

## • LENDER LIABILITY IN CORPORATE FINANCE TRANSACTIONS AND EQUITABLE SUBORDINATION IN THE U.S. — TOWARDS A CANADIAN PERSPECTIVE •

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### COMPARATIVE ISSUES IN THE LAW OF EQUITABLE SUBORDINATION

Any study of comparative legal issues is predicated on the recognition of the continued drive towards globalized economic markets. As the Americas and Europe collapse sovereign borders and form trading blocks, comparative legal issues will invariably clash with international economic comity. This comparative analysis of the doctrine of equitable subordination in U.S. and Canadian jurisprudence is particularly timely to those involved in cross-border financings, as lenders seek protection from exposure to liability.

### EQUITABLE SUBORDINATION IN THE UNITED STATES

It is not uncommon for a lender to a financially troubled company to desire more control over the company's policies and activities as a way of managing that risk. However, as a lender assumes more control over the borrower, the lender risks having its interest against the borrower subordinated to (or brought to parity with) the claims of other creditors. This section of the paper focuses more closely on lender liability issues as they typically arise through the application of the doctrine of equitable subordination in bankruptcies and insolvencies.

Historically, the development of the doctrine of equitable subordination has been fact-driven. That is to say, the cases which have explored the doctrine and applied it are, in most instances, of limited value in determining a test of broad application. Accordingly, it is difficult to elicit consensus on the line between permissible and impermissible conduct in the management of a loan and the assertion of contractual and/or legal rights against a debtor. As a rule, the greater the control that a lender wields over a borrower, the more likely it is that a court will equitably subordinate the lender's rights. At the same time, it is also true that the more sophisticated the borrower, the less likely it is that a court will apply the doctrine, absent evidence that the lender or its agent committed outright fraud or other illegalities.

The doctrine of equitable subordination is codified as s. 510(c) of the United States *Bankruptcy Code*, which provides that:<sup>1</sup>

Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may –

- (1) 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; or
- (2) order that any lien securing such subordinated claim be transferred to the estate.

Bankruptcy courts apply a three-part test to determine whether equitable subordination is appropriate:

- the creditor must have engaged in misconduct (e.g., fraud, illegality, breach of duty or undercapitalization);
- the misconduct must have resulted in injury to other creditors or unjustly improved the position of the creditor; and
- subordination must not otherwise violate the principles of bankruptcy law.<sup>2</sup>

The threshold issue in equitable subordination cases is whether or not the creditor is an insider of the debtor. Insiders (e.g., shareholders) are held to a higher standard of conduct than non-insiders and thus to a lower threshold of misconduct for equitable subordination. This was illustrated in *Liberty Mutual Ins. Co. v. Leroy Holding Co. Inc.*,<sup>3</sup> where the court held that creditor corporation – which directed and managed the financial affairs of debtor; determined which creditors would be paid and in what amounts; determined the location of the debtor's business operations; and established administrative procedures — was an “insider” when determining if it engaged in inequitable conduct for equitable subordination purposes.

Insiders may be subject to two levels of scrutiny, depending on whether they are also a fiduciary of the borrower.<sup>4</sup> An “insider” is not necessarily a fiduciary. As stated in *Wilson v. Huffman (In re Missionary Bap-*

tist Foundation of America),<sup>5</sup> quoting *Collier on Bankruptcy*.<sup>6</sup> “[I]f the insider claimant has no fiduciary responsibilities, his claims, while closely scrutinized, should only be subject to subordination on grounds that would apply equally to outsiders”. Moreover, a commercial lender does not ordinarily owe fiduciary duties to the borrower or its other creditors.<sup>7</sup> However, in the event that the lender is found to be a fiduciary of the debtor, it will find its claim subordinated “unless the fiduciary can show that the transaction that give rise to the contested claim carried ‘the earmarks of an arm’s length bargain’”.<sup>8</sup> This principle was affirmed in *Citicorp Venture Capital Ltd. v. Committee Creditors Holding Unsecured Claims*,<sup>9</sup> where a fiduciary’s purchase of claims without requisite notice to board and committee established inequitable conduct supporting equitable subordination.

