

“Risk Allocation and Efficient Administration: A Comparative Analysis
of the Treatment of Equity Securities Claims in Insolvency”

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I. Introduction

Risk allocation is an integral part of the design of commercial systems. While much of commercial risk is allocated through contract law, and occasionally tort case law, there is extensive codification of risk in the design of corporate, securities, insolvency, secured transactions and other statutory regimes. Corporate law allocates rights and responsibilities to shareholders, directors and officers, in turn allocating risk in terms of which parties risk losses due to any misconduct or shirking. Secured transactions regimes allocate risk of non-payment through registry and first-in-time choices. Securities law, or financial services law as it is called in many jurisdictions, offers private remedies for violation of statutory disclosure requirements, allocating the cost of pursuing remedies for misrepresentation or fraudulent disclosure to investors and risk of liability to corporate officers.² Insolvency law allocates risk by the imposition of a hierarchy of claims to the estate of the insolvent or bankrupt firm.

Underlying these statutory frameworks are fundamental principles of transparency, certainty and fairness. There is also often an overriding objective of efficient administration of any mechanism that processes or resolves claims or that determines a remedy in the appropriate circumstances for commercial actors. Legislative reform in any of these substantive commercial law areas frequently is aimed at achieving these principles and objectives within the particular commercial law area.

However, less attention has been paid to how different statutory regimes intersect, as in the case of securities law and insolvency law. At the point of intersection, there can be tensions in the allocation of risk and the efficient functioning of commercial law. Such a point of intersection is currently occurring in respect of how claims by equity securities holders of remedies arising out of fraud and other corporate misconduct, are treated when companies are insolvent. This paper addresses that point of intersection by undertaking a comparative analysis of the treatment of such claims during insolvency.

Part II examines three foundational principles concerning risk allocation in commercial law, transparency, certainty and fairness. It also discusses efficient administration as an overarching objective in the design of insolvency law. Part III examines the priority of creditor claims during insolvency and why securities law claims have become an issue. Part IV examines six potential options for treatment of equity securities claims arising out of corporate misconduct, some of which have been adopted in different jurisdictions. Those options include complete subordination; subordination with concurrent securities law remedies; the parity option; the new purchaser option; determination from the nature of claim; and the judicial discretion option; each assessed against adherence to the foundational principles on

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² Securities laws and financial services laws also usually create regulatory power to enforce remedies, in the interests of protection of capital markets. For ease of reference, I will refer to financial services law and securities law together as securities law in this paper, although I appreciate that the coverage under financial services and securities legislation varies from jurisdiction to jurisdiction.

risk allocation and commercial law. Consideration of the options reveals that there are tradeoffs between fairness and transparency and certainty, and the challenge is to find a framework that meets, to the extent possible, these foundational principles, while advancing the efficient administration of the insolvency proceeding. Part V concludes.

II. First Principles

In many jurisdictions, the statutory allocation of risk in commercial dealings operates on several first principles. The first principle is transparency of the system, in the sense of clarity in the allocation of rights, obligations and remedies, and limits placed on them. There is a requirement for transparency in respect of the allocation of risk, so that creditors, equity investors and other market participants understand the risks they are assuming in agreeing to a transaction, making a loan or equity investment, or making a contract. Transparency is important because absent an ability to understand the rules governing the situation, creditors would be less willing to advance credit, or it would be priced in such a manner that it was unattainable; investors would be unwilling to offer their capital to companies, business trusts and other wealth generating entities; and brokers and underwriters would be reluctant to offer their services in capital markets. Hence, transparency allows market participants to understand the risks inherent in their investment choices and their commercial dealings such that they can make informed choices.

The second principle is predictability or certainty, in the sense of the system instilling confidence in market participants that one set of rules or allocation of risk will not suddenly change without due process or a legislative process; and thus parties know the remedies available and risks inherent in their claims not being met. Statutory reform can further allocate risk through the timing of amendments coming into force or by the “grandfathering” protection of previous arrangements or conduct prior to the legislative change. The underlying rationale for the need for certainty is the same as that for transparency in terms of how access to capital could be negatively affected by a regime that is uncertain. Certainty provides confidence to capital markets participants, in turn resulting in more capital available to the market.

The third principle is fairness in the commercial law regime. Fairness is a normatively driven concept in terms of the allocation of risk of particular commercial transactions. Different jurisdictions have different normative conceptions of what is fair. For example, in the treatment of employee and pension claims during insolvency, different jurisdictions rank employee claims above secured creditors, while others give a preference over only unsecured claims or other specified preferred claims, while yet others give no preference at all, choosing to reduce risk to employees of losses from insolvency through guarantee funds instead of higher placement in the hierarchy of claims during bankruptcy.³ Yet while different jurisdictions have different notions of fairness for particular stakeholders, an underlying thread is being fair in the allocation of risk.

The interaction of securities and insolvency law is the subject matter of this paper, and specifically, whether equity securities holders’ claims for remedies resulting from the misconduct of the corporation should be treated as unsecured claims in insolvency proceedings. If these equity securities investors’ claims are treated as unsecured claims, then not only will they have a right to participate in any distribution of the insolvent corporation’s assets on liquidation, but they will also have the right to vote on any plan to have the insolvent company continue its operations through an insolvency administration or restructuring proceeding. Yet if equity securities claims are treated as unsecured claims, the issue is whether this treatment is fair to unsecured creditors, who will have their share of any distribution and thus influence over the outcome of any vote diluted by the participation of the securities claimants. The protection of both kinds of claimants is an important public policy consideration and the answer to this question engages notions of fairness, in terms of how a jurisdiction views the allocation of risk and remedy for harms as between equity holders with

³ Janis Sarra, “An Investigation into Employee Wage and Pension Claims in Insolvency Proceedings Across Multiple Jurisdictions: Preliminary Observations” (2007) Norton Journal of Bankruptcy Law.

claims outside of ordinary business risk and unsecured creditors harmed more generally by the company's insolvency.

In addition to these fundamental principles of transparency, certainty and fairness, there is an objective in many, if not most, jurisdictions, of the efficient administration of the system. The ability to enforce claims or seek other remedies is illusory if they cannot be enforced. Such enforcement should ideally be timely and at a price that the claimant can afford, such that commercial parties operate under the shadow of the counter-parties' ability to enforce the claim.

Together, these principles and objectives advance the efficiency of capital markets through the confidence instilled in debt and equity investors in respect of their ability to assess risk, price it appropriately and access remedies where necessary.

III. Priority of Creditor Claims during Insolvency

Priority systems are about the allocation of risk. The features of particular debt instruments reflect the pricing of the level of risk that creditors are willing to take that their loans will not be repaid or their supplies will not be paid for. When companies are financially healthy, creditors can expect to receive the face value of their debt instrument plus interest and charges or the value agreed to under their contract.⁴ When companies become financially distressed, the prior allocation of risk crystallizes and the hierarchy of claims codified in insolvency legislation or the insolvency provisions of corporate legislation creates a high degree of certainty in respect of how claims are to be realized. In turn, this certainty allows for the efficient administration of insolvent or bankrupt estates, because insolvency professionals and creditors understand where their claim ranks and the likelihood of partial or full payment of their claims.

Secured credit is increasingly prevalent in financing transactions globally. Secured credit ranks ahead of unsecured credit and in many jurisdictions, that priority results in unsecured creditors only realizing on a small portion of the total value of their claims during insolvency. One study in Canada found that employees as unsecured creditors received an average of 7% of their total unsecured wage claims on bankruptcy.⁵ An Australian study observes that 95% of insolvent companies in 2005-2006 resulted in a payout to unsecured creditors of less than 10 cents on the dollar.⁶ Hence the pool of capital available for claimants after secured debt is satisfied is very limited in a number of jurisdictions.

Securities law and insolvency law regimes intersect at the point that a company is in financial distress and unable to pay its creditors in full. Many jurisdictions subordinate or postpone the damages claims of equity investors to those of regular creditors. The policy rationale is that equity investors receive the unlimited upside potential of an equity investment, and at the same time, have chosen to bear the downside risks of equity losses. In turn, creditors are confident that if the company becomes financially distressed, the cushion provided by their access to the company's residual capital, in advance of equity investors, will ensure that some or all of their claims will be repaid.⁷ Typically, there is express statutory language that

⁴ Janis Sarra, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings" (2007) 16 *International Insolvency Review* 181-246.

⁵ They have a limited preference claims in addition to unsecured claims, but received only 31% of their fourth ranking preferred wage claims. K. Davis and J. Ziegel, "Assessing the Economic Impacts of a New Priority Scheme for Unpaid Wage Earners and Suppliers of Goods and Services" (1998), <http://strategis.ic.gc.ca/SSG/c100150e.html#BIA-consult> at Appendix B, Table 3.

⁶ Australian Government Corporations and Markets Advisory Committee, *Shareholder Claims Against Insolvent Companies, Implications of the Sons of Gwalia Decision, Discussion Paper*, September 2007, www.cama.gov.au, at 30, citing ASIC 2005-2006 and 2004-2005 statistics.

⁷ *Ibid.*

specifies that shareholders' or members' interests rank after unsecured creditors.⁸ Many jurisdictions follow the so-called "absolute priority rule" by providing that creditors must be paid in full in insolvency proceedings before equity holders are entitled to a distribution on their shares during insolvency. Greece, France, Germany, Brazil, the United Kingdom (UK) and the United States (US) are just a few examples. The policy rationale is that equity investors reap the benefits of any upside value created by the wealth generating activities of a company and also take the risks associated with failure of the company.⁹ In contrast, creditors agree only to repayment of the amount owing to them plus interest. While not entitled to any profits generated, creditors do not assume the risk of loss of their investment in the same way, although arguably, at least for senior creditors, insolvency risk is factored into the pricing and availability of credit. In some jurisdictions, such as the US, damages claims arising out of breach of statutory disclosure obligations are clearly subordinated or postponed to creditors' claims under bankruptcy legislation. In other jurisdictions, such as the UK and Australia, the statutory language subordinating claims differs, and recent judgments indicate that the courts have adopted a purposive and integrative approach in trying to reconcile the securities law and insolvency law regimes.

Most debtor companies have not engaged in misrepresentation or deceptive conduct, such that their insolvency will give rise to securities law claims. However, where such claims are asserted, the question arises as to whether an equity investor's claim for fraud damages should rank after creditor claims because the damages relate to an equity interest, or whether the damages claim instead should rank *pari passu* with creditor claims because the damages relate to fraudulent conduct rather than to the fundamental nature of the equity investment.¹⁰ This issue raises the broader public policy question of what legal framework should govern claims arising out of violation of securities law and other corporate misconduct when the firm is in financial distress.¹¹

A key objective of securities law is the protection of investors and the creation of efficient capital markets. Insolvency law is aimed generally at maximizing the value of the estate in order to meet creditors' claims and at providing a fair and efficient mechanism for creditors to realize on their claims. In many jurisdictions, it also provides a framework for the rehabilitation of a company where there is a viable going forward business plan that is acceptable to creditors. Both regulate different aspects of the provision of capital to business enterprises and their proper functioning is important to the economy.¹² Both serve an important public policy function.

In many jurisdictions, the definition of securities in insolvency law mirrors the definition of securities under securities or financial services law, including both debt and equity instruments sold or traded in the market.¹³ The definition blurs the distinction between security

⁸ See for example, Germany's *Insolvenzordnung*, InsO, as amended; Thailand's *Public Companies Act*, B.E. 2535, s. 172.

⁹ Sarra, *supra*, note 4.

¹⁰ For a discussion, see Sarra, *supra*, note 4.

¹¹ The *Sons of Gwalia* case in Australia, which is considered at length in Part III, 3 of this paper, involved claims that arose out of the *Trade Practices Act* rather than Australia's securities laws; *Sons of Gwalia Ltd v. Margaretic* [2007] HCA 1.

¹² Sarra, *supra*, note 4.

¹³ For purposes of this article, the definition is that used by Canadian bankruptcy and insolvency legislation, specifically, "security" means any document, instrument or written or electronic record that is commonly known as a security, and includes, without limiting the generality of the foregoing, (a) a document, instrument or written or electronic record evidencing a share, participation right or other right or interest in property or in an enterprise, including an equity share or stock, or a mutual fund share or unit, (b) a document, instrument or written or electronic record evidencing indebtedness, including a note, bond, debenture, mortgage, hypothec, certificate of deposit, commercial paper or mortgage-backed instrument, (c) a document, instrument or a written or electronic record evidencing a right or interest in respect of an option, warrant or subscription, or under a commodity future, financial future, or exchange or other forward contract, or other derivative instrument, including an eligible financial contract, and (d) such other document, instrument or written or electronic record as is prescribed; section 253 of the Canadian *Bankruptcy and Insolvency Act*, R.S.C. 198S, c. B-3, as

instruments or certificates, both the paper element and the electronic record keeping, and the actual security in the sense of a party's right, title or interest in something. There are also increasingly hybrid forms of securities, with elements of debt and equity, blurring the lines between the two types of capital. While securities law in many jurisdictions regulates debt and equity instruments together, in insolvency, debt is treated differently than equity investments, both in terms of priority of claims for payment, but also in the special treatment accorded to some forms of securities, such as eligible financial contracts. Hence, a distinction must be made between the types of securities claims, specifically: equity claims, debt claims, and those investments that are a hybrid of debt and equity where the categorization of that investment may be a function of the status of the instrument at the time of the insolvency. The difficult definitional question is whether claims of equity security holders arising out of violations of securities law statutes should be categorized as debt or equity claims for purposes of treatment under insolvency law.¹⁴

There have been an increasing number of cases in which insolvencies are either precipitated by claims alleging fraud or other corporate misconduct, or such claims arise during the course of insolvency proceedings. In large measure, these claims are a function of relatively new statutory remedies granted to securities holders in the post-*Sarbanes Oxley* era of enhanced disclosure and governance requirements, increased availability of remedies, and increased enforcement by securities authorities.¹⁵ In a number of jurisdictions, investors have been granted rights to bring civil actions against directors and officers for alleged failure to meet statutory disclosure requirements and/or fraudulent conduct.¹⁶ The scope of actions that can be brought and the remedies available vary from jurisdiction to jurisdiction, but often include remedies for: failure to make timely disclosure of material information; misleading disclosures in the context of a takeover transaction; primary offering misrepresentations; failure to meet continuous disclosure requirements in the secondary market; failure to disclose an accurate picture of the financial status of the corporation; and more intentional fraud. Given the nature of securities, which can be debt or equity or some combination, the treatment of these claims in insolvency proceedings has been somewhat uncertain, particularly when securities holders are aggressively pursuing remedies in the ordinary courts. Increasingly, there have been complex class action suits filed concurrently with insolvency proceedings. Given that these remedies are not the usual claims by shareholders to a residual share of the value of the assets, but rather, claims by investors for compensation for the injury to the value of their investments, the issue is whether they are "interests" to be subordinated or postponed in the same manner as equity claims when the company becomes insolvent or "claims" to be treated *pari passu* with other unsecured claims against the company.¹⁷

The tension between the two regimes has heightened with the shift from liquidation to restructuring regimes in numerous jurisdictions. Control over decisions becomes critically important in a restructuring or business rescue proceeding, in contrast to a pure liquidation, where the trustee or other insolvency professional is liquidating the assets, subject to any objections that creditors may make in regard to the treatment of their claims.

The other reason that this debate is timely is because investors have been harmed by the misconduct of corporate officers to an extent and manner not historically considered part of

amended (*BIA*). M. Condon, A. Anand and J. Sarra, *Securities Law in Canada* (Toronto: Emond Montgomery, 2005) at 183-191.

