rather than its presence. It appears to be the default descriptor of misconduct. For example, in *Pine Valley*, equitable subordination was dismissed purely on the basis that no "fraudulent conduct" was alleged.[118] The doctrine was equally dismissed in *Romspen*

116 The pension administrator argued that it had a lien on the debtor's assets. The Court found that it did not and while this may have disposed of the issue, the Court continued in its analysis (including its analysis of equitable subordination) on the basis that the administrator had a valid lien. *General Chemical*, *supra* note 10 at paras 72-73.

117 *Ibid* at para 94.

118 *Pine Valley*, *supra* note 66 at para 42.

Investment because there was no evidence that that anyone had "committed a fraud".[119] Indeed, in *Lloyd's*, the Court found that Lacey and Gillingham's activities in falsely writing Lloyd's policies "constituted a fraud upon Lloyd's", which, in addition to the alter-ego findings, grounded the finding of equitable subordination.[120]

But inequitable conduct exists on a range, with a finding of fraud as the easy exemplar of clear misconduct. What is more difficult is the "elusive lower limit" of misconduct, "which cannot be clearly defined".[121] Canadian case law, in the intercorporate debt context or elsewhere, has not explored the remaining elements of the category — illegal conduct or breach of fiduciary duty — and does not provide clarity in defining the scope of inequitable conduct.

Illegality is a good example of the ambiguity at play in the consideration of misconduct. While theft and fraud would appear to be clear examples of misconduct, US law has taken a broader view of "illegal" inequitable conduct. For example, claims acquired in violation of anti-trust laws have been subject to equitable subordination. In *Columbia Gas*, Columbia had purchased equity and debt securities in the debtor, its close competitor, and established a controlling position.[122] Columbia used its control to cancel the construction of its competitor's new gas pipeline that threatened to compete with Columbia's own business. The US Court of Appeals for the Sixth Circuit held that the creditor's "main purpose was to restrain actual and potential interstate competition in the production, transportation, distribution and sale of natural gas", in violation of anti-trust statutes. Thus, this constituted

119 *Romspen Investment Corp v Edgeworth Properties*, 2012 ONSC 4693 (Ont SCJ [Commercial List]).

120 *Lloyd's*, *supra* note 74 at para 16.

121 Telfer, *supra* note 42 at 43 (citing A DeNatale and P Abram, "The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors" (1985), 40 *Bus Lawyer* 417, at 423-24).

122 *Columbia Gas & Electric Corporation v United States*, 151 F 2d 461 (6th Cir 1945).

inequitable conduct that qualified for equitable subordination.[123]

The breach of fiduciary duty category equally presents serious questions as to the scope of inequitable conduct in Canada. In the US, breaches of fiduciary duty were the original conception of inequitable conduct in the Supreme Court's early jurisprudence. In *Pepper*, the parent caused its subsidiary to concede a liability to the parent. This conduct was deemed a breach of the parent's fiduciary duty to the subsidiary, which grounded the award of equitable subordination.[124] However, in comparison to the US, the scope of breaches of corporate fiduciary duty in Canada is more limited, both in terms of the scope of the duties and to whom the duty attaches. Contrary to the US, Canadian courts have rejected the shareholder primacy conception of fiduciary duty, adopting instead a more permissive duty that incorporates consideration of other stakeholders.[125] In further contrast to the US, majority shareholders do not generally owe a fiduciary duty to the companies they own or to its minority shareholders.[126]

The narrower scope of fiduciary duties in Canada calls into question whether a broader statutory mechanism, the

123 *Ibid* at 470.

124 *Pepper*, *supra* note 24; see also, *Citicorp Venture Capital v Committee of Creditors Holding Unsecured Claims*, 160 F 3d 982 (3d Cir 1998).

125 *BCE Inc v 1976 Debentureholders*, 2008 SCC 69. Delaware courts have found that, in insolvency, creditors may too have standing to pursue a derivative claim for breach of fiduciary duty. See *N Am Catholic Educ Programming Found, Inc v Gheewalla*, 930 A 2d 92 (Del 2007) at 101. Even in the context of insolvency, the articulation of the interests to be considered under Canadian law remains broader.