In terms of the level of scrutiny to be applied to insiders, a finding must be made that an insider-lender engaged in “misconduct” for its claim to be equitably subordinated. While there is no clear-cut consensus on what constitutes “misconduct” on the part of an insider, as a rule, it falls short of outright fraud or illegality. Mere undercapitalization of the debtor at the time of the insider transaction is not sufficient to warrant subordination.<sup>10</sup> *In re Lifschultz Fast Freight*,<sup>11</sup> the fact that the debtor was undercapitalized when insiders made a secured loan to the debtor was not, in itself, sufficient grounds for equitable subordination. Likewise, *In re Branding Iron Steak House*, the threshold set by the court required “suspicious, inequitable conduct beyond mere initial undercapitalization”.<sup>12</sup>

Both insiders and non-insiders who plan for insolvency by converting equity positions to debt, or improving a collateralized position, risk having their debt recharacterized as equity. In *In re Envirodyne Industries Inc.*,<sup>13</sup> the court recharacterized as equity the claims of prepetition shareholders whose “inexplicable” failure to tender shares prior to a merger made them creditors. In *In re Kham & Nate’s Shoes No. 2 Inc.*,<sup>14</sup> the court held that “[e]quitable subordination usually is a response to efforts by corporate insiders to convert their equity interests into secured debt in anticipation of bankruptcy”. A significant test for determining whether an insider’s claim is for return of capital contribution and not for repayment of a loan is whether a disinterested lender would have made such a loan at the same time.<sup>15</sup>

Any misconduct by an insider toward the debtor or other creditors, including conduct unrelated to the claim at issue, can be grounds for equitable subordination. For example, where insiders whose claims were based on otherwise valid secured loans to the company to keep it afloat also gave themselves sus-

picious raises just prior to bankruptcy, the court found the actions sufficiently questionable to remand the issue to bankruptcy court for further fact-finding in support of equitable subordination of the insiders’ debt. *In re Lifschultz Fast Freight*,<sup>16</sup> the court held that “[a]ny misconduct by an insider may be invoked to subordinate a particular claim of that insider, ‘irrespective of whether it was related to the acquisition or assertion of that claim’”.

A lower level of scrutiny — “egregious misconduct” — is applied to non-insiders. Egregious misconduct has been characterized as beyond “sharp dealing”. The conduct must be “tantamount to ‘fraud, overreaching or spoliation to the detriment of others’”.<sup>17</sup> In *Teltronics*, the court stated that the burden remains on the objector throughout a proceeding to prove that a non-insider committed the level of egregious conduct necessary to subordinate the non-insider’s claim.

The decision of the *In re Ambassador Riverside Investment Group*<sup>18</sup> court is representative of cases involving egregious misconduct by non-insider lenders. In this particular case, the lender’s agent, who also functioned as debtor’s loan broker, committed the lender to a loan that it was unable to fulfill.

#### REPRESENTATIVE SITUATIONS OF EQUITABLE SUBORDINATION

A lender generally faces equitable subordination in a bankruptcy case in three situations:

- Where the lender effectively exercises day-to-day control over the debtor’s operations;
- Where the lender controls the debtor’s voting stock (e.g., through a pledge of that stock) and uses this control to its advantage over the debtor and other creditors; and
- Where the lender, with the advantage of inside information about the debtor, misrepresents its intentions or the debtor’s condition to other creditors and causes them harm.

Cases involving commercial lenders inevitably turn on questions of effective control of the company through financial dominance.<sup>19</sup> The tension in these cases is usually between the lender’s right to protect its collateral and the borrower’s right to manage its own affairs. Keeping a “watchful eye” over a debtor’s operations, and even proffering “unpalatable” advice to the debtor’s management, does not constitute “control” for purposes of equitable subordination, absent a showing that the lender exercised these tactics solely for its own benefit and in disregard of the rights of other creditors.<sup>20</sup> The cases

demonstrate that, absent outright fraud on the part of the lender or its agents, a court will not subordinate a lender's position based on the lender satisfying one or two of the indicia of control (see below), but generally requires a confluence of factors that suggest both control and coercion.