¹⁴ For a full discussion, see Sarra, *supra*, note 4.

¹⁵ *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745, codified in Titles 11, 15, 18, 28 and 29 USC. (2002).

¹⁶ See, for example, new remedies under Canadian securities law for civil liability for breach of continuous disclosure requirements in the secondary market. Ontario *Securities Act*, R.S.O. 1990, c. S. 5.

¹⁷ For ease of reference, I shall refer to both insolvency and bankruptcy as insolvency, appreciating that some jurisdictions treat these as distinct phases in the debtor's financial life cycle or as applying to different types of debtors, given that in some countries, only individuals are subject to "bankruptcy" laws while corporations are separately dealt with under corporate law.

ordinary business risk.¹⁸ Moreover, numerous jurisdictions have made it easier for equity investors to pursue fraud claims through contingency fee or third party funding arrangements. This last point is critically important. In a "loser pays the winner's legal costs" environment, shareholders simply are not going to risk their own funds seeking recovery from an insolvent company, which is why such cases are rare in the UK.¹⁹ However, if the lawyer takes the risk through a contingency fee, or a litigation funder takes the risk by indemnifying against costs awards, then the claims will be asserted, as is occurring in Australia.²⁰

Just as healthy insolvency laws help to foster robust capital markets through certainty in credit decisions, effective securities legislation is a key to enhancing global capital markets by fostering fair and efficient capital raising processes and confidence in public capital markets through the protection of investors. In considering how to allocate risk at the intersection of the two regimes, an underlying question is how to distribute losses during firm insolvency.

IV. Assessing Policy Options by the Application of First Principles

In developing a framework that would support the public policy goals of both securities law and insolvency law, one needs to consider the nature of the harms for which damages are sought. There is a continuum of behaviour that gives rise to liability of corporate officers, which arguably may be a consideration in the treatment of claims.

For example, fraud is a particularly egregious harm, involving the misrepresentation of the financial status of the company or the misappropriation of funds. Misrepresentation, as defined under securities law, can be intentional, with the intent to defraud investors. Yet liability for failure to disclose can also involve a statutory violation based on timeliness of disclosing information to the market. This latter type of conduct is a harder issue in terms of thinking about remedies as there can be considerable uncertainty in respect of the scope of continuous disclosure requirements, both in terms of the content of the disclosure and in the timing of such disclosure to the market such that ephemeral information does not unnecessarily cause market price swings.²¹ Some jurisdictions, such as Canada, distinguish between material facts and material changes, imposing different disclosure obligations and liability standards for failure to disclose each; and it can be difficult at times to distinguish what is a fact or change within the meaning of the legislation. Hence while securities law mandates timely disclosure and creates remedies for failure to comply, in practice, there are difficult decisions in respect of what is material or sufficiently crystallised such that it should be disclosed.²²

Another question is where business judgment fits in, in respect of decisions regarding the timing of disclosures and how deference to that judgment fits into the overall scheme of how such issues are to be treated. This is an issue recently decided by the Supreme Court of Canada, which held the disclosure requirements under securities legislation are not to be subordinated to the exercise of business judgment.²³ The Court held that it is for the legislature and the courts, not business management, to set the legal disclosure requirements, and while managers should be free to take reasonable risks without having to worry that their business choices will later be second-guessed by judges, justifications for deference, based on relative expertise and the need to support reasonable risk-taking, do not apply to disclosure decisions.²⁴

¹⁸ Enron, WorldCom and Adelphia are three notorious examples; however, there are examples in other jurisdictions, such as Nortel in Canada.

¹⁹ Sarra, *supra*, note 4.

²⁰ *Ibid.*

²¹ Janis Sarra, "Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions", Study for the Task Force to Modernize Securities Legislation in Canada (Toronto: IDA, 2006).

²² An example would be early discussions regarding merger.

²³ *Kerr v. Danier Leather Inc.*, [2007] SCC 44.

²⁴ *Ibid.* at paras. 54-58.

The next part considers six policy options based on the principles outlined above. Whatever policy option is considered, it must be measured against its effect on both debt and equity markets, in terms of investor confidence and the price of credit. It must consider the transaction costs associated with valuation and enforcement of claims.

1. The Complete Subordination Option:

Subordination of all Equity Claims, whether Arising in the Ordinary Course of Business, Fraud or other Violation of Securities Law

The first policy option is the subordination of all equity securities' claims, no matter the circumstances under which they arise. This is the law in the US and will shortly be the law in Canada.²⁵ However, it is important to note that the US system has been tempered with concurrent remedies under securities law, as discussed in the next option.

The absolute priority rule under the US *Bankruptcy Code* clearly specifies that all creditors must be paid in full before shareholders are entitled to receive any distribution, a rule that is largely uncontested in respect of the ordinary business risk that shareholders assume in their investment decisions.²⁶ The *Bankruptcy Code* also expressly subordinates claims arising from rights to rescission and claims for damages arising from the purchase or sale of a security.²⁷

The underlying policy rationale for enacting the provision in the US was that unsecured creditors rely generally on the equity provided by shareholder investment to assist in ensuring trade credit is repaid; shareholders invest understanding that they are undertaking a higher degree of risk and they should justifiably bear the risk of misleading or fraudulent conduct; and it is unfair to allow shareholders to make rescission claims in respect of securities fraud by the debtor such that they are competing with creditors for a limited pool of capital.²⁸ The *quid pro quo* of shareholders' upside potential is that they do not rank on par with creditors in the event of insolvency and the lack of sufficient value in the assets to cover all claims. Hence, US bankruptcy law allocates securities law risks in insolvency proceedings to the equity investors.

The US courts have interpreted the statutory language broadly to subordinate the claims of shareholders to those of unsecured creditors, finding that claims that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged

²⁵ The US subordination is subject to the *Sarbanes-Oxley Act* fair funds provision, as discussed below.

²⁶ 11 USC. § 726 (applicable to Chapter 7 liquidations) & § 1129(b) (applicable to Chapter 11 reorganizations).

²⁷ § 510(b), US *Bankruptcy Code* specifies: "For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock." The US *Bankruptcy Code* also authorizes the court, under the principles of equitable subordination, to subordinate for the purposes of distribution of all or part of an allowed claim or interest; the courts have held that they will look to the nature and substance of the claim and not the form, and that there are three prerequisites: the claimant must have engaged in some type of inequitable conduct; the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and equitable subordination of the claim must not be inconsistent with the provisions of the *Bankruptcy Code*; § 510(c) of the US *Bankruptcy Code*. See also, *In re Mobile Steel Co.*, 563 F. 2d 692 (5th Cir. 1977); *In re Structurlite Plastics Corporation*, 224 B.R. 27; 1998 Bankr. LEXIS 1038, 1998 FED App. 0015P (6th Cir.).

²⁸ John J. Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy" (1973) 48 NYU Law Review 261-300.

illegality in sale or purchase or from corporate misconduct, are to be subordinated.²⁹ Shareholders are to bear the risk of illegality in the issuance of stock in the event that the issuer becomes insolvent.³⁰ In *Re Telegroup Inc.*, the appellate court held that the statutory provisions were enacted “to prevent disappointed shareholders from recovering their investment losses by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding”.³¹ It held that the absolute priority rule reflects the different degree to which each party, securities holders and creditors, assumes the risk of enterprise insolvency; hence the subordinating provision is a risk allocation device, recognizing that shareholders assumed the risk of business failure by investing in equity rather than debt instruments.³²

Hence, the two main rationales for the subordination of shareholder claims are the dissimilar risk and return expectations of shareholders and creditors, and the reliance of creditors on the equity cushion provided by shareholder investment.³³ The focus is on the type of claim possessed, thus parties that were induced to invest through misconduct still fall within the ambit of subordinated claims, as are those that hold on to securities based on misrepresentations.³⁴ In *Re Geneva Steel Co.*, the appellate court held that there is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to hold or sell; both are investment risks that the investors have assumed.³⁵

In *re WorldCom Inc.*, an equity securities holder alleged that his claim for damages arising from ownership of WorldCom stock should not be subordinated under § 510(b) because of the scope of fraudulent and tortious conduct by which he was harmed, arguing that § 510(b) was enacted to subordinate the normal investor risk of loss, not the claims of shareholders harmed by fraud on a massive scale.³⁶ The Court rejected this argument, finding that the statute does not distinguish between massive frauds and petty swindles, rather, it applies even-handedly to both; and that the degree of risk accepted by investors is irrelevant because when investors purchase stock, they agree to accept a total loss, even if they do not consciously expect it, and hence the claim was subordinated.³⁷

²⁹ *Re Telegroup Inc.* (2002) 281 F 3d 133 (3rd Cir. US Court of Appeals); *Re WorldCom* (2005) 329 BR 10 (Bankr. S.D.N.Y.); *Re Granite Partners LP* (1997) 208 BR 332 (Bankr. S.D.N.Y.); *Allen v. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. US Court of Appeals); and *Re Pre-Press Graphics Inc.* (2004) 307 BR 65 (N.D. Ill.), at 78. Early cases had given a narrow interpretation to the scope of § 510(b) to claims arising from a purchase or sale of a security; see for example, *Re Amarex Inc.* (1987) 78 BR 605 (Bankr. WD Okla).

³⁰ *Re PT-1 Communications, Inc.*, (2004) 304 BR 601 (Bankr. E.D.N.Y.); including, where the loss in value of shares was caused by a pre-purchase fraud that induced the purchase and/or a devaluing of the share due to corporate misconduct. *In re Enron Corp. et al v. International Finance Corp.*, interlocutory judgment by Judge Gonzalez, Case No. 01B16034 (Bankr. S.D.N.Y., 2005) at 9, citing *Jackson v. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 476 (S.D.N.Y. 2001).

³¹ *Re Telegroup Inc.* (2002) 281 F 3d 133 (3rd Cir. US Court of Appeals) at 142.

³² *Ibid.* at 139.

³³ *American Broadcasting Systems Inc. v. Nugent*, US Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) at 1097 and the cases cited therein.

³⁴ *Ibid.*

³⁵ *Allen v. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. US Court of Appeals) at 1180; *Re Telegroup, Inc.*, 281 F. 3d at 138.

³⁶ *In re WorldCom, Inc.*, 329 B.R. 10 (Bankr. S.D.N.Y. 2005).

³⁷ *Ibid.* at 13-14. A narrow construction of § 510(b) would limit its application to claims that arise at the time of purchase or sale of shares where there was illegal conduct in the issuance of the stock; Zack Christensen, “The Fair Funds for Investors Provisions of *Sarbanes-Oxley*: Is it Unfair to the Creditors of a Bankrupt Debtor?” (2005) University of Illinois L. Rev 339 at 361. The US courts are not entirely settled on the scope of § 510(b), some courts declining to subordinate claims based on wrongful misconduct that arose after the issuance of shares. See for example, *Re Montgomery Ward Holding Corporation* 272 BR 836 (Bankr. D. el. 2001); *Re Amarex Inc.* 78 BR 605 (W.D. Oak. 1987). However, as the above cases illustrate, US appellate courts for the most part have subordinated such claims.

In Canada, there has not been express statutory language regarding equity claims in either the *Bankruptcy and Insolvency Act (BIA)* or the *Companies' Creditors Arrangement Act (CCAA)*, Canada's two main insolvency statutes. Equity claims have been subordinated to creditor claims under general corporate law and common law principles.³⁸ Generally in insolvency proceedings, equity investors are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full.³⁹ The underlying policy rationale is that shareholders are at the bottom of the hierarchy of claims during an insolvency or bankruptcy proceeding and where there is not sufficient value to meet the claims of unsecured creditors, there is clearly no residual value for equity claims.⁴⁰ There are only four reported judgments in Canada that address the treatment of claims arising out of securities law violations, and only two of these judgments actually decided the issue.

However, Canada is now moving to a statutory scheme that subordinates all equity claims, whether arising out of ordinary business risk or fraudulent conduct. Chapter 36 of the Statutes of Canada, given Royal Assent in December 2007, and soon to be proclaimed in force, will subordinate all equity claims.⁴¹ The *BIA* and the *CCAA* will specify that a party is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied.⁴² The statutes will define equity interest and equity claims for the first time.⁴³ The proposed definition includes claims for losses arising out of purchase or sale of equity investments, which will be considered equity claims and not a debt or liability for purposes of insolvency proceedings; and the proposed statutory language makes no distinction for claims arising out of securities law violations.

In addition, provisions of the *BIA* that currently specify that debts not discharged in bankruptcy for public policy reasons include fraudulent misrepresentation, will now be amended to specify that "any debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim" is not discharged.⁴⁴ The policy rationale for the proposed change is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into

³⁸ *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (*CCAA*). *Re Central Capital Corporation* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at 245; *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402-408. L. Houlden, G. Morawetz and J. Sarra, *The 2007 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2006) at 668; *Sukloff v. A.H. Rushforth & Co.*, (1964), 6 C.B.R. (N.S.) 175 (S.C.C.). Where shareholders lent money to a debtor but did not receive a rate of interest varying with profit or sharing profits, subordination has been found not to apply: *Re Provost Shoe Shops Ltd.* (1993), 21 C.B.R. (3d) 108, 340 A.P.R. 302 (S.C.).

³⁹ *Re Royal Oak Mines Inc.* (1999), 14 C.B.R. (4th) 279 (Ont. S.C.J. (Commercial List)); *Re Central Capital Corporation*, *ibid.* at 245.

⁴⁰ For a discussion, see Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvency Corporations* (Toronto: University of Toronto, 2002).

⁴¹ Statutes of Canada, Chapter 36, Royal Assent, December 14 2007, expected to be proclaimed in force within 6 to 12 months from date of Royal Assent (Chapter 36).

⁴² *Ibid.*, proposed s. 140.1, *BIA*.

⁴³ *Ibid.*, Proposed s. 2, *BIA* and s. 2, *CCAA* specify:

'equity interest' means (a) in the case of a corporation other than an income trust, a share in the corporation – or a warrant or option or another right to acquire a share in the corporation – other than one that is derived from a convertible debt, and (b) in the case of an income trust, a unit in the income trust – or a warrant or option or another right to acquire a unit in the income trust - other than one that is derived from a convertible debt.

'equity claim' means a claim that is in respect of an equity interest, including a claim for, among others, (a) a dividend or similar payment, (b) a return of capital, (c) a redemption or retraction obligation, (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Québec, the annulment, of a purchase or sale of an equity interest, or (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).