126 *Brant Investments Ltd v KeepRite Inc* (1991), 3 OR (3d) 289, 1991 CarswellOnt 133 (Ont CA) at para 16; *Jabalee v Abelmark Inc*, [1996] OJ No 2609 (Ont CA); Jeffrey G. MacIntosh, Janet Holmes & Steven Thompson, "The puzzle of shareholder fiduciary duties" (1991) 19 *Can Bus LJ* 86. Interestingly, the authors point to *Pepper*, *supra* note 24, as the US Supreme Court case establishing the fiduciary duty of shareholders to their company, twinning the origin of this doctrine and the doctrine of equitable subordination.

oppression remedy, has a role to play within equitable subordination. The oppression remedy, codified under the *Canada Business Corporations Act (CBCA)* and its provincial analogues, is a broad remedy.[127] Its availability and breadth may have made it "unnecessary to expand fiduciary duties" in Canada.[128] The oppression remedy can, in certain circumstances, impose a duty of fairness on the actions of majority shareholders.[129] The oppression remedy can also act to protect the reasonable expectations of creditors, including expectations that the corporation will not be used as a vehicle for fraud or be used to gratuitously convey away its assets while the creditor remains unpaid.[130] No Canadian case to-date has considered the question of whether conduct that is oppressive[131] is also inequitable conduct for the purposes of equitable subordination.[132] Given that "fair treatment" is the "central theme running through the oppression

127 *Canada Business Corporations Act*, RSC 1985, c C-44, s 241.

128 Dennis H Peterson & Matthew J Cumming, *Shareholder Remedies in Canada*, 2nd ed, looseleaf (Toronto: LexisNexis Canada, 2009), para 17.126; see also, *Brant Investments Ltd v KeepRite Inc*, *supra* note 126 at para 18.

129 *Canbev Sales & Marketing Inc v Natco Trading Corp* (1996), 30 OR (3d) 778 (Ont Gen Div [Commercial List]); *Agrium v Hamilton*, 2005 ABQB 54.

130 Peterson & Cumming, *supra* note 128 at para 17.144.

131 In *US Steel Decision*, *supra* note 19, the claimants did allege breaches of fiduciary duty and oppressive conduct. However, the Court interpreted these claims as separate and apart from the claim for equitable subordination and did not consider the doctrine in this context.

132 The trial decision in *CC Petroleum Ltd v Allen*, *supra* note 65, held that the creditor's participation in the debtor's cheque kiting scheme was oppressive to the creditors. However, for two reasons this finding is not probative of the question whether oppressive conduct constitutes "some inequitable conduct" for the purposes of equitable subordination. First, the oppressive conduct was of the nature of fraud, which itself would be sufficient as a predicate of equitable subordination. Second, the trial court's conclusion of equitable subordination was overturned by the Ontario Court of Appeal, which determined that there was no need to address this question. *CC Petroleum Ltd v Allen*, *supra* note 65 at para 18.

jurisprudence,"[133] oppressive conduct could prove a future shorthand for inequitable conduct. Such an argument could potentially serve to create equal or larger concepts of inequitable conduct in Canada as compared to its southern neighbour.

Despite the uncertainty of what conduct falls within the category of fraud, illegality, and breach of fiduciary duty, some clarity can be found regarding the minimum conduct required to reach inequitable conduct. It appears that in the US activities undertaken in good faith often fall below the threshold of misconduct.[134] For example, in the case of *Spach v Bryant*, the US Court of Appeals for the Fifth Circuit refused to subordinate the unsecured claims of the debtor's two shareholders on the basis that there was insufficient evidence of bad faith or that the money lent was "not fully paid into the corporation in an honest effort to continue the corporate business".[135] At least one recent Canadian case appears to have adopted the same minimum threshold, finding that equitable subordination could not apply because the impugned transaction had been undertaken "for a proper purpose".[136]

C. Inequitable conduct: undercapitalization

Finally, the third category of inequitable conduct, undercapitalization, has had no determinative judicial treatment in Canada.[137] Recent US case law has held that this

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133 *BCE Inc v 1976 Debentureholders*, *supra* note 125 at para 64.

134 *Barlow v Budge*, 127 F 2d 440 (8th Cir 1942) (loans by an insider will not be subordination if the creditor can show that "the money was needed by the corporation and was used for proper corporate purposes and that the transaction between him and the corporation was open, honest and free from unfairness or fault").

135 *Spach v Bryant*, 309 F 2d 886 at 889 (5th Cir 1962).

136 *Stone Mountain Resources Holdings Ltd v Stone Mountain Resources Ltd*, 2012 ABQB 534 at para 43 [*Stone Mountain*].