Clear examples of situations where a lender's claim was equitably subordinated because of lender dominance include *In re T.E. Mercer Trucking Company*.<sup>21</sup> Before denying the debtor's motion for summary judgment, the court in *Mercer* stated that the following "control" elements in a loan agreement were sufficient to equitably subordinate the lender's claim, assuming that it is demonstrated that the lender exercised most or all of the contractually approved control elements:

- Joint control of debtor's bank accounts, with lender's signature required on all large cheques;
- Right to place designee on debtor's board;
- Right to have bank counsel review all by-laws, books and certificates;
- Right to appoint bank employee to key oversight position, with complete veto power over debtor's decisions;
- Right to require liquidation of debtor;
- Right to set salaries of debtor's officers and directors;
- Right to require debtor to pledge stock to lender; and
- Ability to determine outcome of any dispute between debtor and lender's agent.

Further, the court in *Berquist v. First Nat'l Bank (In re American Lumber Co.)*<sup>22</sup> ordered that the bank's overzealous collection practices and other "shocking" behaviour, including misrepresentations to trade creditors, justified subordination of the bank's debt and liens to that of unsecured creditors. Immediately after being informed by the debtor that it was in default and anticipated acute cash shortages, the bank, which was the debtor's sole source of credit, began efforts to coerce the debtor into granting security interests in property, inventory and equipment; refused to honour the debtor's payroll and general account cheques; cut officers' salaries to one-sixth of former levels; fired all but essential personnel and hired security guards to watch over the rest; threatened foreclosure on assets before determining that it held no lien on those assets; and then commenced a liquidation that took less than two months to complete. After liquidation began, the bank began to pick and choose which cheques it would pay to trade creditors based on whether payment would enhance the bank's ability to recover the receivables. The bank also misrepresented the

debtor's solvency to large trade creditors to keep work and deliveries coming during the liquidation.

Finally, in *In Slefco v. First National Bank of Stuttgart (In re Slefco)*,<sup>23</sup> the court held that the bank's efforts to improve its secured position and receive loan payments without regard to the debtor's trade creditors justified subordination of the bank's claims to unsecured creditors' claims and also payment of unsecured creditors' administrative costs incurred by the unsecured creditors in pursuing their rights. The court found that the lender breached its contractual obligation to loan the debtor sufficient funds to complete his crop year and misrepresented its willingness to loan money to the debtor in the future, causing the debtor to pledge assets to the bank and to "ride" (extend or delay) payments to other creditors.

Notwithstanding the foregoing, every situation of lender dominance does not result in the equitable subordination of such lender's claims. For example, in *In re Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*,<sup>24</sup> a lender who extended financing in reliance on a DIP financing order in which the lender was erroneously granted superpriority status could not have its claims subordinated, absent a showing of bad faith on the part of the lender. The objectors argued, that, among other factors supporting equitable subordination, the bank violated the agreement by failing to give *both* telephone and written notice that it would not extend further credit. The court found this breach non-material. This case stands for the proposition that contractual obligations generally should be enforced and not second-guessed by bankruptcy judges, and that trivial breaches cannot form the basis of equitable subordination.

Moreover, the Sixth Circuit established a high bar for proving that a lender used its bargaining power to exercise some control over management activities and in refusing to make further loans absent debtor concessions. The court found no impropriety in the lenders' "watchful" eye in its hard-bargaining with an already distressed borrower.<sup>25</sup> This was also demonstrated in *Harris Trust and Savings Bank (In re Prima Company)*,<sup>26</sup> where the court approved a lender's requirement that new management take complete control of the debtor, and held further that the lender was not liable for damages caused by the new management because the manager was not the lender's agent.

In addition, a lender who otherwise complies with financing agreements and a financing order, and has not made any commitments of further support, is under no duty to extend financing beyond the terms of the agreement and/or order. In general, a lender is "free to walk away" from the deal.<sup>27</sup> Similarly, in *Pan Am Corporation v. Delta Airlines, Inc.*,<sup>28</sup> the court held that a non-debtor airline had no duty to

extend financing to the debtor airline prior to the effective date nor to extend funds beyond those provided for in the financing agreements.

A lender's insistence on the appointment of a liquidator, and on channeling of cash collateral proceeds through a "control account", is also insufficient evidence that the lender controlled the debtor for purposes of equitable subordination. Rather, as stated by the court in *In re Castleton's Inc.*, such actions are "appropriate, justifiable actions to protect its security interest".<sup>29</sup>

Finally, the mere fact that a lender is materially involved in a failed leveraged buyout ("LBO") is not grounds for equitable subordination, absent evidence or overreaching.<sup>30</sup> In *Telesphere*, the court found that the LBO lenders had provided initial and then further financing at the request of the debtor and received payments in accordance with the terms of its agreements.