⁴⁴ Chapter 36, *supra*, note 41, proposed s. 178(1)(e), *BIA*.

investing in a business, when a firm is financially distressed, shareholders should be placed at the bottom of the priority of claims.⁴⁵

Under the proposed Canadian statutory reform, no proposal under the *BIA* or plan of compromise or arrangement under the *CCAA* that provides for the payment of an equity claim is to be approved by the court unless the proposal or plan provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.⁴⁶ In restructuring proceedings, the new statutory language specifies that creditors having equity claims are to be in the same class of creditors in relation to those claims, unless the court orders otherwise, but may not vote at any meeting, unless the court orders otherwise.⁴⁷ This authority codifies current practice where courts have allowed equity claimants to vote where there is still equity remaining in the debtor corporation. The public policy objective of the proposed amendments is to reduce the power of equity claimants, who might otherwise control the voting where they have substantial claims, and thus avoid any ability to defeat a restructuring plan that has the requisite support of creditors. The language in the 2007 amendments tempered an earlier proposed complete prohibition on voting to add the phrase “unless the court orders otherwise”.⁴⁸ However, this authority will be of limited assistance to claimants arising out of securities law violations. The proposed amendments also specify that a plan of compromise or arrangement may not deal with a claim that relates to any debt or liability resulting from obtaining property or services by false pretenses or fraudulent misrepresentation unless the creditor in relation to that debt has voted for the compromise, other than a debt or liability that arises from an equity claim.⁴⁹ Thus, a debtor corporation will need the consent of creditors to compromise such claims but will not require the consent of equity claimants for the same type of liability.⁵⁰

Hence the proposed statutory language resembles that in the US. In enacting the new Canadian statutory provisions, there was almost no public policy debate, in contrast to the attention that other areas of proposed reform were given.⁵¹ In part, the amendments are a response to pressure to align the Canadian provisions with those in the US. Some insolvency cases in which debtor corporations were registered in Canada had their claims processed in US proceedings, arguably because creditors wanted the higher degree of certainty that the US strict subordination regime offered.⁵²

Although there has been no express statutory language, the only two cases in Canada that have directly determined the issue gave the identical treatment to equity claims as under the highly codified US *Bankruptcy Code*, although two other judgments have indicated a different treatment.

⁴⁵ Government Briefing Book, Chapter 47 amendments at bill clause no. 37.

⁴⁶ Chapter 36, *supra*, note 41, proposed s. 60(1.7), *BIA* and proposed s. 6(8), *CCAA*. This language may be too rigid in that in some cases there may be claims for damages from securities law violations and other creditors may decide that it is helpful to place some value on the table in order to reach agreement on a restructuring plan or because there is goodwill or other reputational reasons to recognize and value such claims. The language as currently proposed would prevent giving such claimants any remedy where other creditors are not paid in full and thus may prevent a positive outcome in some circumstances; see the discussion in Sarra, *supra*, note 4.

⁴⁷ Chapter 36, *supra*, note 41, proposed s. 54(2)(d), *BIA* and s. 22.1, *CCAA*.

⁴⁸ Chapter 36, *ibid.*, proposed s. 54(2)(d), *BIA*.

⁴⁹ *Ibid.*, proposed s. 19(2)(d), *CCAA*.

⁵⁰ The amendments also specify that the stay order in a restructuring proceeding will not affect the rights of a regulatory body with respect to any investigation in respect of the company or any action, suit or proceeding to be taken by it against the company, except when it is seeking to enforce any of its rights as a secured creditor or an unsecured creditor. There is an exception where the court determines that a viable compromise or arrangement could not be made in respect of the company if that subsection were to apply and where it is not contrary to the public interest that the regulatory body be affected by the stay order. *Ibid.*, proposed s. 69.6, *BIA* and proposed s. 11.1(1), *CCAA*.

⁵¹ Joint Task Force on Business Insolvency Law Reform, *Final Report*, 2002 at 32.

⁵² The *Laidlaw* and *Loewen* proceedings are arguably examples of this, although each had extensive operations in the US and hence numerous claims were located there.

In Canada, restructuring of the capital structure of a corporation can occur under corporate statutes or insolvency statutes. Under most Canadian corporate statutes, a plan of reorganization or plan of arrangement can restructure equity without a shareholder vote if the equity investment has no value. These provisions come into play where the corporation is insolvent. In the context of restructuring proceedings, Canadian courts have held that where there is no equity value left in the debtor corporation, shareholders will not be allowed to vote on a restructuring plan or a proposal and will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding or the specific proposal or plan of arrangement and compromise.⁵³ Unlike a Chapter 11 debtor company in the US, a Canadian company must meet an insolvency test before it can have access to insolvency legislation; hence the interests of equity investors are most often already under water at the point that the debtor files insolvency proceedings.

Re Blue Range Resource Corp. was the first Canadian case that dealt directly with the issue of whether an equity investor in a takeover bid, allegedly induced by fraud to purchase shares of a debtor corporation, was able to assert its claim in such a way as to achieve parity with other unsecured creditors in a CCAA proceeding.⁵⁴ The Court considered the treatment of shareholder claims for negligent misrepresentation, addressing the question of whether the treatment of such claims differed from the risks of ordinary business investments.⁵⁵ The Court held that it was clear under corporate law and common law principles that shareholders are not entitled to share in the assets of the debtor corporation until ordinary creditors have been paid in full, as creditors assess risk and price their loans on the basis of that priority and shareholders invest with the knowledge that they are taking the risk of business failure.⁵⁶ The Court relied on the fundamental corporate principle that claims of shareholders should rank below those of creditors on insolvency, finding that even though the claim was a tort claim on its face, it was in substance a claim by a shareholder for a return of what it paid for shares by way of damages.⁵⁷ The Court held that the nature of the claim against Blue Range for an alleged share exchange loss, transaction costs and cash share purchase damages was in substance a claim by a shareholder for a return of what it invested *qua* shareholder, and hence the claim ranked after the claims of unsecured creditors.⁵⁸

The Alberta Court of Queen's Bench in *Blue Range* observed that a restructuring plan under the CCAA does not provide a statutory scheme for distribution, as it is based on the premise that a plan of arrangement will provide a classification of claims that will be presented to

⁵³ See for example, *Re Canadian Airlines Inc.* (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List)); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

⁵⁴ *Re Blue Range Resource Corp.*, 2000 CarswellAlta 12, 15 C.B.R. (4th) 169 (Alta Q.B.).

⁵⁵ *Re Blue Range Resource Corp.*, *ibid.* Blue Range involved an application for determination of whether Big Bear Exploration Ltd.'s claim should rank equally with claims of unsecured creditors. Big Bear had succeeded in a takeover bid for Blue Range Resource Corp. by way of exchange of shares and claimed that its decision to undertake the takeover was made in reliance on information publicly disclosed by Blue Range regarding its financial situation. After the takeover, it discovered that the information disclosed by Blue Range was misleading and that the Blue Range shares were essentially worthless. As sole shareholder, Big Bear caused the company to apply for protection under the CCAA. The Court held that the very core of the claim was the acquisition of Blue Range shares by the shareholder, Big Bear, and whether the consideration paid for such shares was based on misrepresentation. It held that Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder. The Court concluded that the tort claim derived from Big Bear's status as a shareholder, and not from a tort unrelated to that status. *Ibid.* at para. 22.

⁵⁶ *Re Blue Range Resource Corp.*, (2000) 15 C.B.R. (4th) 169 (Alta Q.B.), at 17. The Court left open the question of whether there were instances in which the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, but this appears to be a narrow exception, the Court giving the example of a shareholder who slips and falls outside of the corporate office who may have potential claims in negligence.

⁵⁷ *Ibid.* at para. 29.

⁵⁸ *Ibid.* at para. 14.

creditors for approval. Creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of insolvency. The Court held that the identification of risk-taking assumed by shareholders and creditors was illustrated by the investor's behaviour in that in the course of the hostile takeover of Blue Range, it sought access to Blue Range's books and records for information, but had its requests denied. Nevertheless, the investor pursued the takeover in the absence of information it knew would have been prudent to obtain.⁵⁹ *Blue Range* was highly fact driven, with the court addressing particular conduct of a shareholder in its takeover bid and hence may not offer real guidance to parties.

The reasoning in *Blue Range* was subsequently endorsed by another judge of the same court in *National Bank of Canada v. Merit Energy Ltd.*, where the Court held that the claims of shareholders arising from alleged misrepresentation in a prospectus were subordinate to the claims of the debtor company's unsecured creditors as they were in substance shareholder claims for return of equity investment.⁶⁰ The Court held that while the shareholders paid a premium for the shares, the debt features associated with an indemnity from the debtor did not transform that part of the relationship from a shareholder to a creditor relationship.

Hence the only two reported judgments in Canada that have decided the subordination issue have used equitable principles and corporate law principles to subordinate shareholder claims in insolvency proceedings without really detailed consideration of securities law violations or the intersection of securities laws and insolvency law and their respective public policy goals. Securities litigation has generally been less frequent in Canada than the US as Canada has a "costs follow results" rule that is generally applied, which acts as a restraint on bringing frivolous or unmeritorious actions.

There are two other Canadian judgments that indicate a different approach, but do not determine the question. Although of limited assistance because it was an uncontested endorsement order, Justice Farley of the Ontario Superior Court dealt with the subordination question on an unopposed motion.⁶¹ The Court, in approving a motion for Bell Canada International as a continuing corporation to redeem and pay out on maturity of high yield notes, addressed a pending shareholder action. It held that even if leave was granted to the shareholders by the Supreme Court of Canada and there was subsequent success at trial, the Court did "not see any reasonable justification for any award that might then be granted not being treated as subordinate to the obligations under the High Yield Notes".⁶² The Court held that "any exercise in logic or practicality would lead to the reasonable conclusion that such an award relating to secondary market activity (i.e. it not being a section 130 *Securities Act* claim as to a primary issue) should be treated as continuing in priority terms to be the equivalent of equity (and not as debt, whether or not it be subordinated or *pari passu*)".⁶³ Section 130 refers to liability for misrepresentation in an offering memorandum.⁶⁴ The Court left open the question of whether a claim arising from primary market securities law violations would be treated differently than secondary market purchases.

A second Ontario court judgment suggests, without deciding the issue, that claims for damages arising out of securities law violations may be unsecured creditor claims. *Menegon v. Philip Services Corp.* involved a motion by Philip Services for authorization to enter into a proposed settlement under the Ontario *Class Proceeding Act*.⁶⁵ Philip Services Corp. was the

⁵⁹ The Court observed that it also actively embraced its shareholder status despite the allegations of misrepresentation, putting Blue Range under the CCAA in an attempt to preserve its equity value and, in the result, holding Blue Range's creditors at bay and yet it was also attempting to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim. *Ibid.*

⁶⁰ *National Bank of Canada v. Merit Energy Ltd.* 2001 CarswellAlta 913 (Alta. Q.B.).

⁶¹ *In the Matter of Bell Canada International Inc.*, Court File No. 02CL-4553 (14 September 2004) (Ont. S.C.J. (Commercial List)), Endorsement of Farley, J.

⁶² *Ibid.* at para. 3.

⁶³ *Ibid.*

⁶⁴ Section 130(1) of the Ontario *Securities Act*, R.S.O. 1990, c. S. 5.

⁶⁵ *Menegon v. Philip Services Corp.* [1999] O.J. No. 4080 (Ont. S.C.J. (Commercial List)).

parent company of a network of 200 directly and indirectly owned subsidiaries in Canada, the US and elsewhere.⁶⁶ Class actions alleged that Philip's financial disclosure contained material misstatements in violation of US securities laws.⁶⁷ Philip filed for bankruptcy protection in the US and for protection in Canada under the CCAA. The shareholder class actions in both the US and Canada were based on the same non-disclosure. In the US, the class action claims were clearly subordinated and had no voting rights because of s. 510(b) of the *Bankruptcy Code*, but in Canada, there was no equivalent provision. The problem was that there were identical claims against one company that were entitled to different treatment on different sides of the border. The parties entered into a memorandum of understanding that outlined a proposed settlement between Philip and the US and Canadian class action proceedings, whereby the claims, whether Canadian or US, were to be dealt with under the US Plan and governed by Chapter 11 of the US *Bankruptcy Code*.⁶⁸

The Court held that the class action plaintiffs and the co-defendants were all unsecured claimants of Philip.⁶⁹ The Court held that it was premature to approve a settlement of the US and Canadian class action proceedings at that stage of the restructuring process.⁷⁰ The Court held that where the proposed structure of the reorganization affects the substantive rights of claimants in a fashion that treats them differently than they would otherwise be treated under Canadian law, and where the effect of that treatment is to place the claimants in a position where their ability to engage in full and complete negotiations with the debtor company are impaired, there is cause for concern on the part of the court; hence the loss of the right to vote in the Canadian plan was problematic.⁷¹ The Court held that while the fact that treatment of claims under US bankruptcy law would be considerably less favourable than their treatment under Canadian law was not determinative, but it was a factor for consideration when taken in conjunction with the loss of voting rights in the Canadian plan.⁷² The Court viewed the claims for damages arising out of securities law violations as unsecured claims and it expressed concern about a proposed settlement that compromised the right of those claimants to vote on a Canadian CCAA plan, although the court did not have to make a definitive determination on the ranking of the claims.⁷³

Hence the caselaw in Canada is not entirely settled in respect of the subordination issue. To date there has not been an appellate judgment in Canada on the treatment of claims arising out of securities law violations in respect of an insolvent company. However, once the new legislation is proclaimed in force, any difference between the Alberta and Ontario courts will be moot.

The complete subordination option does leave room to give priority to equity securities claims arising from misconduct a higher priority than other residual claims of shareholders. Such an

⁶⁶ *Ibid.* at para. 2.

⁶⁷ The class action proceedings were an action for misrepresentation, negligent misrepresentation and rescission relating to the purchase of shares. Menegon commenced a class proceeding in Ontario for misrepresentation, alleging violations of Canadian securities law. The actions were consolidated and ultimately dismissed, though an appeal was pending at the time of this judgment.

⁶⁸ *Menegon v. Philip Services Corp.*, *supra*, note 101 at para. 13.

⁶⁹ *Ibid.* at para. 29.

⁷⁰ *Ibid.* The Court held that the claim against Philip and its former officers and directors arose out of the same "nucleus of operative facts" as the claims of the class action plaintiffs against Philip; and that one follows from the other. The Court held that it has frequently been noted that the full name of the CCAA is "An Act to facilitate compromises and arrangements between companies and their creditors". In the bare-knuckled ring of commercial restructuring negotiations, this cannot be accomplished if one group of unsecured claimant is given an unwarranted advantage over another. *Ibid.* at para. 29.

⁷¹ *Ibid.* at paras. 35-36.

⁷² *Ibid.* at para. 39. The Court concluded that the Canadian plan was flawed because it sought to exclude Canadian claimants from participation in its process by providing that their claims against Philip were to be governed by the US proceedings while at the same time seeking to bind them to the provisions of the Canadian plan, all without affording those claimants any right to vote. *Ibid.* at paras. 49, 55.

⁷³ The case also illustrates that it would be helpful to have coordination of Canadian and US law on the issue of treatment of equity claims as a means of facilitating the reorganization of corporate groups.

option would not disturb the hierarchy of creditors' claims. However, since in most cases there is not enough value in the company to satisfy unsecured creditors' claims, the very definition of insolvency, such an option would be meaningless in most cases, unless, as in the US, the legislation allows debtor companies to file before they are actually insolvent.

Application of First Principles to the Subordination Option

Assessing the complete subordination option, it does meet several principles articulated at the outset of the paper. In the US, there is transparency in the treatment of claims, and the proposed reforms in Canada will offer the same clarity. There is certainty in that debt and equity investors will be able to make their investment choice knowing the limits on any recourse for fraudulent misconduct. Creditors are entitled to some certainty in respect of where their claims are placed in the hierarchy of credit and subordinating shareholders' claims creates greater certainty and increases the pool of capital available to unsecured creditors at the point of insolvency because they do not share on a *pari passu* basis with equity investors.

Fairness

The regime clearly shifts risk to equity investors, in terms of insolvencies precipitated by fraudulent conduct. In terms of the fairness principle, this option may or may not meet the fairness principle, depending on one's normative conception of whether equity investors take on the risk of fraud when they invest in the firm. Clearly, historically, investors did not take on this risk, and so fairness may dictate that these claims are more in the nature of unsecured claims than claims arising out of ordinary business risk. On the other hand, given the prevalence of fraud and misrepresentation in recent years, one could argue that even where it was not previously an ordinary business risk, it has become one in the current market.

