“Another Day”:

Equitable Subordination in *CCAA* Proceedings

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Introduction

In 1992, Justice Iacobucci left the question of whether the equitable subordination doctrine should exist in Canadian law "open for another day."[1] With the Supreme Court of Canada's ("**SCC**") decision to grant leave to appeal on that issue from the Ontario Court of Appeal's decision in *U.S. Steel Canada Inc., Re*[2], that day will soon arrive. This essay will argue that the SCC should follow the Ontario Court of Appeal in finding that equitable subordination is not available in proceedings under the *Companies' Creditors Arrangement Act* ("***CCAA***").[3]

The Doctrine of Equitable Subordination

Equitable subordination is a doctrine in United States bankruptcy law which allows the court to subordinate the claim of a creditor based on the creditor's conduct. While the doctrine now enjoys statutory recognition,[4] it was initially developed by the U.S. courts relying on the court's equitable jurisdiction.[5] The principles of the doctrine were set out as a three-part test in *Mobile Steel Co., Re*:

> (i) The claimant must have engaged in some type of inequitable conduct.
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> (ii) The misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant.
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> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act. [6]

Equitable Subordination in Canada and the Decision in *U.S. Steel*

Equitable subordination has had a varied history in Canada. While the SCC has considered the doctrine twice, each time it declined to decide whether it should exist in Canada.[7] Some subsequent

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[1] *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* [1992] 3 S.C.R. 558, para. 97.
[2] *U.S. Steel Canada Inc., Re*, 2016 ONCA 662 ["***U.S. Steel***"], leave to appeal granted March 9, 2017.
[3] R.S.C., 1985, c. C-36 ["***CCAA***"].
[4] See 11 U.S.C. § 510 (c) (1982).
[5] The doctrine was affirmed in *Pepper v. Litton*, 308 U.S. 295, 305 (1939), where the Supreme Court of the United States said "[c]ourts of bankruptcy… exercise equity powers, and have not only the power, but the duty, to disallow or subordinate claims if equity and fairness so require." (para. 2).
[6] *Mobile Steel Co., Re*, 563 F.2d 692 (U.S. C.A. 5th Cir. 1977), page 700.
[7] *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, *supra* note 1, para. 91, and *Indalex Ltd., Re* 2013 SCC 6, para. 77.

cases have been skeptical of the doctrine's existence[8], while others have found it to exist and used it to subordinate the claim of a creditor.[9][10]

The most recent consideration of equitable subordination occurred in *U.S. Steel*. The case concerned U.S. Steel Canada ("**USSC**"), who is under *CCAA* protection. USSC's former employees claimed that the parent company, United States Steel Corporation ("**USS**"), deliberately caused USSC to underperform and thereby caused USSC to become insolvent. The former employees argued that as a result USS should have their secured claims subordinated to the claims of the unsecured creditors.

The Ontario Court of Appeal was unanimous in finding that equitable subordination was not available in *CCAA* proceedings. Speaking for the Court, Chief Justice Strathy found that the doctrine did not help the *CCAA* fulfil its purpose.

The Unsuitability of Equitable Subordination in the *CCAA* Context

In *U.S. Steel*, the Court decided that the *CCAA* did not grant the Court authority to order equitable subordination, as "nowhere in the words of the *CCAA* is there authority, express or implied, to apply the doctrine of equitable subordination. Nor does it fall within the scheme of the statute, which focuses on the implementation of a plan of arrangement."[11] This meant that the Court's broad discretion under section 11 *CCAA*[12] could not be exercised. Chief Justice Strathy found that section 11 only granted the Court the jurisdiction to grant orders "in furtherance of the purposes of this act."[13]

This is an appealing argument. The title of the *CCAA* makes clear that the act is "to facilitate compromises and arrangements between companies and their creditors". Equitable subordination