#### TOWARDS A CANADIAN PERSPECTIVE

As discussed above, the development of the U.S. doctrine of equitable subordination is invoked in the United States in the face of a conflict of interest that may arise when a lender to a financially troubled company assumes too much control over the said company's policies and activities. In assuming control, the lender risks acting in a fashion that enhances his/her claims upon the realization of security, while prejudicing the claims of ordinary creditors. In order to ensure that a secured creditor does not act in a fashion that prejudices other creditors, U.S. bankruptcy courts can invoke the statutory powers in order to preserve the rights of all the creditors over an insolvent company's assets.

Canadian courts do not have the statutory regime to consider the doctrine of equitable subordination nor have they exercised their equitable jurisdiction. The first case where equitable subordination was considered was *AEVO Co. v. D & A MacLeod Co.*,<sup>31</sup> where the court held that the doctrine had no place in Canadian case law. Although the doctrine has not yet been applied in Canada, the Supreme Court of Canada did open the door by expressly considering its application in *Canada Deposit Insurance Corp v. Canadian Commercial Bank*.<sup>32</sup> Currently, Canadian courts have been reticent to apply the doctrine; however, the decision in *Deposit* has moderated the stance of the court in *AEVO*, suggesting that Canadian courts may eventually adopt an approach similar to the U.S. courts' application of the doctrine of equitable subordination.

As previously noted, U.S. courts have taken a fact-specific approach in applying the doctrine of

equitable subordination. In order to subordinate a secured creditor's claim, the particular facts of a case must demonstrate three elements:

- the creditor must have engaged in misconduct (fraud, illegality, breach of duty or undercapitalization);
- the misconduct must have resulted in injury to other creditors or unjustly improved the position of the creditor; and
- subordination must not otherwise violate the principles of bankruptcy law.<sup>33</sup>

In comparing Canadian case law with U.S. jurisprudence, it is insufficient to demonstrate how the doctrine was considered. The necessary question that must be answered is how would a U.S. court have treated the same factual situation. If a U.S. court would have considered equitable subordination and refused to apply it on identical facts, then the doctrine may have more weight than one might assume in Canada. Conversely, if Canadian courts repeatedly consider and refuse to apply the doctrine based on facts that warrant its application according to the U.S. criteria, then the doctrine of equitable subordination has little, if any, support in Canadian law.

In *AEVO*, Newven Consulting Group Inc. ("NCG") granted a general security agreement to Stanley Levine, the owner of AEVO. AEVO advanced funds to NCG on the strength of the general security agreement. When the bank demanded repayment, AEVO settled the indebtedness and was assigned the bank's security. AEVO then created a separate account in which it deposited NCG's receivables. Subsequently, NCG was adjudged bankrupt, and the trustee in bankruptcy sought to subordinate Levine's claim on all of the money in the receivables account set up by AEVO. On these facts, the Ontario Court of Justice held that the doctrine of equitable subordination was inapplicable.

The issue before the court was the motivating intention behind Levine's actions. Was he acting in a fashion that encouraged NCG to incur debt, prejudicing other creditors while maximizing his own security? Or, was Levine merely attempting to protect his own security, and not intentionally jeopardizing the position of the unsecured creditors? As a matter of fact, the court held that the three elements stated at s. 510(c) of the U.S. *Bankruptcy Code* were not met. Notwithstanding this, the court noted that even if the U.S. criteria had been met, "[t]o 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".<sup>34</sup> In effect, the court

yielded no room for the application of the doctrine of equitable subordination, even in circumstances where the facts would warrant its application in the United States.

In commenting on the *AEVO* decision, some legal scholars have suggested that there are mechanisms in Canadian bankruptcy law granting the court residual powers in equity.<sup>35</sup> This conclusion is based on the *dicta* of the British Columbia Court of Appeal in *Laronge Realty Ltd. v. Golconda Investments Ltd.*,<sup>36</sup> which stated that bankruptcy courts do have a long arm to prevent grossly unjust results. Despite the *dicta* in *Laronge*, and other mechanisms existing within the *Bankruptcy and Insolvency Act* seeking to prevent unjust results, the doctrine of equitable subordination (or its underlying rationale), was not applied in *AEVO*.