In terms of the fairness of the allocation of risk, in many cases, equity investors are able to diversify their risk, except perhaps employees whose investments are concentrated in their employers' stock. This ability to diversify risk may be greater than the ability of some trade suppliers or other small unsecured creditors that do not have the bargaining power to demand security. They may be dependent on a single company, for example, "just-in-time" suppliers to the North American auto industry and thus have undiversified risk.

A further consideration is the sophistication of investors. Institutional investors clearly understand the nature of the risk of their investment, whereas individual retail investors may not understand their risk in the context of fraud or misrepresentation. Should information asymmetries dictate fairness in the treatment of fraud and misrepresentation claims?

The fairness inquiry also engages the expectations of investors and creditors. At the same time as Canada is undertaking insolvency law reform, new statutory civil remedies for securities law violations have been introduced. Four jurisdictions with more than 95% of the capital market activity in Canada, have granted securities holders the right to bring civil suits for misrepresentation.⁷⁴ The provisions are aimed at giving meaningful remedies to investors where corporate officers act in violation of continuous disclosure requirements. Since Canadian securities law is premised on disclosure and transparency, the new provisions are important to the integrity of the system. These provisions are aimed at overcoming common law barriers to remedies by adding a deemed reliance provision such that causation need not be proven. The new remedies are viewed as important investor protection measures. Yet where the impugned companies are insolvent, the new remedies will be largely ineffective, given the proposed amendments to the *BIA* and *CCAA*. The decision to allocate the risk of loss to unsecured creditors over equity investors with claims for losses arising out of corporate misconduct is a normative choice regarding how fairness is to be determined as between claimants under insolvency and securities law.

⁷⁴ See for example, the Ontario *Securities Act*, Part XXIII.1.

Another aspect of the fairness assessment is the ability to monitor for corporate misconduct. One US scholar has observed that since the subordination theory of creditor reliance was developed in the US, the nature of both debt and equity investment has changed; the majority of shareholders are no longer a small group of entrepreneurs; rather, they are a broadly dispersed group that cannot easily monitor officer conduct.⁷⁵ Creditors frequently include large sophisticated financial institutions that are able to monitor the activities of corporate officers through disclosure and other covenants, and for the most part no longer include only small vulnerable trade suppliers; hence, the comparative ability of debt and equity classes to protect themselves from fraud has shifted.⁷⁶ A counter-point is that it is the equity investors that vote for the directors, who in turn select the corporate officers; and arguably, shareholders should organize themselves to be effective monitors of corporate officer conduct.⁷⁷ However, this suggestion may not be realistic, given the small proportion of shareholdings that most investors have at risk. Moreover, there is a further shift in the nature of corporate debt, with financial institutions such as banks generally holding less corporate debt and hedge funds that have varying monitoring capacities holding more corporate debt.

Efficiency

The subordination of equity securities law claims does meet the objective of efficient administration of the insolvency proceeding. The Canadian court in *Blue Range* was concerned about the administrative difficulties that would be imposed on insolvency professionals in trying to process claims. There is an issue of the timeliness of the insolvency process, which in Canada is conducted on a “real time basis” and the implications for resolving securities law claims.

Equally, however, the subordination of equity claims, as currently defined in the proposed legislation, may encourage debtor corporations to enter restructuring proceedings in order to subordinate claims, on the basis that if the claims were realized, the company would be insolvent within the meaning of Canadian insolvency legislation. Recent case law in Canada has held that “insolvent” should be given an expanded meaning under the CCAA in order to give effect to the rehabilitative goal of the statute.⁷⁸ This broader definition has facilitated going concern restructurings but may also create inappropriate incentives when coupled with the proposed provisions that subordinate all equity claims in a CCAA restructuring proceeding. If the securities claims or other equity-related claims against a debtor are so large they render the debtor insolvent, there is nothing inappropriate about entering restructuring proceedings to deal with the claims and to devise a going forward business strategy. However, if the subordination of claims might encourage tactics where a filing is done as a means to wipe out equity claims without a vote and without compensation, the proposed legislative amendments may or may not provide a means to deal with the issue. If there is a reasonable argument that there is net value in the business after other claims but before the equity claim, the court could decide to exercise its power to allow the holders of the equity claims to vote, providing claimants with leverage in the Canadian system, where there is no cram-down.

In sum, while the complete subordination option meets the transparency and certainty principles, it is at considerable sacrifice to the fairness principle. The option does advance the efficiency objective as trustees and other insolvency professionals do not have to value these claims to determine what value should be paid out to unsecured creditors, in turn creating at least the opportunity for a timely resolution of the insolvency proceeding. The fairness

⁷⁵ K. B. Davis, “The Status of Defrauded Securityholders in Corporate Bankruptcy” (1983) Duke L.J. 1; Robert Stark, “Reexamining the Subordination of Investor Fraud Claims in Bankruptcy: A Critical Study of *In re Granite Partners*” (1998) 72 Am. Bankr. L.J. 497.

⁷⁶ Davis, *ibid.* at 29.

⁷⁷ *Ibid.*

⁷⁸ *Re Stelco Inc.* (2004), 2004 CarswellOnt 1211, 48 C.B.R. (4th) 299 (Ont. S.C.J. [Commercial List]), leave to appeal to C.A. refused (2004), 2004 CarswellOnt 2936 (C.A.). The Court held that a court should determine whether there is a reasonably foreseeable expectation at the time of filing that there is a looming liquidity condition or crisis that will result in the applicant running out of money to pay its debts as they generally become due in the future without the benefit of the stay and ancillary protection.

question is, however, significant, and in reality, the US has moved to a concurrent system, as set out in the next part, such that the unfairness created by the complete subordination model is tempered by granting other remedies to harms caused to equity securities holders from the misconduct of the corporation and its officers. That shift means that the proposed Canadian legislation may stand as one of the only jurisdictions planning to adopt the complete subordination model.

2. The Concurrent Strategies Option:

Complete Subordination of Equity Securities Claims with Concurrent Remedies for Investor Harms under Securities or Financial Services Law

A second option is the concurrent strategies option, which is the complete subordination option with concurrent authority granted to securities regulators to exercise enhanced powers to require disgorgement of funds and penalties paid for misconduct to be directed towards investors harmed by corporate misconduct, as has occurred in the US.

US securities law has provided for civil remedies for claims of misrepresentation, fraudulent conduct and other violations of securities laws for a number of years. As a consequence, there have been a number of class actions against corporations, which either precipitate US firms filing US *Bankruptcy Code* Chapter 11 proceedings or liquidation proceedings, or that arise once the conduct of officers becomes known in a bankruptcy proceeding. The vast majority of these cases settle before judgment. While the claims under the settlement are subordinated under US bankruptcy law, remedies under the *Sarbanes-Oxley Act of 2002* have given rise to new indirect remedies to equity investors for harms caused by securities law violations.⁷⁹

The Securities Exchange Commission (SEC) under the *Sarbanes-Oxley Act* is given express power to distribute payments to investors as part of the “fair funds for investors” civil penalty and disgorgement powers.⁸⁰ The fair funds provisions have been successfully used to return some of the losses to investors. In 2005, \$1.9 billion in disgorgement and penalties was ordered, 96% of which was collected.⁸¹ A number of these cases involve bankruptcy proceedings.

Section 308(a) of the *Sarbanes-Oxley Act* allows civil penalties to be added to disgorgement funds for the relief of victims of securities fraud, allowing the SEC to distribute both the civil penalties and disgorgement funds created under the *Sarbanes-Oxley Act* from the assets of the bankruptcy estate to investors.⁸² SEC claims rank equally with those of unsecured creditors in a bankruptcy or reorganization proceeding. The fair funds provision allows investors wronged by securities law violations to recover at least a portion of their losses from the fraudulent conduct of the debtor by route of the SEC’s lawsuit against the debtor

⁷⁹ *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, 116 Stat. 745, codified in Titles 11, 15, 18, 28 and 29 USC. (2002). The *Sarbanes-Oxley Act* was enacted in response to corporate scandals and considerable public pressure to respond to the harms caused by massive frauds perpetrated by US companies. It represents the particular nature of US democracy in that it was a rapid response to severely shaken markets and the result of intense lobbying to address the weaknesses in US securities law and the consequent harms.

⁸⁰ *Sarbanes-Oxley Act of 2002*, at section 308. For a discussion, see Christensen, *supra*, note 37; Marvin Sprouse and Jackson Walker, “A Collision of Fairness: *Sarbanes-Oxley* and § 510(b) of the *Bankruptcy Code*” (2005) 24 American Bankruptcy Institute Journal 8.

⁸¹ In 2006, \$1.2 billion was ordered, 82% of which was collected. Christensen, *ibid.* at 56. Compensation to investors is a secondary function and the primary objective of the provisions is deterrence.

⁸² Section 308(a). Previously, civil penalties could only be paid to the US Treasury.

corporation.⁸³ Hence, while a shareholder's claim is subordinated pursuant to § 510(b) of the US *Bankruptcy Code*, the investor may be eligible for a distribution pursuant to the fair funds for investors provision under the *Sarbanes-Oxley Act* from the bankrupt's assets indirectly through the SEC.⁸⁴

The fair funds provision was enacted as further recognition of the SEC's authority to create equitable remedies, including disgorgement orders that obligate the surrender of profits and interest acquired in violation of securities law.⁸⁵ The provision allows the SEC to enhance its enforcement of securities law and to seek remedies that will serve as a deterrent to fraudulent conduct by issuing corporations. The amount of civil liability that the SEC will seek to impose depends on the egregiousness of the issuer's conduct, the degree of its scienter, whether the conduct created substantial losses or risk of losses to others, whether the conduct was of a recurring nature, and the debtor's current and anticipated financial condition.⁸⁶ The SEC may seek orders requiring parties to disgorge any money obtained through wrongdoing and is empowered to seek civil penalties for violations of securities laws.⁸⁷ Disgorgement is an equitable remedy that requires the corporation or party that engaged in fraudulent activities to give up the amounts by which they were unjustly enriched by the wrongful conduct. While the SEC bears the burden of proving that the amount sought is appropriate, the courts have held that the amount of disgorgement need only be "a reasonable approximation of profits causally connected to the violation".⁸⁸

Where the SEC has received a judgment for civil penalties and disgorgement, either on a settlement basis or after litigation, the amount ordered by the court is the SEC's claim against the estate of the debtor corporation and it ranks with ordinary creditors, above equity claimants.⁸⁹ Under Chapter 11 *Bankruptcy Code* proceedings, the debtor is discharged from the SEC's monetary penalty on confirmation of a plan of reorganization; however, the debtor must pay the SEC a percentage of the penalty equal to the percentage received by unsecured creditors under the reorganization plan. Where appropriate, the SEC has returned disgorged funds to harmed investors and, as a result of the fair funds provision of the *Sarbanes-Oxley Act*, has used amounts paid as penalties to reduce losses to injured parties.⁹⁰

For example, in *SEC v. WorldCom*, the Southern District of New York Court approved a settlement where WorldCom had engaged in a massive accounting fraud of more than US \$3 billion.⁹¹ The SEC action had been filed almost one month before WorldCom filed for Chapter 11 protection and the SEC action and the Chapter 11 proceeding were being conducted concurrently. The SEC secured an injunction against WorldCom and proposed a settlement agreement whereby the SEC would impose a US \$2.25 billion monetary penalty that would be

⁸³ See for example, *S.E.C. v. Lybrand*, 281 F. Supp. 2d 726 (S.D.N.Y. 2003) at 727; *S.E.C. v. Giesecke*, Accounting and Auditing Enforcement Release No. 1636 (25 September 2002), <http://www.sec.gov/litigation/litreleases/lr17745.htm>.

⁸⁴ The SEC already has had the ability under the US *Bankruptcy Code* to enforce securities law even if the debtor was in bankruptcy proceedings, although the statute prohibits it from enforcing a money judgment outside of the bankruptcy proceedings and recovery of the penalty amounts may only occur through the final bankruptcy distribution. This exemption from the usual stay provisions recognizes the public policy underpinning securities law enforcement activities; section 362(b), *Bankruptcy Code*.

⁸⁵ SEC, *2006 Performance and Accountability Report* <http://www.sec.gov/about/secpar/secpar2006.pdf> at 56.

⁸⁶ *S.E.C. v. Kane*, 2003 US Dist. LEXIS 5043 (S.D.N.Y. 2002) at 11; *S.E.C. v. Credit Bancorp, Ltd.*, 2002 US Dist. LEXIS 20597 (S.D.N.Y. 2002) at 9.

⁸⁷ SEC, *2006 Performance and Accountability Report*, *supra*, note 85 at 56.

⁸⁸ *S.E.C. v. Patel*, 61 F. 3d 137, 139 (2d Cir. 1995).

⁸⁹ In a bankruptcy proceeding, the SEC's civil action is frequently settled and in such cases, the court must approve the settlement. The court determines whether the proposed settlement is fair and equitable and in the best interests of the estate, and the court must be assured that it does not fall below a range of reasonableness.

⁹⁰ SEC, *2006 Performance and Accountability Report*, *supra*, note 85 at 56. Funds not returned to investors are sent to the treasury.

⁹¹ *SEC v. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

satisfied by a US \$750 million payment from the bankruptcy estate, comprised of US \$500 million cash payment and US \$ 250 million in the reorganized company's common stock.⁹² The settlement expressly provided that the settlement assets would be directed to defrauded shareholders pursuant to the fair funds for investors' provision of *Sarbanes-Oxley*.⁹³

The Court in *WorldCom* recognized the potential conflict between the fair funds for investors provision of the *Sarbanes-Oxley Act* and the US *Bankruptcy Code*, observing that a civil penalty imposed by the SEC premised primarily on compensating defrauded shareholders might arguably run afoul of the provisions of the *Bankruptcy Code* that subordinate shareholder claims below all others. The Court held that compensation is a secondary goal to deterrence, but that the SEC could rationally take account of shareholder loss as a relevant factor in formulating the size and nature of the penalty and it could distribute the settlement amount from civil penalties to investors.⁹⁴ In the bankruptcy proceedings of *WorldCom*, Judge Gonzalez approved the settlement with the SEC pursuant to Federal Rule of Bankruptcy Procedure 9019, based on the creditors committee support for the settlement, the risk of an even greater penalty if the amount were litigated to judgment, and the uncertainty in the priority issue as between the two statutory regimes. While noting the apparent conflict between the two statutes, the Court held that "in considering approval of a settlement, the court is not required to resolve the underlying legal issues related to the settlement" and it did not "fall below the lowest point in the range of reasonableness."⁹⁵ The Court held that the SEC had taken adequate account of the magnitude of the fraud and the need for deterrence, while fairly and reasonably reflecting the realities of a complex situation.⁹⁶ Thus in *WorldCom*, while the court was not required to determine the conflict between the two statutes, it did recognize the tension and balanced the interests at stake in finding the settlement appropriate. The outcome is that shareholders realized some value on their losses indirectly through the SEC's action.

In *Adelphia*, the bankruptcy court was asked to endorse a comprehensive settlement proposal addressing disgorgement of profits and civil penalties based on fraud and accounting irregularities that would require Adelphia to contribute US \$715 million to a restitution fund in exchange for the Department of Justice not instituting criminal action and the SEC dropping its claims against the corporation and its subsidiaries.⁹⁷ Although creditors objected to the proposed settlement based on the absolute priority rule, the Court held that § 510(b) of the US *Bankruptcy Code* did not prohibit the settlement since shareholders would not be sharing in the assets of the estate under a plan, but rather sharing in a fund created and owned by the government, and that the subordination provision does not apply to assets belonging to the government. While defrauded equity-holders would have to confront the absolute priority rule and § 510(b) when trying to share in the assets, that issue was far removed from the request to approve the settlement.⁹⁸ The Court approved the settlement on the basis that it was reasonable.