137 In *Stone Mountain*, *supra* note 136 at para 36, the claimant argued that the relevant creditor (an insider who controlled the debtor) had advanced funds to the debtor when it knew it was undercapitalized, which it alleged "constitutes a form of inequitable conduct". The

"conduct" is not, by itself, sufficient to ground a claim of equitable subordination — thereby questioning whether undercapitalization can really be described as a standalone category of inequitable conduct.

References to undercapitalization as inequitable conduct began with the US Supreme Court's initial endorsement of equitable subordination. In *Pepper*, the Court held that subordination was appropriate in cases of undercapitalization: where "the paid in capital was purely nominal and the operations of the company being furnished by the stockholder as a loan".[138] In *Mobile Steel*, the Court defined undercapitalization as follows:

> (1) Capitalization is inadequate if, in the opinion of a skilled financial analyst, it would definitely be insufficient to support a business of the size and nature of the bankrupt in light of the circumstances existing at the time the bankrupt was capitalized;
>
> (2) Capitalization is inadequate if, at the time when the advances were made, the bankrupt could not have borrowed a similar amount of money from an informed outside source.[139]

Reliance on undercapitalization as inequitable conduct is particularly relevant for claims against creditors who are corporate parents or majority shareholders. For example, in *Costello*, the partners in a partnership withdrew most of the capital in the partnership immediately preceding the debtor's incorporation, by way of a promissory note.[140] The debtor failed and filed for bankruptcy. The bankruptcy trustee successfully sought to subordinate the former partners' claims on the basis that the former partners had caused the undercapitalization.[141]

Court found that equitable subordination did not apply because the transaction was for a proper purpose and thus did not address whether undercapitalization was a form of inequitable conduct.

138 *Pepper*, *supra* note 24 at 310.

139 *Mobile Steel*, *supra* note 9 at 703.

140 *Costello v Fazio*, 256 F 2d 903 (9th Cir 1958).

141 *Ibid*.

However, as a result of the broad and subjective scope of "undercapitalization", US courts have retreated from considering undercapitalization by itself to be a sufficient cause of inequitable conduct. In *Lifschultz Fast Freight*, the US Court of Appeals for the Seventh Circuit expressly considered the question of whether undercapitalization could itself be sufficient inequitable conduct for a claim of equitable subordination.[142] It held that it could not. At most, undercapitalization was a relevant factor in indicating other inequitable conduct: "while undercapitalization may indicate inequitable conduct, undercapitalization is not in itself inequitable conduct".[143]

Undercapitalization as inequitable conduct has only been raised once in a Canadian context. In *Stone Mountain*, the relevant creditor, an insider who controlled the debtor, had advanced funds to the debtor under a general security agreement.[144] The claimant argued that the creditor lent under the security agreement when it knew the debtor was undercapitalized, diluting the potential recoveries for unsecured creditors, and thus, its course of action "constitutes a form of inequitable conduct". The Alberta Court of Queen's Bench dismissed the claim for equitable subordination on the basis that the general security agreement was an arm's length transaction, done "for a proper purpose".[145] The Court thus had no need to address whether undercapitalization was a form of inequitable conduct, leaving the question for a future day. However, it should be noted that with respect to other areas of corporate law, the concept of undercapitalization is less utilized in Canadian law than its American counterpart.[146]

142 *Lifschultz Fast Freight*, *supra* note 2 at 349.
143 *Ibid* at 345.
144 *Stone Mountain*, *supra* note 136 at para 36.
145 *Ibid*, para 43.
146 For example, while US courts have considered undercapitalization to be a significant factor in piercing the corporate veil, Canadian courts have not given much weight to this issue. Compare

In sum, analysis of what constitutes "some inequitable conduct" in Canadian law has, to this point, been lacking. Inequitable conduct is the element that separates the doctrines of recharacterization and equitable subordination, and allows the court, under the latter doctrine, to subordinate otherwise valid debt. In order to create some clarity as to when debt — including debts of corporate affiliates — will be relegated to take last, it is not enough for Canadian courts to simply accept or dismiss the existence of inequitable conduct. Rather, they should detail what threshold they are assessing equitable conduct against and explain why the test is or is not met.