In *Deposit*, the Canadian Commercial Bank (“CCB”) faced a solvency crisis as a result of a drastic reduction in its loan portfolio. Consequently, both the Canadian and Alberta governments, along with the six major Canadian banks, provided emergency financial assistance to CCB. The issue before the court, upon winding-up of CCB, was the status of the creditors claim for the amount of the emergency loan.<sup>37</sup> Counsel for the appellant presented an alternative argument that the respondent banks should not be treated equally — *pari passu* — with the other creditors, and that their claim should be equitably subordinated given their prejudicial effect on the other creditors. This argument was not presented to the Court of Appeal level; therefore, the Supreme Court of Canada had a very limited fact base to work with in considering the doctrine. Citing the three elements necessary to subordinate a claim in the United States, the court held that the respondent’s activities did not meet the threshold set out in the U.S. *Bankruptcy Code* or case law: “Even if this Court were to accept that a comparable doctrine to equitable subordination should exist in Canadian law, I do not view the facts of this case as giving rise to the ‘inequitable conduct’ and ensuing ‘detriment’ necessary to trigger its application.”<sup>38</sup> Although the doctrine was not applied in this case, the Supreme Court seemed to give it far more weight than the court in *AEVO*. As the court stated, “[e]ven if equitable subordination is available under Canadian law, a question which I leave open for another day, the facts of this case do not call for an intervention...”<sup>39</sup> In light of the court’s acknowledgement of the doctrine of equitable subordination, it is necessary to examine how Canadian courts have reacted to the decision in *Deposit*.

In *Lorbeth Development Corp. v. 795923 Ontario Ltd.*,<sup>40</sup> Justice Sharpe considered the doctrine of eq-

uitable subordination based on the language used by the Supreme Court in *Deposit*. However, he held that, even if equitable subordination could be incorporated into Canadian case law, it was not warranted on the facts of this case. The facts of the case turned on the right of Lorbeth Corporation to purchase a first mortgage, which allowed its controlling partner, Falus to foreclose on the Board of Education for the city of Toronto (the Board), thereby granting the first mortgagee priority over the Board’s interest in a levy agreement on the property in question. Justice Sharpe held that this factual situation did not give rise to the application of the doctrine of equitable subordination, according to the American test. Much like the Supreme Court before him, Sharpe J. was hesitant in stating what the holding of the court would have been had the criteria set out in U.S. jurisprudence been met.

In the U.S. doctrine, jurisprudence and statutory law sets out a clear contextual situation in which the doctrine of equitable subordination can be applied. The ultimate threshold, according to the U.S. test, relates to the degree of control exercised by a creditor over a debtor. If the creditor is characterized as an insider of debtor company, then the threshold is higher, mandating that the creditor show that a transaction was completed at arm’s length. However, if the creditor is characterized as an outsider, then the threshold is one of egregious conduct. By comparison, the Canadian courts have not taken a clear stand on the acceptance or rejection of this doctrine in Canada. In *Deposit*, the court had a clear opportunity to pronounce itself on the standing of equitable subordination in Canadian case law. In a rather Solomonic decision, it neither accepted nor rejected the doctrine. Consequently, Canadian courts have opted for certainty in the law by deferring to the “wisdom” of the *Bankruptcy and Insolvency Act*, and the supremacy of Parliament to adopt new law if it so desires. The door once slammed shut by *AEVO* has been opened by *Deposit* (albeit only slightly). One cannot predict with certainty what Canadian courts will do when faced with a situation that fits in neatly within the requirements set out in the U.S.; however, the Court of Appeal in Ontario recently had the opportunity to apply the doctrine of equitable subordination in a fact scenario that more closely matches the requirements set out in the U.S., but refused to do so on the basis that the portion of the judgment rendered at the trial level which applied equitable subordination was unnecessary.

In *C.C. Petroleum Ltd. v. Allen*,<sup>41</sup> two brothers, Robert Allen and Edward Allen Jr., and their respective spouses, Karen Allen and Yvette Allen, were actively involved in the family business, Payrite Pe-

troleum (“Payrite”). The brothers were officers and directors as well as the directing minds of Payrite. The spouses were each the holders of 50 per cent of the outstanding shares of Payrite, and respectively part-time employees as well as secured creditors by virtue of a general security agreement (“GSA”), which was issued to secure money purportedly advanced to Payrite by the family patriarch, Edward J. Allen Sr., and subsequently assigned to the spouses (at trial, the court noted that “no satisfactory proof has been provided to substantiate the alleged advances of money purportedly secured” by the GSA to the spouses<sup>42</sup>).