⁹² 40% of the estimated liquidation value of *WorldCom*), *ibid*.

⁹³ *SEC v. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003) at 435. The settlement amount was 75 times greater than any prior penalty for accounting fraud. The Court held that the amount was aimed at ensuring that there was sufficient penalty to deter the officers from future fraudulent conduct while also ensuring that the corporation was able to reorganize.

⁹⁴ *Ibid*.

⁹⁵ *S.E.C. v. WorldCom Inc.*, 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 435; *In re WorldCom Inc.*, Ch. 11 Case No. 02-13533, Docket # 8125 (Bankr. S.D.N.Y. Aug. 6, 2003). *S.E.C. v. WorldCom Inc.*, Litigation Release No. 17588 (Civil Action 02 CV 4963 (S.D.N.Y.) (27 June 2002)), available at www.sec.gov/litigation/litreleases/lr17588.htm.

⁹⁶ *S.E.C. v. WorldCom Inc.*, 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 436.

⁹⁷ *In re Adelphia Communications Corp.*, 327 B.R. 143, 149 (Bankr. S.D.N.Y. 2005).

⁹⁸ *Ibid*. at 169.

Application of First Principles to the Concurrent Strategies Option

The concurrent strategies option meets the transparency and certainty principles in that the SEC's authority is clear and certain, while at the same time, creditors have certainty in respect of the subordination of equity securities claims within the insolvency proceeding.

Arguably it also meets the fairness principle in that while equity investors continue to have their right to distributions subordinated under ordinary business risk principles, the fair funds process offers a means to recover some of their losses. It creates a public policy mechanism aimed at deterring corporate misconduct and at allocating proceeds recovered from such harms to those harmed through distribution of disgorgement and civil penalties funds. This mechanism of indirect redress for harms is distinguishable from granting equity investors direct remedies for harms arising out of statutory violations during insolvency proceedings, which is not a public policy choice that the US has made.

The fact that investors realize only through the enforcement activities of the SEC means that the SEC acts in a gatekeeping role in respect of these claims, ensuring that only meritorious claims are advanced and that securities claims are not inappropriately used by shareholders to leverage their position or their voice and control rights during insolvency proceedings. This role may address arguments that equity investors would somehow use securities claims to bootstrap their position on liquidation. The SEC's primary function in seeking disgorgement and civil penalties is the deterrence objective. While secondary, compensation to investors does appear to have assisted in meeting the public policy goals of securities laws, while continuing to observe the public policy goals of insolvency law. One issue that deserves further examination is precisely how disgorgement from the company creates a deterrent effect on corporate officers, unless their own personal wealth is also disgorged where they have engaged in fraud. While arguably there are reputational losses and sometimes criminal sanctions, it would seem that financial forfeiture of personal gains from misconduct would be an effective way in which future misconduct by these or other officers is discouraged.

Assessment of the US approach also depends on the normative choice in respect of fairness to what parties. Some have argued that the treatment of the fair funds provisions in bankruptcy has violated the absolute priority rule and is unfair to creditors. Others suggest that the court's application of the fair funds provision is correct, and while it may be contrary to the theory underlying the absolute priority rule and subordination of shareholder claims, it is a proper application of securities law and treatment of funds arising from securities law fraud claims.⁹⁹

Canada does not have the mechanisms and resources afforded to US securities regulators to provide remedies to harmed equity investors and that allow regulators to serve a gatekeeping function such that insolvency proceedings can continue to provide an expeditious resolution to the firm's financial distress. Some provinces have enacted provisions allowing for a forfeiture of funds and some restitution to investors, but given that Canada is a federal regime, provincial securities law remedies would be invalid due to federal paramountcy in a contest between securities regulation and federal insolvency law, even if they were strengthened to include fair funds type of provisions with enforcement teeth behind them.¹⁰⁰

While this option does not allow equity investors to realize directly on their claims, it does offer some financial relief from the harms caused. The difficulty is that securities regulators may determine that the harms caused in a particular case do not merit its resources being directed towards enforcement, leaving those equity investors without a remedy. However, it could impose a system as with the trustee whereby if the regulator does not want to act, the

⁹⁹ David Henry, "Subordinating Subordination: WorldCom and the Effect of *Sarbanes-Oxley's* Fair Funds Provision on Distributions in Bankruptcy", (2004) 21 *Emory Bankruptcy Developments Journal* 259.at 297.

¹⁰⁰ See for example, the B.C. *Civil Forfeiture Act*, which came into force on April 20, 2006. Pursuant to the Act, the Province can apply to the Supreme Court of British Columbia to seize and sell assets acquired through unlawful activity. The Act also allows disposal of forfeited proceeds to eligible victims. http://www2.news.gov.bc.ca/news_releases_2005-2009/2007PSSG0054-000891.htm.

claimants can seek leave of the court to bring an action. Moreover, few, if any, jurisdictions have committed the resources and energy to securities enforcement that the US has, and hence such an option in other jurisdictions may be less meaningful or effective.

This option may present one that offers the greatest simultaneous advancement of the transparency, certainty and fairness principles. The rules are transparent, allowing creditors and equity investors to make appropriate risk assessments and investment decisions; it is certain in respect of the ranking of claims and possible consequences of insolvency; and it advances fairness in recognizing the public policy goals of both securities law and insolvency law. The gatekeeping role played by the securities regulator also reduces the transaction costs of claims arising out of violations of securities law, creating some administrative efficiencies in the insolvency proceeding. The option's negative feature, that of equity investors having to rely on the resources and goodwill of the regulator to recover some of their losses, may be outweighed by the positive advancement of the principles of transparency, certainty and fairness.

3. The Parity Option:

Treat Securities Law Claims for Fraud or Misrepresentation on an Equal Basis with Unsecured Creditors

The third option is to treat all shareholder claims arising out of securities law violations as unsecured creditor claims on the basis that these liabilities are remedies to which investors are entitled under various statutes providing protection to investors. A number of jurisdictions throughout the world have adopted this model, including Japan, Mexico, France and India.¹⁰¹

It is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk.¹⁰² It also seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Parity in treatment of claims arising from statutory violations would remedy this problem.

In Japan, the claims of equity investors for misconduct rank with other unsecured creditors. This parity includes claims for remedies arising out of misrepresentation, manipulation and short-swing transactions under the *Financial Instruments and Exchange Act*.¹⁰³ There is no subordination of these claims in an insolvency proceeding. Japan uses a concept of bankruptcy fund, where all assets and liabilities of the corporation become part of the bankruptcy estate.¹⁰⁴ Fraud claims under financial services legislation are treated as a specific liability, and are a distinct liability from tort claims. In an insolvency proceeding in

¹⁰¹ Professor Masafumi Nakahigashi, correspondence re Japan, January 10, 2008, on file with author; Thomas Heather, correspondence re Mexico, January 20, 2008, on file with author. However, in Mexico, there has not been a case litigated to final judgment. In Germany, it depends on the nature of the conduct; however, many such claims are treated as unsecured claims; Professor Christoph Paulus, correspondence re Germany, January 16, 2008, on file with author.

¹⁰² Sarra, *supra*, note 4.

¹⁰³ There are special provisions for the claims in *Financial Instruments and Exchange Act*, Misrepresentation under art. 21, 24-4; manipulation, art. 160; short-swing, art. 164; Insider trading (Civil Code art. 709 (tort); see <http://www.fsa.go.jp/en/policy/fiel/index.html>). Confirmed, Professor Masafumi Nakahigashi and Professor Yoshishiro Yamada, correspondence, January 19 and 20, 2008, on file with author.

¹⁰⁴ The claims of the corporation against directors for disgorgement are treated as same as other claims against general debtors.

Japan, fraud claims under the financial services statute are ranked along with other unsecured creditors. Investors must individually file their claims as claims provable in bankruptcy, so there is a high onus on them to act in order to receive a dividend as an unsecured creditor. Japan does not have a concept of class action proceedings that addresses collective action issues, and thus it is difficult for equity investors harmed by corporate misconduct to recover their damages from directors or officers.¹⁰⁵ The insolvency proceeding offers them a mechanism to file a claim.¹⁰⁶

In France, claims arising out of fraud and other financial services law violations are treated as unsecured creditor claims.¹⁰⁷ For the claim itself, the insolvency professional, *mandataire judiciaire*, checks all claims filed, including challenged ones. The *mandataire judiciaire* proposes to the judge that claims without merit or that are fraudulent be rejected. If there is a pre-existing judicial decision about the fraud or other misconduct, the claim can be admitted immediately without any subordinated rank and without further investigation.¹⁰⁸ Other than claims arising from specified government securities, all other claims arising out of financial services law violations are unsecured claims in insolvency, except in the case of contractual securities.¹⁰⁹ In case of fraud or civil liability of directors, managers or third parties, the insolvency practitioner is entitled to commence any law suit against any person deemed responsible for insolvency of the debtor. The Commercial Code provides that any funds received from individual civil actions led by the insolvency practitioner are to be distributed to creditors, including the equity claimants.¹¹⁰

In India, claims of equity investors arising out of violations of securities legislation are treated as unsecured claims on parity with other unsecured creditors.¹¹¹ § 529A and § 530 of the Indian *Companies Act* set out the ranking among the creditors and the language is silent in respect of tort claims and fraud claims, hence they have not been placed in a category separate from other unsecured claims.¹¹² Hence, such claims are considered to rank equally with unsecured claims and above the equity claims in an insolvency proceeding.¹¹³ This

¹⁰⁵ *Ibid.*

¹⁰⁶ Professor Nakahigashi observes that Japan does not have an effective method to make directors disgorge their illegal profits from their fraudulent conduct to return to investors, although the government confiscates the property obtained by fraudulent conduct. Because the confiscation is a penalty, it is considered irrelevant to the investors' damages, and thus it would be theoretically difficult to establish the similar mechanism as the fair fund provision in US, *ibid.* Professor Yoshiro Yamada, correspondence, January 15, 2008, on file with author.

¹⁰⁷ The Honourable Jean-Luc Vallens, correspondence re France, January 21, 2008, on file with author.

¹⁰⁸ The only subordinated claims provided for by the law are for specified loans granted by public bodies ("prêts participatifs"). *Ibid.*

¹⁰⁹ *Ibid.* or something called legal privileges.

¹¹⁰ *Ibid.* See for example, Article L651-2, *Insolvency Act*, France. There is no specific provisions regarding funds obtained from fraudulent third parties.

¹¹¹ Professor Vaneeta Patnaik, Correspondence re India, January 2008, on file with author.

¹¹² *Companies Act*, India, wherein, the ranking of claims is provided, as followed in case of bankruptcy proceedings;

http://www.mca.gov.in/MinistryWebsite/dca/actsbills/pdf/Companies_Act_1956_Part_1.pdf.

¹¹³ India has a market regulator, the Securities Exchange Board of India (SEBI), and under S. 11 C and D, of *The Securities and Exchange Board of India Act*, 1992, Statute No. 15 of 1992, India, and Chapter VIA. These provisions do not deal directly with the disgorgement of the funds from directors found engaged in fraudulent conduct, but what they do is provide penalties for the fraudulent activities. As far as investor protection is concerned, India's approach is still aimed at disclosure norms and educating investors. There are currently draft regulations open for public comment until January 21, 2008, aimed at checking insiders from making short-term profits based on their access to price sensitive company information. Under these proposed regulations, an insider would be asked to surrender the profits made through trading in shares of the company, as well as its parent and subsidiaries, if the purchase and sale transactions are conducted within six months. According to the draft regulations, the insiders would include all key management personnel, directors, direct or indirect beneficial owners having at least 10 percent shares, alone or in concert, of the company. The short-swing rules will automatically apply if same shares are purchased and sold by the insider within six months. It also stipulates that "where there is a delay, interest may be payable" by the insider. 'Short

ranking is due to the fact that although § 528 of the Indian *Companies Act* allows provable damage claims, the sections following that provide the ranking does not do so and so the claims are treated as unsecured creditor claims.

In Australia, previously, it was generally thought that all equity claims, including claims for remedies arising out of the misconduct of the company or its officers, were subordinated, and thus that shareholders (members) had no right to participate as creditors in a voluntary administration or liquidation.¹¹⁴ The subordination provision contained in the Australian *Corporations Act, 2001* specifies that: “payment of a debt owed by a company to a person in the person’s capacity as a member of company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied” meant that shareholders’ claims against the debtor company are to be subordinated to the claims of creditors, the Australian courts drawing on early English case law.¹¹⁵ More recently, the Australian courts had adopted a different approach, similar to the reasoning of the UK House of Lords, in *Soden v. British & Commonwealth Holdings* for treatment of claims arising from statutory violations.¹¹⁶ However, the High Court of Australia took a different analytical approach in *Sons of Gwalia Ltd. v. Margaretic*, decided in January 2007.¹¹⁷

Sons of Gwalia Ltd. v. Margaretic marked a departure from the UK reasoning and reflects further development of the Australian court’s balancing of different public policy objectives. An investor that purchased shares in Sons of Gwalia Ltd. in the secondary market shortly before the company entered voluntary administration claimed damages pursuant to trade practice and securities legislation on the basis that the company had engaged in misleading and deceptive disclosure in that it failed to disclose material adverse information.¹¹⁸ Specifically,

Swing Profit’ regulations in India; SEBI Consultative Paper, <http://www.sebi.gov.in/commreport/ShortSwing.pdf>. Under the regulations, these provisions will not apply in case of transactions approved by a regulatory authority, employee benefit plans, *bona fide* gifts, inheritances and mergers and acquisitions. SEBI has also said that “certain securities may also be considered as exempt altogether” from the purview of short-swing regulations, though it has clarified the categories that might qualify for such exemption. Patnaik, *supra*, note 111. My sincere thanks to Professor Patnaik for explaining these recent developments in India.

¹¹⁴ External administration under insolvency law in Australia can involve a voluntary administration under Part 5.3A of the *Corporations Act* or a scheme of arrangement under Part 5.1, or a liquidation under Part 5.4ff. Under Australian law, a voluntary administration generally concludes when creditors support a deed of company arrangement, a resumption of trading without a deed of arrangement or liquidation and wind-up of the company; CAMAC, *supra*, note 6, at 1, 37, which notes that a distinction must be made between a voluntary administration and implementing a deed of company arrangement or conducting a wind up, whether or not there has been a voluntary administration.

¹¹⁵ In *Webb Distributors (Aust) Pty Ltd. v. The State of Victoria* (1993) 179 CLR 15; [1993] HCA 61, the Australian High Court held that the *Corporations Act* subordination provisions extended to subordinate the claims of shareholders for misleading and deceptive conduct under the Australian *Trade Practices Act, 1974*. The Court relied on the UK House of Lords judgment in *Houldsworth v. City of Glasgow Bank* (1880) 5 App Cas 317. Essentially, the rule in *Houldsworth’s* case is that a person that has subscribed for shares in a company may not, while retaining those share, recover damages against the company on the ground that he or she was induced to subscribe for those shares by fraud or misrepresentation by the company; see *Re Media World Communications Ltd.* (2005) 52 ACSR 346 at 10, characterized as a rule protecting the maintenance of the company’s capital, absent other statutory language altering the rule. See also *Re Addlestone Linoleum Co.* (1887) 37 Ch D 191. The UK corporations statute was amended in 1985 to specify that shareholders were not prohibited from claiming damages only by reason of the fact they continued to be shareholders. See also *Ford’s Principles*.