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[8] See for example *Pioneer Distributors Ltd. v. Bank of Montreal*, 1994 CarswellBC 625, or *Canadian Imperial Bank of Commerce v. Sayani*, 1996 CarswellBC 2709.
[9] See *Lloyd's Non-Marine Underwriters v. J. J. Lacey Insurance Ltd.*, 2009 CarswellNfld 244. In this bankruptcy case, a creditor's (Hiland) unsecured claim against a company's estate (Lacey) was subordinated to another unsecured claim (Lloyd's), as Hiland and Lacey were found to have engaged in a form of inequitable conduct in together illegally appropriating funds belonging to Lloyd's.
[10] For a more thorough history of equitable subordination cases in Canada up to 2008, see 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).
[11] *U.S. Steel, supra* note 2, para. 101.
[12] Section 11 *CCAA* gives the court a wide discretionary power, and reads: "Despite anything in the Bankruptcy and Insolvency Act or the Winding-up and Restructuring Act, if an application is made under this Act in respect of a debtor company, the court, on the application of any person interested in the matter, may, subject to the restrictions set out in this Act, on notice to any other person or without notice as it may see fit, make any order that it considers appropriate in the circumstances."
[13] *U.S. Steel*, *supra* note 2, para. 81.

is a doctrine that seeks to settle disputes between creditors, not between creditors and a company, and so falls outside of the goals of the *CCAA*.

There are further reasons to be skeptical of equitable subordination in the *CCAA* context. It is a remedy that, even in the U.S. context, lacks clarity. By the first limb of the test, equitable subordination requires there to be "inequitable conduct". While certain behaviours such as fraud clearly suffice, the U.S. courts have struggled to define the lower limit of inequitable conduct: it has been called "the elusive boundary that cannot be clearly defined."[14] Importing such a standard into Canadian law is liable to cause ambiguities. This would make it harder for commercial actors to reliably predict their likely recovery in *CCAA* proceedings, and would lead to delays and costly litigation as parties fight over their entitlements. Lastly, it makes credit more expensive: risk averse parties who could formerly rely on their secured interest become less willing to lend when there is a possibility their interest could be subordinated due to conduct that is found, on the margins, to be inequitable.[15]

This is particularly the case for an imported standard. Equitable subordination was developed in the U.S. in a manner that is not sensitive to the Canadian legal context, and transplanting such a doctrine could cause problems. This difficulty was recognized in *Re I. Waxman & Sons Ltd.*,[16] where Justice Pepall noted "[t]here is of course a danger associated with taking a doctrine divorced from its legal home and applying it to Canada's statutory bankruptcy regime unencumbered with the deep knowledge of the origin, development and legal system from which it originated." Similarly, Alan Watson has noted that generally "legal rules which are unsatisfactory at home appear even less satisfactory when they are transplanted."[17]

One situation where the differences between the U.S. and Canadian legal systems may cause difficulties is that of fiduciary duties. In *Pepper v Litton*[18], a breach of fiduciary duty led to the granting of equitable subordination. Jeremy Opolsky argues that "the scope of breaches of corporate fiduciary duty in Canada is more limited."[19] Such differences make proper analysis of the standard of "inequitable conduct" more challenging in the Canadian context, raising the possibility that conduct falling short of a breach of fiduciary duty could be deemed as inequitable conduct.

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[14] A. DeNatale and P. Abram, "The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors" (1985), 40 *Bus Lawyer* 417, page 423.
[15] For example, DeNatale and Abram observe that "the case law offers few concrete guidelines to the creditor as to when it will cross the boundary line between proper conduct in preserving its position in the assets of the debtor and improper assumption of control over the business of the debtor" (DeNatale and Abram, *ibid*, page 442).
[16] *Re I. Waxman & Sons Ltd.*, 2009 CarswellOnt 6551.
[17] A. Watson, *Legal Transplants: An Approach to Comparative Law*, 2nd ed. (Athens, U. of Georgia Press, 1993), page 35.
[18] *Pepper*, *supra* at note 5.
[19] J. Opolsky, "Intercorporate Debt and Equitable Subordination: One Case Forward and One Case Back" in Janis P. Sarra ed., *Annual Review of Insolvency Law 2015* (Toronto: Thomson Carswell 2016), page 78.

Furthermore, the unfamiliarity of Canadian courts with American jurisprudence is likely to cause errors in interpretation. For example, in *Blue Range Resource Corp., Re*,[20] the Court accused other Canadian cases of "accept[ing] the erroneous proposition that inequitable misconduct is required in all cases under the American doctrine",[21] whereas in the U.S. in *In re Lifschultz Fast Freight*[22], the Court stated to the contrary that "equitable subordination is predicated upon creditor misconduct". Canadian commentary has suggested *Blue Range* "runs counter to recent United States Supreme Court jurisprudence which prohibits the categorical subordination of claims."[23] Such uncertainty about the correct position of the law is likely to cause extra expense and delays when pursuing legal action.