As of September 30, 1996, Payrite was an “insolvent person” as defined in the *Bankruptcy and Insolvency Act*.<sup>43</sup> In October 1996, Payrite commenced a cheque kiting scheme between and among the five banks used by the company, which occurred with greater frequency over the ensuing months. On January 2, 1997, Karen and Yvette issued a demand for repayment of the shareholder loan amounts at a time when Payrite was not in a position to repay the amounts in question. On January 20, 1997, the cheque kiting scheme was stopped, and C.C. Petroleum Limited, which was carrying on business as Budget Petroleum, was left with three cheques returned for insufficient funds totalling \$451,101.15. At the same time, between January 20 and January 28, 1997, payments totalling \$398,225.31 were made as follows: Karen Allen (\$155,300); Yvette Allen (\$112,985.31); Robert Allen (\$25,000); Edward Allen Jr. (\$25,000); and Steinberg Morton Frymer (the defendants’ personal and corporate solicitors) (\$80,000).

On Friday, January 24, 1997, it came to the attention of the plaintiff that the cheques had been returned due to insufficient funds. The plaintiff then contacted Robert Allen, who advised that he would look into the matter on Monday. On Sunday evening, the defendants met with their counsel who advised that Karen and Yvette should appoint Schwartz, Levitsky and Feldman Inc. as their Receiver pursuant to their GSA, which the spouses proceeded to do without issuing a Notice of Intention to Enforce Security pursuant to s. 248 of the *Bankruptcy and Insolvency Act*. The Receiver then engaged the services of Steinberg Morton Frymer as its solicitors, and on Monday, January 27, 1997, an order was obtained confirming the appointment of the Receiver “on consent”. The Receiver subsequently engaged Robert Allen and Edward Allen Jr. to collect the accounts receivable despite the objections of the plaintiff’s former counsel. According to the court, the brothers did collect the receivables “...on behalf of the Receiver without supervision by the Receiver

and without maintaining proper records of the collections”.<sup>44</sup>

The Receiver collected \$455,407.69, and paid out, without notice to the plaintiff’s former solicitors and without court approval, the following amounts: \$65,919 to the Receiver; \$46,648.58 to Steinberg Morton Frymer; \$81,400 to Robert and Edward Allen Jr. for “consulting and accounting fees”; and \$175,000 to Karen and Yvette Allen. The amount that was subsequently available for distribution was \$36,587.05.

Finally, in June 2001, Karen Allen as charger, and Robert Allen as a consenting spouse, gave Canada Trustco Mortgage Company a change in the amount of \$693,750 on her home. A subsequent charge was registered later that month in favour of Sharon Childs in the amount of \$275,000, which was prepared by Steinberg Morton Frymer. Under cross-examination, Robert Allen admitted that Sharon Childs was his cousin.

In addition to awarding the plaintiff its costs “...throughout on a solicitor and own client basis to provide the Plaintiff with full indemnity”,<sup>45</sup> the court ordered as follows:<sup>46</sup>

- \* Judgment against the Defendants in the amount of \$539,658.41 [...] to cover its loss incurred as the result of the cheque kiting of the Defendants plus pre-judgment interest from January 24, 1997, and
- \* a declaration that the conduct of the Defendants was oppressive within the meaning of the Business Corporation Act, and
- \* judgment against the Defendants for punitive damages in the amount of \$300,000.00, and
- \* judgment subordinating the secured claim of the female Defendants to the claim of the Plaintiff and an order that all money received by the Defendants from Payrite or its Receiver be paid to the Plaintiff, and
- \* an order that the Defendants account for all money received by each of them from the corporation or Receiver or agent of the corporation.

In ordering the subordination of Karen and Yvette Allen’s secured claims, the court stated as follows:<sup>47</sup>

Because of the ubiquitous and rampant fraud of the Defendants, the G.S.A. (secured claim) of the female Defendants, should be postponed to the claim of the Plaintiffs. The Defendants engaged in fraudulent conduct, acquired an unfair advantage and injured the Plaintiff. In my view, all the prerequisites are present for the application of the doctrine of equitable subordination and the remedy should be granted.