¹¹⁶ *Cadence Asset Management v. Concept Sports Ltd.* (2005) 147 FCR 434, citing *Soden v. British & Commonwealth Holdings plc* [1998] AC 298 (H.L.). *Soden* is discussed below under the “Nature of the Claim Option”.

¹¹⁷ *Sons of Gwalia Ltd v. Margaretic* [2007] HCA 1.

¹¹⁸ *Ibid.* at para. 8. Specifically, he claimed breach of disclosure requirements under securities law continuous disclosure obligations; and misleading or deceptive conduct pursuant to s. 1041H of the Australia *Corporations Act, 2001* and s. 12DA of the Australia *Securities and Investments Commission*

Margaretic alleged that the company had failed to notify the Australian Stock Exchange that its gold reserves were insufficient to meet its gold delivery contracts and that it could not continue as a going concern, and had deceived Margaretic into buying shares.¹¹⁹ The shareholder sought to be treated as an unsecured unsubordinated creditor. The court at first instance, the Full Court of the Federal Court and the High Court of Australia all found that the shareholder could be treated as an unsecured creditor because the claim was not “in the person’s capacity as a member of the company”, although the reasoning of the High Court differs from the lower courts. Given that the shares were purchased in the secondary market, the Federal Court held that his claim under the misleading and deceptive statutory provisions did not arise in his capacity as member, adopting the approach of the UK House of Lords.¹²⁰

On appeal, the High Court of Australia upheld the results, but departed from the UK reasoning, with the High Court holding that a shareholder with a claim under a statute against a company for misleading or deceptive conduct, or for failure to comply with its continuous disclosure obligations could prove in the administration or liquidation of that company in respect of the damages for which the company was liable, and that this applied whether the shareholder acquired the shares by subscription or purchase.¹²¹ This ability to claim applied even though the investor’s loss did not crystallize before the administration.¹²² The High Court held that s. 563A of the *Corporations Act, 2001* did not operate to postpone the debts owed to shareholders with claims against a company for misleading or deceptive conduct. Shareholders with such claims were not owed debts in their capacity as members of the company; rather, they were seeking to enforce against the company remedies to which they were entitled under various statutes providing protection to investors. The Chief Justice of the High Court held that the determining factor was that the shareholder’s claim was not founded on any rights he or she obtained or any obligations incurred by virtue of membership of the company.¹²³ He noted that modern legislation has greatly increased the scope for shareholder claims with more intensive regulation of corporations, breach of which may sound in damages for the protection of members of the investing public.¹²⁴ He wrote:

On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the

Act, 2001; and s. 52 of the *Australia Trade Practices Act*. The company subsequently executed a deed of company arrangement arising from the voluntary administration that provided for a distribution of the debtor’s assets on the same priority basis as a winding-up proceeding.

¹¹⁹ He alleged that he was harmed by the misleading or deceptive conduct of the company in its failure to disclose in breach of s. 52 of the *Trade Practices Act 1974*, s. 1041H of the *Corporations Act* and s. 12DA of the *Securities and Investments Commission Act 2001*.

¹²⁰ See also *Re Media World Communications* [2005] FCA 51, 52 ACSR 346 (Australia), where the Federal Court of Australia Victoria District adopted the reasoning in *Sons of Gwalia*, but on the facts of that case, it was not a situation where shares were acquired by the shareholder from a third party and the Court held that if the company is in liquidation, the subscribing shareholders’ right to be paid a loss from a prospectus purchase (i.e. in their capacity as investors) is postponed under s. 563A, *Corporations Act, 2001* until the claims of persons other than members have been satisfied.

¹²¹ Hence, while the Full Federal Court had adopted the reasoning in *Soden* in distinguishing transferees from subscribers, the majority (6 to 1) of the High Court did not adopt this analysis.

¹²² The Court held that it would not have applied to equity investors that had sold their shares before the company went into insolvency administration, or who were never on the register, because they invested through nominees, custodians or trusts, as those investors would not have been postponed on any view; *Sons of Gwalia Ltd v. Margaretic, supra*, note 117.

¹²³ *Ibid.* All of the Justices wrote a decision.

¹²⁴ Gleeson, C.J., *ibid.* at para. 17.

apparent benefit of the protection are subordinated to the claims of ordinary creditors.¹²⁵

The Court distinguished the language under Australian legislation from the subordination language in the US *Bankruptcy Code*. The High Court judgment also distinguished claims arising from deceptive practices from those that arise normally in a shareholder's capacity as shareholder. In this respect, the High Court noted that claims arising under securities, corporate and trade practices legislation are not restricted to only shareholders and hence do not arise out of the shareholder contract. The judgment balanced securities, corporate and insolvency law regimes, allowing shareholder claims arising out of securities laws violations essentially to rank with ordinary creditors based on the terms of the applicable Australian statute, which did not contain the US statute's express subordination mandate.¹²⁶ The result of the judgment is that equity investors harmed by the misconduct of the company may be able to participate as unsecured creditors in an insolvency administration, assuming that they are able to meet other criteria for establishing their claim.¹²⁷

In the Australian *Sons of Gwalia* case, there were 5,304 shareholder claims made in the administration, asserting aggregate damages of Aus \$242 million arising from allegations of violations of securities, corporate and trade practices legislation.¹²⁸ The judgment does not necessarily create extensive remedies for similarly situated shareholders, as there are hurdles to shareholders proving that the company engaged in prohibited conduct and that the conduct led to his or her loss or damage. The *Sons of Gwalia* case only established that a shareholder can bring an action, but it does treat the claims arising out of corporate misconduct on a parity basis with other unsecured creditors.

Subsequent to the *Sons of Gwalia* judgment, the Court of Appeal in New South Wales declined to grant leave to appeal in a case where the primary judge had dismissed a claim under the *Trade Practices Act* for losses due to misleading and deceptive information on the basis that the plaintiff had not established reliance.¹²⁹ The appellate court held that although in light of the *Sons of Gwalia* judgment, the judge's finding that any claim would have been postponed under s. 563 of the *Corporations Act* must be reversed, it declined to grant leave on the basis of the judge's findings and the small monetary amount of the claim, Aus \$10,700.¹³⁰

Application of First Principles to the Parity Option

Applying the first principles set out in part II to the parity option, where those with claims against the debtor corporation for its misconduct are found to resemble unsecured creditors more closely than equity claims, this option should ideally have express statutory language in order to best meet the transparency principle. Both equity and debt investors need a clear understanding of the scope of claims that will be treated equally and those that will be subordinated. Explicit statutory language would assist in clarifying the nature of claims to be treated on an equal basis as opposed to those claims arising out of losses associated with ordinary business risk; the period or timing in terms of such claims;¹³¹ a means of readily ascertaining the quantum of harms;¹³² and where possible, set out mechanisms for recognizing and declining these claims when they are contingent. If issues regarding scope,

¹²⁵ *Ibid.* at para. 17.

¹²⁶ The judgment deals with the status of the claim if it is established; it does not determine the case on its merits.

¹²⁷ Under the Australian *Corporations Act, 2001* (Cth), Part 5.3A, creditors have participation rights in determining that an administration should be terminated, that the company should execute a deed of company arrangement or that the company should be wound up, Divisions 2, 5 and 10, Part 5.3A,

¹²⁸ Ferrier Hodgson, *Report to Creditors, Sons of Gwalia*, ACN 008994287 (24 November 2006); <http://www.ferrierhodgson.com.au/caseprofiles/details.cfm?objectID=11>.

¹²⁹ *Johnston v. McGrath* [2007] NSWCA 231.

¹³⁰ *Ibid.* at paras. 36-43.

¹³¹ For example, from the time the disclosure should have been made until it was made.

¹³² Such as a share price drop immediately after the misconduct becomes public.

notice and valuation are codified, the parity option would meet the transparency principle, and would in turn meet the certainty principle because parties could make their investment decisions understanding where their claims lay on the hierarchy.

However, predictability will not be entirely achieved through codification of the placement of claims. There are questions, for example, in relation to causation that may create uncertainty. In US fraud cases in a non-insolvency context, there has been some issue as to how to treat claims for fraud where the fraud had occurred over an extended period, given that there may be other factors that contributed to price drops in the interim. In those jurisdictions in which causation is required to be established, there could be a great deal of uncertainty in respect of what portion of equity investors' claims would or would not be subordinated.

Fairness

In terms of fairness, if equities securities claims arising out of corporate misconduct are treated as unsecured claims, it would achieve a greater measure of fairness for equity investors in recognizing their claims that do not arise out of ordinary business risk. The parity option makes a normative choice that it is fair to treat equity investors harmed by misrepresentation or fraud on a *pari passu* basis with debt securities holders.

The parity option does affect other unsecured creditors, in that the amount of their claim that has a priority over equity investors will be reduced and their participation and recovery rights diluted by giving those rights to equity claimants on a parity basis. Depending on the nature of the fraud or other misconduct and the amounts misappropriated, there can be significant implications for the pool of assets available to satisfy creditors' claims. Trade creditors are not the only class of unsecured creditors affected. In jurisdictions where workers' claims do not enjoy a preference claim, the parity option may dilute the amount of assets available to meet their claims at a time when they are particularly vulnerable. On the other hand, in jurisdictions such as the US, where workers have been encouraged for many years to invest in the shares of their employer under the relevant pension plans, the subordination of such claims combined with job losses have devastating financial consequences for those employees and the parity option may partially ameliorate that economic hardship.

The parity option also engages fairness questions in respect of the claims of beneficial owners of shares. In many jurisdictions, the majority of investments held by small retail investors are held by central depositories, and these investors are not the registered shareholders of the company.¹³³ A parity option should ensure equitable treatment of such investors for fairness reasons, or alternatively, ensure that those in whose name the securities are registered have a fiduciary obligation to realize any value on the claims and pass that value onto the beneficial shareholders. A more difficult issue in respect of the parity option is determining the treatment of those that hold options or warrants for shares or other equity derivatives. Arguably, they may or may not have made decisions in respect of the structuring of those options or warrants or the exercise of them, had they known of the misconduct; hence a parity option would need to be transparent and fair in how such claims would be treated.

The protection of both equity and creditor claimants is an important public policy consideration and as noted above, how this question engages notions of fairness depends on how a jurisdiction views the allocation of risk and remedy for harms as between equity holders with claims outside of ordinary business risk and unsecured creditors harmed more generally by the company's insolvency. Overriding all of this discussion is the limited degree to which unsecured claims are met in any insolvency, whether securities claims for corporate misconduct are given parity or not,

¹³³ Canadian securities law has been amended to give voice and voting rights to beneficial owners and such rights need to be recognized in an insolvency proceeding.

Incentive Effects of Parity

Another fairness issue is whether recognition of such claims will create particular incentive effects, such as creating incentives to make such claims as a means of being recognized as a creditor in the negotiations for a workout or other outcome of a firm's insolvency. However, in jurisdictions with "costs follow results" regimes, equity investors are unlikely to generate claims. Fairness perhaps dictates that although the claim is contingent, some basic aspect of the claim should be established before the claimant is given participation rights in the proceeding.

The recognition of contingent claims in insolvency proceedings varies from jurisdiction to jurisdiction. In Canada, contingent claimants have been recognized as unsecured creditors under both the *BIA* and the *CCAA*.¹³⁴ A creditor with a contingent claim has the onus of demonstrating that the claim is neither speculative nor remote; and while the claimant does not need to establish the probability success of the claim, it must lead some evidence of its claim and probable success.¹³⁵ In Australia, a contingent creditor does not have to prove its claim in order to have a vote at a creditors' meeting, although it must have a just estimate of the value of the claim and the administrator can choose to value the claims at a full or nominal value.¹³⁶ Hence an issue is whether the appropriate incentives are created under this option to encourage equity investors that are harmed from misconduct to bring their claims forward, as the same time as discouraging frivolous claims or claims that can be brought up by distressed investors to influence the outcome of the proceeding. Given the requirement to have support of a workout by number and value of creditors, the participation of harmed equity investors may influence the outcome.¹³⁷

Efficiency

In terms of efficiency objectives, the parity option presents some challenges. The ability of equity investors to bring claims under insolvency proceedings raises the question of whether there will be higher administration costs as administrators assess whether to admit shareholder claims, and in dealing with challenges to their decisions. Although there are arguably notice challenges, in respect of alerting claimants of the insolvency proceedings and the need to file claims, arguably these challenges are no more onerous than cases in which there are products liability or other tort claims. The experience in Canada is that the use of mass media and electronic data-rooms has been efficient and effective in ensuring fair notice to potential claimants and access to information once they bring a claim. Granted, the costs are higher in the administration of the proceeding, but no more so that tort cases.

The subordination of an equity claim does not facilitate a restructuring unless the issue of voting rights is also addressed, because securities claimants could form a class that could veto a proposed restructuring plan, absent clear statutory language preventing such an outcome. Litigation involving claims of this type is complicated and slow. If there is a class action that hasn't been certified, the case can take a very long time. Litigation alleging securities law violations can be complex, time-consuming and expensive for security holders and debtors alike, and can work to defeat the goal of an expeditious resolution of a debtor's insolvency. The claims of equity securities holders create a risk to timely realization of creditors' claims at the point of firm financial distress.¹³⁸ On the other hand, if the claims were certain based on a pre-designated price drop period or the claims were valued at a *de minimus* amount, the trustee or other insolvency professional could administer the proceeding fairly expeditiously. Certainly this would be the case in a financial restatement, where the debtor company has admitted its breach of securities law in the act of the restatement. In

¹³⁴ Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

¹³⁵ *Re Air Canada (CUPE Contingent Claim Appeal)* (2004), 2004 CarswellOnt 3320, 2 C.B.R. (5th) 23 (Ont. S.C.J. [Commercial List]).

¹³⁶ CAMAC, *supra*, note 117 at 39, citing Corp. Reg. 5.6.23(2).

¹³⁷ As noted above, Australia is somewhat unique in that in the event that votes by number and value differ, the administrator has the casting vote, *ibid.* citing Corp. Reg. 5.6.21(4).

¹³⁸ For jurisdictions with federal legislative structures, there also may be paramountcy questions in respect of insolvency and securities laws, Canada being such an example.

terms of voting, Canada has in the corporate area moved to electronic voting in respect of shareholder votes; similarly technology could be applied to the process of insolvency proceedings votes.