IV. CASE STUDY: CHALLENGING INTERCORPORATE DEBT IN *US STEEL*

Both recent Canadian cases where intercorporate debt has been challenged with equitable subordination, *Target* and *US Steel*, were ongoing at the time this article was published. Thus, the discussions below are necessarily preliminary. However, they are helpful illustrations of two trends. First, both cases demonstrate that, in the absence of clear guidance from the courts on the contours of equitable subordination and its applicability, creditors will continue to use it to challenge intercorporate debt. Second, in *US Steel*, Justice Wilton-Siegel continued the vacillation of Canadian jurisprudence, holding that there was no place for equitable jurisdiction within the statutory framework of the *CCAA*.

In *US Steel*, the Court considered equitable subordination on a procedural motion: the determination of which objections

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Zimmermann Inc v Barer, 2014 QCCS 3404 (the Court rejected an argument of veil piercing on the basis of undercapitalization) with *Hambleton Bros Lumber Co v Balkin Enterprises, Inc*, 397 F 3d 1217 at 1228 (9th Cir 2005): piercing the corporate veil can be justified by "gross undercapitalization"; *Trustees of Nat Elevator Indus Pension v Lutyk*, 140 F Supp 2d 447 at 458 (ED Pa 2001), "Whether a corporation is grossly undercapitalized for the purposes of the corporate undertaking is of particular importance in a veil-piercing analysis, especially in the case of a closely held corporation".

would proceed forward in the *CCAA* process.[147] The *CCAA* judge considered the subordination claims in two categories. First, he considered them as a claim on behalf of USW members and pension beneficiaries for remedies for oppression under the *CBCA* and for breach of trust pursuant to the principles of equity. The Court assumed, for the purposes of argument, that subordination was an available remedy if either claim could be made out but made no further determinations on the likelihood of their success. Although the claims sought relief only for a specific creditor, the Court nonetheless determined that the claims should be heard within the *CCAA* process.[148]

Second, the Court considered the subordination claims as a basis for application of the doctrine of equitable subordination. The Court then considered whether it had jurisdiction to order equitable subordination. The Court held that it did not. It added to the long line of jurisprudence questioning the existence of the doctrine in Canada.

The Court found that case law provided no support for the availability of equitable subordination. Without reference to *Lloyd's*, the *CCAA* judge noted that he was "not aware of any Canadian law in which the doctrine of equitable subordination has been expressly applied".[149] Also, contrary to other post-*CCB* cases, the Court in *US Steel* concluded that the Supreme Court's reluctance to decide the question of equitable subordination in *CCB* and *Indalex* was in fact a rejection of the doctrine:

> Moreover, given the silence of the Supreme Court on this issue when presented with the opportunity to affirm its existence in Canadian law, one might infer that the Supreme Court has, in effect, rejected the principle of equitable subordination.[150]

However, in the event that the question remained open, the Court held that the language of the *CCAA* effectively closed off

147 *US Steel Decision*, *supra* note 19 at para 34.
148 *Ibid* at para 97.
149 *Ibid* at para 46.
150 *Ibid* at para 49.

the possibility for its application. The USW and the retirees argued that jurisdiction to order equitable subordination was found in section 11 of the *CCAA*. Section 11 provides the court with broad jurisdiction: "the court, on the application of any person interested in the matter, may, subject to the restrictions set out in this Act, [...] make any order that it considers appropriate in the circumstances".[151] The Court disagreed, finding that analogous provisions for recharacterizing or challenging claims served as an implied restriction in the *CCAA*.

The Court correctly defined the doctrine of equitable subordination as seeking to "subordinate in whole or in part an otherwise valid debt claim based on some form of inequitable conduct on the part of a creditor that has resulted in loss to the other creditors of a debtor corporation generally or that has conferred an unfair advantage on the creditor".[152] There are no provisions in the *CCAA* expressly authorizing equitable subordination. In contrast, recharacterization seeks to determine whether a claim is properly considered a valid debt claim. Recharacterization arises from the court's jurisdiction to determine whether a claim is an "equity claim", as defined in the *CCAA*, and thus whether it should be treated as a valid claim or effectively subordinated as an equity claim. The Court further noted that the *CCAA* also permits the court to consider the validity of a claim in the context of section 36.1. This section expressly incorporates provisions from the *BIA* that allow a court to invalidate prior transactions as fraudulent preference or fraudulent assignments.[153]

The Court held that Parliament had the opportunity to expressly incorporate authority for equitable subordination in the *CCAA*, but had not. It could have included language in the definition of "equity claim" to consider the equitable conduct

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151 *CCAA*, *supra* note 6, s 11.