On appeal, the portions of the judgment dealing with the finding of oppressive conduct, an award of punitive damages, and equitable subordination, were all struck. In deleting the portion of the judgment dealing with equitable subordination, the Court of Appeal stated as follows:<sup>48</sup>

The trial judge also ordered that the secured claim of the female appellants against Payrite should be subordinated to the unsecured claim of Budget. It is an open question whether the trial judge had jurisdiction to subordinate the female appellants' secured claims to the unsecured claims of Budget. We were advised, in the course of argument that the female appellants were paid by the trustee in bankruptcy long ago. The subordination order made by the trial judge is, therefore, of no consequence. Given the uncertain state of the law on this point, that portion of the judgment should be deleted as it is unnecessary.

Given the facts in *C.C. Petroleum v. Allen* and the Court of Appeal's decision, it seems that the courts will continue to refrain from applying the doctrine, unless a pragmatic situation arises or Parliament takes action based on perceived inequitable action by creditors.

#### STRATEGIC CONSIDERATIONS IN THE CONTEXT OF CROSS-BORDER INSOLVENCY

In light of the continued development of North-South trade relations, a parallel sense of judicial comity is becoming increasingly integral to cross-border insolvencies. Within the context of an insolvency, a company may have its corporate residence in Canada and yet have its physical assets in the U.S. Such a situation may lead to the consideration of the doctrine of equitable subordination by the U.S. courts over a Canadian corporation. Similarly, a U.S. company may have its corporate residence in Delaware and its physical assets in Canada, which may be subject to Canadian jurisdiction. In this case, the question lingers: how will Canadian courts address the doctrine of equitable subordination? As cross-border insolvency issues continue to come to the fore, both the American and Canadian judicial communities will have to address the discrepancy in the treatment of truly "North American" companies in similar situations based on the jurisdiction in which their assets are seized. At present, secured creditors seem to be more secure with respect to their ability to enforce their claims against a debt in Canada. What remains to be seen is whether this situation will continue to persist.

At the moment, however, wise and honest leaders could use this discord to their advantage. Given the Canadian courts' unwillingness to recognize the doctrine of equitable subordination, a financial institution which exercised questionable control over a borrower may well try and arrange to have the insolvency proceeding commenced in Canada, in an attempt to have the process governed as much as possible by the Canadian law. For instance, assuming the insolvent is subject to Canadian jurisdiction, the primary insolvency proceeding would be initiated in Canada with an ancillary proceeding under s. 304 of the *Bankruptcy Code* commended in the U.S. The 304 proceeding should give the Canadian debtor the benefit of the automatic stay over its U.S. assets, while blocking creditors from initiating a formal bankruptcy proceeding under the *Bankruptcy Code* and thereby restricting access to s. 510(c).

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- <sup>1</sup> There is no further clarification of the standards for equitable subordination in the *Bankruptcy Code* or in the legislative history. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977); S.Rep. No. 989, 95th Conf., 2nd Sess. 74 (1978), reprinted in 1978 U.S. Code Cong. & Admin. News 5787 (noting that the provision essentially codifies case law and citing cases).
- <sup>2</sup> See *Benjamin v. Diamond (In re Mobile Steel Co)*, 563 F.2d 692 (5th Cir. 1977).
- <sup>3</sup> 226 B.R. 746 (N.D.N.Y. 1998).
- <sup>4</sup> See e.g., *In re Kids Creek Partners L.P.*, 200 B.R. 996, 1015 (Bankr. N.D. Ill. 1996) [hereinafter "Partners"].
- <sup>5</sup> 818 F.2d 1135, 1144 n. 8 (5th Cir. 1987).
- <sup>6</sup> 510.05(3)(a) at 510-14 (15th Ed.) (1987).
- <sup>7</sup> *Cosoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599, 609 (2nd Cir.); cert. denied, 464 U.S. 822, 104 S. Ct. 89, 78 L. Ed. 2d 97 (1983).
- <sup>8</sup> *Supra*, note 4, at 1015 as cited in *Pepper v. Litton* 308 U.S. 295, 306, 60 S.Ct. 238, 84 L. Ed. 281 (1939).
- <sup>9</sup> 160 F.3d 982 (3rd Cir. 1998).
- <sup>10</sup> See *In re Filtercorp Inc.*, 163 F.3d 570 (9th Cir. 1998), where the fact that Chapter 11 debtors were insolvent when insiders made prepetition loans to the debtor was insufficient to require equitable subordination of insider's claims.
- <sup>11</sup> 132 F.3d 339 (7th Cir. 1997).