In some jurisdictions, such as the US and Australia, a claim of alleged misconduct requires a causal connection to be established between the company's misconduct and the losses suffered by the investor.¹³⁹ In those jurisdictions requiring a causal link between the misconduct and harm suffered by the investor, the determination of causation may be difficult for equity investors to establish, particularly where the conduct continued for a period or where there was a lapse in time before the misconduct was discovered, with many other events arguably influencing price drops in the intervening period. In some jurisdictions, such as Australia, the equity investor's actions subsequent to the misconduct can destroy the causal link and thus any access to a remedy.¹⁴⁰

Some jurisdictions also require evidence of reliance on the misrepresentation or fraudulent disclosure, creating another hurdle before equity claims for corporate misconduct are recognizable in an insolvency proceeding.¹⁴¹ Absent a statutory framework that creates a "deemed reliance" on the conduct such that causation need not be proven, the processing of these claims could prove extremely costly and time consuming, both for insolvency administrators and for the claimants, whether they are proceeding by class action or individually. In contrast, in Canada, there are deemed reliance provisions such that causation need not be established. Even with deemed reliance, there have been very few cases litigated in Canada, even outside of the insolvency context. In the US, the fraud on the market approach negates the necessity of proving reliance, with remedies available based on disclosure of the misconduct followed by a sharp price drop in the stock.¹⁴²

There are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims. In some jurisdictions, for example, there is the issue of causation, which is time-consuming and expensive to determine and which would slow the resolution of securities law claims in insolvency proceedings considerably. Hence this option could result in insolvency proceedings grinding to a near halt, which in turn may result in value lost for all stakeholders with an interest in the firm. Moreover, claimants seeking remedies may suffer litigation fatigue and loss of even greater resources as they try to establish their claims. Yet the challenges for designing a system for the expeditious determination of claims arising out of securities law violations should not be a bar to recognizing these claims, just as product liability or other tort claims are treated as unsecured claims. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

Another issue is how insolvency professionals are going to assess the quantum of the loss and damage, particularly where there are many investors seeking a remedy for the misconduct of the debtor company. Misrepresentations made at a fixed point in time, such as release of financial statements followed later by a financial restatement, may allow for relatively easy determination of the period that the claims arise and the quantum of loss, as has occurred in class action cases for securities law fraud in the US. Alternatively, the valuation may be difficult because of fluctuations in the value of claims during an extended period of breach of continuous disclosure obligations.

¹³⁹ See for example, s. 1041I, *Corporations Act*, Australia, which creates a remedy for recovery of losses associated with false or misleading disclosure or misleading or deceptive conduct. There are also remedies under the *Australian Trade Practices Act* for damages arising from misleading or deceptive corporate conduct.

¹⁴⁰ *Henville v. Walker* (2001) 206 CLR 459 (HC).

¹⁴¹ Australia is an example; *Digi-Tech (Australia) Ltd. v. Brand & 5Ors* [2004] NSWCA 58 at 159; *Ingot Capital Investments Pty Ltd. v. Macquarie Equity Capital Markets (No 6)*, [2007] NSWSC 124.

¹⁴² Adam Pritchard and Janis Sarra, "The Future of Securities Class Actions in Canada", forthcoming, 2008.

Where claims are contested, insolvency proceedings will be most costly and less timely based on the need to determine the scope of misconduct by corporate officers; based on the need for evidence, including possibly expert evidence, on the value of claims; and in determining the specific claims, given that equity investors make decisions to purchase, sell or hold at different times. There may be further delays where determinations by insolvency professionals are challenged on appeal. Realistically, there would have to be value remaining in the company after secured claims were satisfied before equity investors harmed by corporate misconduct would have an incentive to pursue claims. In Canada, the UK and other jurisdictions, the rule of legal costs, in terms of “costs follow results” regime acts in a gatekeeping role in the bringing of civil liability law suits, a cost allocation rule that does not apply in the US.¹⁴³ In Australia, however, the courts have approved the ability of litigation funding firms to provide funding not only for the prosecution of shareholder claims but also to indemnify the shareholders against an adverse costs order.¹⁴⁴ In a somewhat imperfect fashion, this helps to minimize the pursuit of spurious shareholder claims, on the basis that for-profit litigation funding firms are not likely to pursue shareholder claims unless the funders have concluded that there is a high probability of success on the merits. In the UK, on the other hand, litigation funding firms have not found favour, which is likely the principal reason why shareholder damages claims are rarely asserted in UK insolvencies as a practical matter.

In liquidation proceedings, where the trustee or administrator is valuing and determining claims and paying out the value of the assets based on the statutorily specified hierarchy, the parity option can be administered on a timely and efficient basis once the framework is set for determining the value of claims. In a workout proceeding under the parity option, equity investors claiming damages for misconduct would have participation rights in the proceeding. Given that their claims arising from misconduct are contingent in the sense that while the claim has crystallized at insolvency, the scope of liability and damages has not yet been determined; and given that there are time pressures in insolvency proceedings, a concern is that such claims may detract from developing a viable going forward business plan, particularly where shareholders do not see any upside in compromising their claims in order to facilitate a restructuring. The additional process may affect the timeliness of meeting creditors’ claims.

There may be timing requirements that are difficult to meet. In Canada, the initial stay period under the restructuring provisions both major insolvency statutes is thirty days, but parties can receive an extension for fixed periods. The *BIA* is more restrictive in that if a viable going forward business plan has not been agreed on within six months, the company is automatically bankrupt and must be liquidated. In Australia, in a voluntary administration, an administrator must convene a meeting of creditors within 28 days to ascertain whether it would be in their interests for the insolvent company to execute a deed of arrangement, exit administration or be wound up.¹⁴⁵ The timing in Australia places a considerably degree of pressure on the administrator to determine whether there is more value to creditors from a deed of arrangement or wind-up, and if there is uncertainty, other creditors may be required to make decisions without full information.¹⁴⁶

Arguably, some of these pressures also create a pressure to settle within the insolvency proceeding. This pressure may go to fairness of any of the unsecured creditor groups, including harmed investors. However, where there is no settlement and amounts have been allocated to the value of claims, parties in many jurisdictions can make application to the court to have the plan declared unfair or inequitable, and in some jurisdictions such as Canada, there are arguably remedies under oppression provisions of corporate laws.

There are a number of administrative options to create a timely and efficient development of a workout plan. Securities claims could be treated similarly to tort claims, in that a pool of claimants could be created, with claims valued at \$1 for voting purposes, addressing the need to not skew control rights. Such a strategy was used in the *Canadian Red Cross* proceeding

¹⁴³ Sarra, *supra*, note 4.

¹⁴⁴ *Campbells Cash and Carry Pty Limited v. Fostif Pty Limited* (2006) 229 ALR 58, 80 ALJR 1441.

¹⁴⁵ Section 439A (3)-(4), *Corporation Act*, Australia.

¹⁴⁶ CAMAC, *supra*, note 117 at 38.

in Canada, where there were an estimated 30,000 potential tort claims arising from tainted blood transactions.¹⁴⁷ The strategy allowed a large number of contingent creditors to participate, through representative counsel, but reduced the administrative burden for purposes of work out negotiations. Such a mechanism allows equity investors to participate in the proceedings on a timelier basis than would occur if their claim had to be determined at the outset of the proceeding. The court would then be able to ensure the decision-making process was not derailed in respect of an insolvency workout.¹⁴⁸ Since most insolvency workouts are highly time-sensitive if customers and goodwill are not to be lost, this approach could ensure more successful going concern plans being approved.

Another option is to impose a limit or cap on the value of claims that would rank on a parity basis, as with employee wage claims in some jurisdictions, giving some priority, but capping the amount. Such an approach allocates risk differently, and would meet the transparency, certainty, and efficiency objectives of the legislation.

The outcome of the *Gwalia* case is illustrative of the challenges of efficient administration of claims under the parity option. Subsequent to the judgment, shareholders of Gwalia were permitted to vote on a proposed sale of the business by the administrators, even though the alleged fraud had not been proven and reliance not yet established, and they were permitted to vote the full amount, Aus \$250 million, of their claims, some of which were quite contingent.¹⁴⁹ The proposed sale would yield a dividend to creditors of only 12 cents on the dollar. A group of US creditors holding Aus \$300 million in claims proposed a competing bid because they felt the sale price was too low; and their proposal featured the upside potential of an equity distribution.¹⁵⁰ Most of the shareholders were individual investors and voted with the administrators' proposal. However, creditors with claims totalling Aus \$600 million voted against the administrators' proposed sale, while only Aus \$320 million voted in favour, including the shareholders.¹⁵¹ Under Australian law, where a vote splits, the administrator casts the deciding ballot and notwithstanding that the majority of claimants by value voted against the sale, the administrator's vote is determinative.¹⁵² The case, while still pending, illustrates how recognition of such claims may affect the outcome of insolvency proceedings, and raises new questions in respect of fairness in the claims valuation and voting process. Here, the process recognizing shareholder claims on a *pari passu* basis worked to advance the insolvency professional's proposed sale, but did so against the express wishes of creditors holding the vast majority of claims by value. In Canada, such a situation would not occur as creditors must approve a proposed plan or proposal with a majority in number of creditors by class and two-thirds of the value of claims.

Another possible efficiency measure under the parity option is the use of the trust device. In the *Canadian Red Cross* case, which involved tort claims, once the global payout amount to be given to the tort claimants was negotiated, there was a trust fund set up. Adjudicators appointed to later determine the specific quantum of individual claims, allowing the parties to

¹⁴⁷ *Canadian Red Cross*, CCAA proceedings, for a discussion see Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvency Corporations* (Toronto: University of Toronto Press, 201).

¹⁴⁸ CAMAC reports that administrators in Australia have valued contingent claims at a nominal amount, such as one dollar, where there is uncertainty about the claim. Hence these claimants may have a majority in number, but not by value, (see earlier discussion re how administrators in Australia have the authority to exercise a deciding vote where the number and value differ in a vote of creditors, Corp. Reg 5.6.21(4), as discussed CAMAC, *supra*, note 117 at 73.

¹⁴⁹ Evan Flaschen, "Australia: The Sins of the Sons (of Gwalia) are Visited on Creditors Yet Again", Bracewell & Giuliani Newsletter, 27 July 2007, http://www.bracewellgiuliani.com/index.cfm/fa/news.advisory_print/item/2108cb12-96f3-40bb-8.

Flaschen reports that some of these claims included claims for "lost opportunity damages", such as, if the investor had known of the fraud he or she would have invested in another company and hence the investor lost the amount of profits made by that other company. He reports that shareholders were deemed for voting purposed to hold Aus \$250 million of the Aus \$1.1 billion of claims eligible to vote.

¹⁵⁰ *Ibid.* at 2.

¹⁵¹ *Ibid.*

¹⁵² This is in contrast to US or Canadian law, whereby a vote by creditors to against the proposed sale would be sufficient to defeat it.

proceed with the restructuring and exit insolvency proceedings while satisfying the tort claims through a longer term claims adjudication process. While the trust fund strategy could be contested where the tort harms have not yet fully manifested themselves, such as long-term health effects, the harms arising out of corporate misconduct have crystallized at the moment the misconduct is revealed and so this device could be an effective means of moving proceedings forward.

In other cases, the Canadian courts have imposed a claims bar date, after which no one can bring a claim except with leave of the court for valid reason such as the company failing to give adequate notice. This mechanism has injected timeliness and certainty into the claims valuation process.

In sum, the parity option makes normative choices in respect of fairness, according equal weight to the fair treatment of equity securities claims arising from statutory violations and to unsecured creditors' claims in an insolvency proceeding. In this respect, it advances a measure of fairness to all stakeholders implicated in the firm's financial distress. If the language according such parity is clearly set out in statutory language, the principles of transparency and certainty would be advanced, and creditors would adjust their credit granting and pricing decisions accordingly. It seems evident that in India, Japan and other countries that have adopted the parity model, there has not been a detrimental effect on access credit. However, the parity option creates tremendous challenges for the efficient administration of the insolvency proceeding, raising the question of whether any fairness gains would be lost due to the transaction costs of processing claims, and determining and allocating participation and control rights in a restructuring proceeding. While jurisdictions that have "costs follow results" legal cost regimes are less likely to face the degree of litigation because of the financial risks, new types of actors, such as litigation funders, may shift the dynamic and contribute to inefficient administration of the insolvent company and premature liquidation of some companies. Given that other jurisdictions appear not to be negatively affected by a parity model, further research should be undertaken to ascertain how the fairness principle has been balanced against the administration costs in those jurisdictions.

4. The New Purchaser Option:

Ranking the Claims of New Purchasers of Equity Securities with Unsecured Creditors

The fourth possible policy option is that only new purchasers of securities under either primary offerings or secondary market purchases would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that the purchaser of an equity investment would not be a shareholder in respect of the investment but for the company misstating its financial status or other failure to disclose. This option recognizes that there are information asymmetries as between pre-existing equity investors and new purchasers in that the latter must rely entirely on public disclosures in making investment decisions. In support of this option, one could observe that existing shareholders arguably have access to information such that they can be monitoring their risk and making timely decisions to buy more equity, hold or sell their investment.¹⁵³

Jason Harris and Anil Hargovan advocate this model on the basis that the causation issue is not problematic for new shareholders because they can identify the misrepresentation that induced them to purchase.¹⁵⁴ They observe that existing equity investors have a power and informational advantage over both the company's unsecured creditors and prospective investors, and they suggest that "it is this advantage that justifies subordination, not the mere

¹⁵³ Sarra, *supra*, note 4.

¹⁵⁴ Jason Harris and Anil Hargovan, "The Intersection between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective", in *Annual Review of Insolvency Law, 2007* (Toronto: Carswell, 2008) at 709.

fact of membership".¹⁵⁵ Harris and Hargovan suggest that this option offers a targeted approach to subordination that draws a distinction between new purchasers that have suffered harms from corporate misconduct and other shareholders, drawing a line between two different types of risk, while advancing both corporate and securities law objectives.¹⁵⁶

A variation on this option would rank new purchasers equally with unsecured creditors only where there were violations of primary offering requirements of securities law. This option is premised on the fact that violations of securities law in primary markets offerings results in a benefit accruing directly to the company and hence claims arising out of that misconduct should be treated as unsecured creditor claims in insolvency. In contrast, secondary market violations do not result in any money directly to the corporate treasury. This difference was alluded to by the Canadian court in *Bell International*, which left open the possibility that claims arising from primary market purchases might be accorded parity in Canada.¹⁵⁷ Arguably then, secondary market investors should seek remedies directly from the corporate officers that engaged in the misconduct, and then those officers could pursue the corporation if indemnity was available for the particular misconduct.

Application of First Principles to the New Purchaser Option

Either variation of the new purchaser option would meet the transparency and certainty principles in that the class of persons that would receive equal treatment with secured creditors would be well-known in advance and parties could make their credit and other investment decisions with this ranking in mind. The quantum of the claim could be valued at the price drop from the occurrence of the misconduct to the point that the fraud or misrepresentation was discovered or made public, similar to how losses are calculated in respect of securities law remedies in some jurisdictions. The scope of claims would be certain and transparent. However, where the misconduct has occurred over an extended period, such as violations of continuous disclosure obligations, absent a precise event that was required to be disclosed, it will be difficult to measure the value of claims.

Arguably, it would partially meet the fairness principle in that new purchaser equity investors would be treated in the same manner as unsecured creditors that also suffered losses due to the fraud or misrepresentation and subsequent insolvency of the debtor company. A likely result of such a framework is that there would be enhanced investor confidence in the market as equity investors newly purchasing equity could be confident of some participation rights in the event that at the time of their investment, any misconduct on the part of the company would give rise to participation rights on an equal basis with unsecured creditors. However, if a key objective is deterrence of misconduct, the fact that the assets of the company are used to compensate for damages may not be the optimal approach to deterrence of officers' conduct. This option fails to make the distinction between new purchasers purchasing in the secondary market, where the company only indirectly benefits from the misconduct (absent fraud) and new purchasers in the primary market.

The variation of this option applied only to primary market purchasers may better address the fairness issue in that where companies have directly benefited from the fraud or misrepresentation, the investors should have an enhanced claim for that misconduct, and such a claim would more fairly allocate risks as between these investors and unsecured creditors. This option would assist in maintaining the integrity of primary markets by ensuring that prospectuses are accurate and timely in their disclosures. There is, however, a fairness issue in respect of this option. To treat primary market and secondary markets differently where the company has violated securities law may be difficult to justify on public policy grounds, notwithstanding the temptation to try to scope the availability of such remedies during insolvency. This distinction is not made outside of insolvency. Moreover, the introduction of short form prospectuses and the seasoned issuers requirements in the US, Canada and other jurisdictions means that the lines between primary and secondary markets

¹⁵⁵ *Ibid.* at 713.