152 *US Steel Decision*, *supra* note 19 at para 40.

153 *CCAA*, *supra* note 6, s 36.1 incorporates ss 38 and 95 to 101 of the *BIA*, *supra* note 6.

of the creditor. It could have drafted section 36.1 of the *CCAA* "more broadly" to grant authority beyond the fraudulent preferences and fraudulent assignments in the *BIA*.[154] The Court concluded that the omissions in the *CCAA*'s language in the definition of "equity claim" and in section 36.1 acts as an implied "restriction set out in the Act" therefore limiting the court's authority under section 11.[155]

The decision rests on a theory of implied exclusion: had Parliament wished to include an analogue of § 510(c) of the US *Bankruptcy Code*, it would have done so. The Court thus concluded:

> Parliament could have expressly introduced the law of equitable subordination into the *CCAA* at the time of the most recent amendments but chose not to do so. The Court must respect that policy decision.[156]

The USW has sought to appeal the decision on the basis that the issue was not properly argued before the *CCAA* judge and the various submissions to the court addressed equitable subordination only peripherally, with no real treatment given to the equitable subordination jurisprudence in Canada or the US. The appeal is ongoing at the time of publication.

V. CONCLUSION

After *Lloyd's* and *US Steel* we find the law very much in the same shape as those courts found it: "sketchy".[157] However, the courts took a divergent approach to clarifying the law. In *Lloyd's*, the Court determined that it had a continuing duty to expand the common law where appropriate:

> Difficulty in limiting the scope of the doctrine should not stop courts from expanding the law so that the law responds to those clear cases

154 *US Steel Decision*, *supra* note 19 at para 50.
155 *Ibid.*
156 *Ibid* at para 53. The Court reaches this conclusion in reliance on the caution articulated by the Supreme Court in *Indalex*, *supra* note 68, para 82: "courts should not use equity to do what they wish Parliament had done through legislation".
157 *Lloyd's*, *supra* note 74 at para 54.

> where right thinking persons can clearly and easily discern oppressive unfairness as having occurred.[158]

In contrast, *US Steel* took the doctrine of equitable subordination full circle, harkening back to the beginning of the Canadian exploration of the doctrine. Justice Chadwick, in 1991, held that the then *Bankruptcy Act*, exhaustively set out how claims were to be determined, leaving no room for the court's subordination of a claim based on the equities of the case.[159] He relied on the Parliament's silence on the issue to determine the absence of authority. Only after *CCB* was decided did Justice Chadwick acknowledge that the question was open.[160] Although *US Steel* addresses a different, newly-amended statute, the decision is essentially the same as *AEVO*, holding that statutory and judicial silence precludes a role for the doctrine of equitable subordination.

For each step forward in the development of the doctrine, there appears a step in a different direction. All that is clear is that some judges are finally willing to begin the process of slowly evolving the law to address the proper boundaries of equitable jurisdiction, if the doctrine is permissible at all. Nonetheless, the judiciary cannot be accused of rushing into a decision on the matter. Twenty-four years after this issue was addressed by the Supreme Court of Canada, the indecision of the jurisprudence gives new meaning to the speed of "incremental change" in the common law.[161] It may however

158 *Ibid*, para 54. See also *Waxman*, *supra* note 23 at para 34 ("a vibrant legal system must be responsive to new developments in the law and the need for reform").

159 *AEVO*, *supra* note 54 ("If the Parliament of Canada felt that this doctrine had some application I am confident that in their wisdom they would have incorporated similar provisions into our statute".); see also *Matticks v B & M Construction Inc (Trustee of)* (1992), 11 OR (3d) 156, 1992 CarswellOnt 193 (Ont Bktcy) at para 11 ("The Act provided a specific code for the determination of bankruptcy matters. There was no room in the interpretation of the Act for that equitable doctrine.").

160 *Re/Max Metro-City Realty Ltd v Baker (Trustee of)* (1993), 16 CBR (3d) 308, 1993 CarswellOnt 180 (Ont Bktcy).

161 *R v Salituro*, [1991] 3 SCR 654 at 670 ("The judiciary should confine

take the Court rendering an affirmative position on the issue — finally — to break this cycle of vacillation.

itself to those incremental changes which are necessary to keep the common law in step with the dynamic and evolving fabric of our society.").