- 12 536 F.2d 299, 302 (9th Cir. 1976).  
13 79 F.3d 579 (7th Cir. 1996).  
14 908 F.2d 1351, 1356 (7th Cir. 1990).  
15 The reasonable lender test was applied in *In re Lafayette Hotel Partnership*, 227 B.R. 445 (S.D.N.Y. 1998), noting that courts may also consider the sufficiency of capitalization, the name given to the debt instruments, the source of payments and whether payment of interest comes from corporate allocations for dividends.  
16 132 F.3d 339 (7th Cir. 1997), as cited *In re Mobile Steel Co. Inc.*, 563 F.2d 692 (5th Cir. 1977).  
17 *In re Baker & Getty Financial Services Inc.*, 974 F.2d 712, 718 (6th Cir. 1992), as cited *In Matter Teltronics Services Inc.*, 29 B.R. 139, 169 (Bankr. N.D.N.Y. 1983) [*"Teltronics"*].  
18 62 B.R. 147 (Bankr. M.D. La. 1986).  
19 *In re T.E. Mercer Trucking Co.*, 16 B.R. 176 (Bankr. N.D. Tex. 1981).  
20 *Cosoff v. Rodmon (In re W.T. Grant Co.)*, 669 F.2d 599, 610 (2nd Cir.); cert. denied, 464 U.S. 822 (1983).  
21 16 B.R. 176, 189-90 (Bankr. N.D. Tex, 1981) [*"Mercer"*].  
22 5 B.R. 470 (D. Minn.1980).  
23 107 B.R. 628 (Bankr. E.D. Ark, 1989).  
24 908 F.2d 1351 (7th Cir. 1990).  
25 *Cosoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599; cert. denied, 464 U.S. 822 (1983).  
26 98 F.2d 952 (7th Cir. 1938).  
27 *Unsecured Creditors' Comm v. Banque Paribas (In re Heartland Chemicals Inc.)*, 136 B.R. 503 (Bankr. CD. Ill. 1992).  
28 175 B.R. 438 (S.D.N.Y. 1994).  
29 990 F.2d 551, 557-59 (10th Cir. 1993).  
30 *In re Telesphere Communications Inc.*, 179 B.R. 544, 561 (Bankr. ND. Ill. 1994) [*"Telesphere"*].  
31 [1991] O.J. No. 1354 (QL), 7 C.B.R. (3d) 33 (Gen. Div. (Bkcy.)) [*"AEVO"*].  
32 [1992] S.C.J. No. 86 (QL), [1992] 3 S.C.R. 558 [*"Deposit"*].  
33 *Supra*, note 2.  
34 *Supra*, note 31, at 38.  
35 L. Crozier, *"Equitable Subordination of Claims in Canadian Bankruptcy Law"* (1992), 7 C.B.R. (3d) 40. [1986] B.C.J. No. 848 (QL), 7 B.C.L.R. (2d) 90 (C.A.).  
36 [1998] O.J. No. 3433 (Gen. Div.) (QL).  
37 The court of first instance held that the emergency package was a capital investment, whereas the Court of Appeal reversed this holding and stated that the package was a loan.  
38 *Supra*, note 32, at 610.  
39 *Ibid.*, at 612.  
40 [2002] O.J. No. 2203 (QL), 35 C.B.R. (4th) 22, 2002 CarswellOnt 2375, 26 B.L.R. (3d) 47 (S.C.J. [Commercial] June 5, 2002); reversed in part on appeal: *C.C. Petroleum Ltd. v Allen*, [2003] O.J. No. 3726 (QL), 46 C.B.R. (4th) 221, 2003 CarswellOnt 3624, 36 B.L.R. (3d) 244 (C.A. September 26, 2003).  
41 S.C.J. decision, at para. 8.  
42 R.S.C. 1985, c. B-3, as amended.  
43 *Ibid.*, at para. 48.  
44 *Ibid.*, at para. 75.  
45 *Ibid.*, at para. 74.  
46 *Ibid.*, at para. 68.  
47 C.A. decision, at para. 18.