¹⁵⁶ *Ibid.* at 734.

¹⁵⁷ See the discussion at note 61.

is blurring such that the same disclosure information is applied for securities issued and resold, and hence there is a question as to why claims from securities law violations should be distinguished based on primary or secondary markets.¹⁵⁸

There is also arguably a lack of fairness in this approach in that existing equity investors have also suffered harm for the corporation's misconduct. While they may not have been induced by the fraud or misrepresentation to buy further shares, the same misconduct may have led to them to retain their holdings, when they would have sold had they been aware of the misconduct. Existing equity investors have been harmed similar to the new investors and they suffer the consequences of both the original harm and then further losses as corporate assets are directed to compensate claimants, assuming that is any equity left at the point of insolvency proceedings. Hence, this option may create unfairness for this class of investor. For the most part, today's shareholders are not insiders; they are a widely dispersed group that does not have the time, resources or capacity to monitor corporate officers. Their decision to hold or sell is based on the disclosures being made by the corporation in any new offerings or under continuous disclosure obligations. While their claims arising from ordinary business risk are those that they have willingly accepted, this approach does not deal with the distinction of remedies for statutory violations.

As with the third option above, the new purchaser option raises a further fairness question in respect of trade suppliers and other unsecured creditors whose participation and recovery rights may be diluted by the existence of such claims and the consequent participation rights accorded to those harmed. For secured creditors, the priority of their claim is unaffected, and hence the quantum that they are entitled to recover is not compromised by recognition of equity claim arising out of securities law violations. However, in a restructuring or administration proceeding, the ability of new purchasers to vote could affect the outcome of any approval proceeding for a going forward plan, depending on how a jurisdiction's legal framework allocated decision and veto rights in creditor voting for a restructuring plan. For trade suppliers and other unsecured creditors, their inability to protect themselves *ex ante* from the risk of a new group of unsecured claims that have participation rights could arguably affect their willingness to offer unsecured credit. However, in many cases such unsecured creditors are unsecured precisely because they do not have the bargaining power to secure their credit or to have their claims subordinated by any subsequent creditors that do have such power. Nor are they able to bargain to prevent any number of other unsecured credit obligations being acquired by the company during the period prior to insolvency. Hence the vulnerability of unsecured creditors is an issue that engages notions of fairness beyond treatment of equity claimants, and arguably, unsecured creditors have taken on this level of risk in their initial and continuing credit decisions.¹⁵⁹

In sum, the new purchaser option thus represents a partial advance of fairness, but makes some arbitrary choices that may not be justified given both the information asymmetries of investors and the public policy objectives of securities law. It does advance, however, the principles of transparency and certainty. The issue of whether such an option would meet the efficient administration objective would depend on how the treatment of such claims was dealt with administratively, and the challenges are the same as the previous option. This option could advance the efficient administration of the insolvency proceeding as the class of claimants would be smaller and easily identifiable. But the fairness issues in respect of where risk is being allocated may outweigh the efficiency objective.

¹⁵⁸ See the discussion in Sarra, *supra*, note 22, regarding WKSIs in the US and the blurring of primary and secondary market disclosure requirements.

¹⁵⁹ This, of course, assumes that unsecured creditors even appreciate the nature of their unsecured claims in their credit transactions with debtor companies. Arguably, there is a wide range of levels of information and understanding about the hierarchy of credit.

5. The Nature of Claim Option:

Adopt the UK Approach of Not Subordinating Claims Arising Outside of Shareholders in their Capacity as Shareholders

In the UK, member (shareholder) claims are generally subordinated in insolvency proceedings. However, in the case of misconduct under financial services laws, the House of Lords has adopted a more purposive approach to reconciling securities claims and insolvency priorities. Section 74(2)(f) of the UK *Insolvency Act 1986* specifies that a “sum due to any member of the company, in his [her] character of a member, by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself [herself] and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves”.¹⁶⁰ The UK Act also specifies that a person is not disbarred from obtaining damages or other compensation from a company by reason only of holding shares in the company and any right to subscribe for shares or to be included in the company’s register in respect of shares.¹⁶¹ The specific language has given rise to the question of whether a claim by a member arising out of misconduct by the debtor corporation or its officers should be treated as a claim “in his character of a member” and, therefore, subordinated, or should be treated as a claim in his or her character as a tort victim, not as “a member,” and therefore not subordinated.

In *Soden v. British & Commonwealth Holdings Plc.*, a successful takeover bidder, British & Commonwealth Holdings (“B&C”) had purchased all the share capital of the target company for £434 million and sought damages for negligent misrepresentation against the target company when the latter’s financial distress became known after the completion of the takeover.¹⁶² The target company went into administration and the court approved a scheme of arrangement to which the bidder, B&C was not a party. The action for damages had not come to trial and the Administrator sought direction on whether B&C’s action and another action for third party contribution, if successful, would be subordinated to the claims of other creditors. The critical question for the House of Lords was whether damages ordered for negligent misrepresentation would constitute “a sum due to a member in its character of a member”.¹⁶³ The House of Lords held that s. 74(2)(f) requires a distinction to be drawn between sums due to a member in his or her character as a member and sums due to a member otherwise than in his or her character as a member, and that sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company pursuant to provisions of the UK *Corporations Act*, i.e. arise out of a cause of action on the statutory contract.¹⁶⁴ The House of Lords held that the relevant principle is not that “members come last”, but rather, that the “rights of members as members come last”, i.e. rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors. The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors; however, a member having a cause of action independent of the statutory contract is claiming as a creditor and is in no worse position than any other creditor.¹⁶⁵

The House of Lords further held that the subordination provision, s. 74(2)(f), of the U.K. *Insolvency Act*, did not apply to the takeover bidder because it had purchased shares in the market and not directly from an offering of the debtor company.¹⁶⁶ The House of Lords held

¹⁶⁰ Section 74(2) (f), UK *Insolvency Act 1986*. While member refers to equity investors under UK legislation, this article will refer to members and shareholders interchangeably for the remainder of the article.

¹⁶¹ Section 111A, UK *Insolvency Act 1986*.

¹⁶² *Soden v. British & Commonwealth Holdings plc* [1998] AC 298 (H.L.). It is unclear from the judgment why the acquiring B&C was not alerted to the corporation’s true financial condition.

¹⁶³ *Ibid.*

¹⁶⁴ *Ibid.* Section 14(1) of the Act specifies that the memorandum and articles bind the company and its members.

¹⁶⁵ *Ibid.*

¹⁶⁶ *Ibid.*

that the misrepresentation claims of transferee shareholders should not be subordinated and should rank *pari passu* with unsecured creditors. Hence, the subordination provisions have been interpreted to apply to subscribing shareholders and not transferees.

Essentially, the UK court has distinguished the nature of the claim based on the statutory contract of shareholding. It is not a distinction based on fraud versus ordinary business risk associated with equity investments. However, since remedies that arise out of secondary market purchases are remedies for fraud and misrepresentation, the courts are effectively distinguishing on that basis, although only for secondary market purchasers.

Application of First Principles to the Nature of the Claim Option

The UK approach is the opposite of the previous option or that suggested by the Canadian court in *Bell International*, in that in the UK, secondary market purchases are not subordinated whereas in *Bell International* the court indicated that it was open to parity treatment of primary market claimants. In assessing first principles in respect of the UK option, there does appear to be transparency in that the *Soden* approach did not result in an upswing in the number of cases, nor did it appear to disrupt the credit market in the subsequent ten years.¹⁶⁷ In terms of certainty, as long as the courts continue to be consistent in their substantive approach to such claims, parties can rely on the ranking given. The UK government is in a process of considering whether to alter the priorities, in terms of conducting a public consultation process.

The fairness issue raises the same problems as the previous two options in that it is not evident that there is a cogent policy rationale for dissimilar treatment of primary and secondary market investors where the nature of their claims arises from exactly the same misconduct. It is unclear whether this option has resulted in administrative efficiency, a topic worthy of further research.

6. The Judicial Discretion Option:

Subordinate Equity Securities Claims but Provide the Court with Authority to Redress Harms on a Preferred Basis where Equitable to Do So

A statutory amendment that specifies “unless the court determines that it is ‘fair and equitable’ or ‘fair and reasonable’ to order otherwise”, would grant the court authority to exercise its discretion in particular circumstances based on the equities in the case. It would allow the court to approve a remedy in cases where damages are sought for egregious conduct on the part of the debtor corporation and its officers. The other option would be to remove damage claims arising out of securities law violations from the above proposed definition of equity claim because, arguably, such claims are not equity claims.

Application of First Principles to the Judicial Discretion Option

While this option allows a degree of fairness in that the courts could exercise their authority on an equitable basis to allow claims arising out of corporate misconduct to be treated on a parity basis, this option is unlikely to lead to transparency or certainty for parties. This problem could be addressed by expressly setting out the criteria that the court would use in exercising such authority. The option does, however, considerably temper the harshness of the complete subordination option in terms of fairness to equity securities investors, although it would be dependent on how purposive the courts interpreted any language granting them authority or discretion. The efficiency objectives would have the same challenges as discussed in the options above.

¹⁶⁷ CAMAC, *supra*, note 6 at 64.

V. Conclusion

Given the variety of approaches to the question of equity securities claims for corporate misconduct arising under insolvency proceedings, it is unlikely in the short term that there will be convergence of approaches across jurisdictions. As a result, what is likely most important is that whatever normative choices are made, that creditors have a clear sense of the risks imposed. While it is true that credit decisions may be adjusted given the shifting of priorities in a jurisdiction (as shifting the priority of employee claims has illustrated), there is less likely to be an issue of the amount of available credit and more likely a rise in the cost of credit, which in turn may disadvantage particular types of unsecured creditors. Adoption of the parity option could result in a greater percentage of secured debt, although that is a trend that has been occurring for some time now, as creditors seek a higher measure of security in their investment decisions. However, the principles of transparency, certainty and fairness are likely to drive those decisions, as well as the objective of timely and efficient administration of the insolvency proceeding.

Shortly after the High Court's judgment was rendered, the Australian government directed the Corporations and Markets Advisory Committee ("CAMAC") to study the treatment of equity claims arising out of corporate misconduct.¹⁶⁸ The CAMAC Discussion Paper was issued in September 2007 with a consultation process currently ongoing.¹⁶⁹ The CAMAC report observes that in principle, how equity investors purchased their shares, in the primary market, or from a third party privately or from the publicly traded market, should not make a difference in the treatment of their claims arising out of corporation misconduct.¹⁷⁰

One of the unknown factors in considering all of these options in respect of Canadian law is that the secondary market civil liability regime is so new that it is difficult to determine how easily it will or will not be to establish damages for violation of securities law requirements. Under the recent Canadian legislation, there is no requirement to establish reliance, but there is a cap on the amount that individuals can be found liable for any failure to disclose or misrepresentation. There is no cap on damages where fraud or intentional authorization of misrepresentation or failure to disclose is proven.¹⁷¹ Hence, the deterrence effects of particular options may also be limited. These options also reveal that conflation of remedies for deterrence or investor compensation for harms may not always be possible, and thus there are both tensions within securities law and tensions that arise when it intersects with insolvency law.

There is also the increasingly complex issue of corporate groups and how they are to be treated in insolvency, particularly where there is a cross-border component. Creditors frequently construct their credit transactions with a particular entity in the corporate group, as means to protect their claims on particular assets. This practice may continue in a different way, specifically, creditors may make credit decisions below the parent corporation level in order that equity investors in a holding company that is the sole shareholder of a subsidiary is

¹⁶⁸ The Committee was to consider whether shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct; any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims; and if not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information. In announcing the study, the Parliamentary Secretary observed that the *Sons of Gwalia* decision raises the question of which party is best able to manage the risk of misleading statements by a company prior to an insolvency proceeding being commenced; the Honourable Chris Pearce, MP, Parliamentary Secretary to the Treasurer, <http://parlsec.treasurer.gov.au/cjp/content/pressreleases/2007/002.asp>, (7 February 2007).

¹⁶⁹ CAMAC, *supra*, note 6.

¹⁷⁰ *Ibid.* at 4. The report also raises the question of how a range of equity-linked investors, such as holders of warrants, options or derivatives that convert into equity interests should be treated, as while they are not shareholders, decisions to exercise such warrants or options made have been made in reliance on the company's misconduct.

¹⁷¹ See for example, ss. 138.1, Ontario *Securities Act*, *supra*, note 16.

subordinated.¹⁷² However, the question engages a much broader issue of when and to what extent the courts will draw aside the corporate veil to assist a range of creditor claims from realizing on the value of assets, a process currently being examined by the UNCITRAL Working Group on Corporate Groups.

At the heart of all the issues canvassed in this article is the allocation of risk and the allocation of remedies at the point of firm insolvency. It is uncontested that in the ordinary course of business, equity claims come last in the hierarchy of claims. What is less clear is whether this should encompass all equity claims or whether claims arising from the violation of public statutes designed to protect equity investors ought to be treated differently. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals.

If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. In this respect, however, it is important to note that recognizing claims arising from securities law violations would not affect the realization of claims by secured creditors, who would continue to rank in priority and who generally set the thresholds for pricing of credit.

The challenge is to advance the protection of investors as much as possible while recognizing the importance of the priority scheme of credit claims under insolvency legislation. The critical question is the nature of the claim advanced by the securities holder, and is it more properly characterized as a claim in equity arising out of ordinary business risk, or whether it is more akin to a claim of an unsecured creditor where the claim arises from a statutory violation under securities or corporate law. It would seem that absolute subordination of all shareholder claims is overreach by insolvency legislation that may give rise to inappropriate incentives for corporate officers within the insolvency law regime where restructuring is an option.

Further research questions include the extent to which remedies against directors and officers personally for misconduct arising out of securities law violations will be sufficient to meet the public policy goals of securities legislation. Under both corporate and securities statutes in a number of jurisdictions, there are remedies for directors and officers that fail to act in the best interests of the company or breach their duties of good faith, loyalty and care. As noted earlier, there are also new remedies under securities or financial services statutes against directors and officers for misrepresentation or other statutory disclosure violations. Here, jurisdictions vary wildly. The US does not have a liability cap, although other aspects of the regulatory system are trying to curb the incidence of litigation. Canada has a very restricted cap except in the case of actual fraud. The interaction of this liability regime with insolvency proceedings could become significant.

The options discussed in this paper need to be carefully developed as part of an ongoing public policy debate. It seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings. In the absence of such a mechanism, whatever increase in fairness towards wronged securities holders is achieved will be outweighed by the increased transaction costs generated by a lengthy and complex process for resolving securities holders' claims in insolvency proceedings. A similar mechanism will be required during a corporate restructuring or rescue in order to avoid delay and excessive litigation involving the

¹⁷² *Ibid.* at 46.

resolution of the participation rights of securities holders based on their claims arising from violations of securities law.

Various jurisdictions around the globe have arrived at several very different answers to the questions discussed in this paper. These different answers could reflect different normative judgments regarding the correct balance between fairness in the treatment of the claims of creditors and those of equity securities holders for violations of securities law and for fraud. To the extent that they are the result of concerns about transparency, certainty, and administrative efficiency, however, there may be other alternatives that may increase fairness while providing comparable values of the other principles to those provided by an existing system.