The Necessity of Equitable Subordination in the *CCAA* Context

It is also questionable whether the equitable subordination doctrine is necessary in Canada. There are several other paths to challenge the priority of competing creditors. For example, common law principles (including equitable principles) may be used where there is the absence of a statutory regime governing the priority of different claims.[24] Alternatively, courts have been willing to consider whether a debt could be properly recharacterized as equity, which would result in the claim ranking behind the unsecured creditors.[25]

If a discretion-based approach is desirable, a potential avenue rooted in Canadian law already exists in the form of the oppression remedy. Section 241 of the *Canada Business Corporations Act* gives the court a broad discretion to "rectify the matters complained of", including, under s 241(3)(d), "an order directing an issue or exchange of securities." [26]

This potential order was considered in the context of *CCAA* proceedings in *Lightstream Resources Ltd., Re*.[27] In similar language to *U.S. Steel*, the Court found that the remedy at s 241(3)(d)[28] was

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[20] *Blue Range Resource Corp., Re*, 2000 ABQB 4 ["***Blue Range***"].
[21] This statement refers to the cases of *Olympia & York Developments Ltd. v. Royal Trust Co.* (1993), 17 C.B.R. (3d) 75 (Ont. Gen. Div. [Commercial List]) and *Unisource Canada Inc. v. Hongkong Bank of Canada (1998)*, 43 B.L.R. (2d) 226 (Ont. Gen. Div.).
[22] *In re Lifschultz Fast Freight*, 132 F 3d 339 (7th Cir. 1997) at page 348.
[23] T. Telfer, "Transplanting Equitable Subordination: The New Free-wheeling Equitable Discretion in Canadian Insolvency Law", (2002), 36 CBLJ 36.
[24] *Bulut v. Brampton (City)*, 2000 CarswellOnt 1063 at para. 89.
[25] See for example *Re I. Waxman & Sons Ltd.*, *supra* at note 16, or *Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra* at note 1.
[26] R.S.C., 1985, c. C-44 ["***CBCA***"].
[27] *Lightstream Resources Ltd., Re*, 2016 CarswellAlta 2278. In this case, two creditors of Lightstream participated in a secured notes exchange transaction with Lightstream. Two different unsecured creditors sued on the basis that a) Lightstream had informed them that no such transaction was being contemplated, and b) they were not given the opportunity to participate in the exchange transaction.
[28] In the case, the relevant legislation was the *Alberta Business Corporations Act*, R.S.A. 2000, c. B-9, s 242(3)(e), which is worded identically to CBCA s 241(3)(d).

"contrary to the scheme and object of the *CCAA*." However, the analysis of the inappropriateness of the remedy requested was focused on the prejudice it would cause to other creditors, as opposed to any incompatibility with the goals of the CCAA.

More promising is the recent case of *Ernst & Young Inc. v. Essar Global Fund Ltd. et al*.[29] While the Court did not reorganize the priority of claims in the case, they were willing to take the radical step of altering the disputed transactions. This had the effect of improving the position of the Represented Creditors, as their reasonable expectation that unwarranted value would not be given to a third party was protected, thereby enhancing their potential recovery.

While the oppression remedy has not yet evolved to a point where courts are comfortable using it to subordinate the claims of one creditor to another, the wide discretion it offers combined with the radical approach the courts are adopting with respect to the remedies they order suggest that this may be an avenue to give the equitable subordination doctrine its own Canadian flavour.

Conclusion

Due to the unsuitability of equitable subordination in *CCAA* proceedings, and the uncertainty associated with introducing such a new doctrine, we should hope that the SCC follows the Ontario Court of Appeal's decision in *U.S. Steel*. If there is an appetite for this sort of equitable remedy, developing equitable subordination through the oppression remedy rather than introducing it independently may provide the courts with more reliable guidance.

However, one of the most significant sources of uncertainty is the uncertainty over the current state of the law. If nothing else, the upcoming *U.S. Steel* case before the SCC should be welcomed for providing clarity about the position of the doctrine of equitable subordination in Canadian law.

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[29] 2017 ONSC 1366. In this case, the monitor of the *CCAA* proceedings sued on behalf of several creditors of the insolvent company (the "**Represented Creditors**") over several transactions, which the monitor claimed (among other things) gave unwarranted value to a party related to the insolvent company.