Court File No. CV-13-10274-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT,* R.S.C. 1985, c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF 8440522 CANADA INC., DATA & AUDIO-VISUAL ENTERPRISES WIRELESS INC., AND DATA & AUDIO-VISUAL ENTERPRISES HOLDINGS INC.

Applicants

BOOK OF AUTHORITIES OF THE APPLICANTS

NORTON ROSE FULBRIGHT CANADA LLP
Royal Bank Plaza, South Tower, Suite 3800
200 Bay Street, P.O. Box 84
Toronto, Ontario M5J 2Z4 CANADA

Orestes Pasparakis LSUC#: 36851T
Tel: (416) 216-4815
Email: Orestes.Pasparakis@nortonrosefulbright.com

Virginie Gauthier LSUC#: 41097D
Tel: (416) 216-4853
Email: Virginie.Gauthier@nortonrosefulbright.com

Evan Cobb LSUC#: 55787N
Tel: (416) 216-1929
Fax: (416) 216-3930
Email: Evan.Cobb@nortonrosefulbright.com

Lawyers for the Applicants

Index

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INDEX

Tab 1

Case Name:

Nortel Networks Corp. (Re)

IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended
AND IN THE MATTER OF a Plan of Compromise or Arrangement of Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation
Between
Donald Sproule, David D. Archibald and Michael Campbell on their own behalf and on behalf of Former Employees of Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation, Appellants, and
Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation, the Board of Directors of Nortel Networks Corporation and Nortel Networks Limited, the Informal Nortel Noteholder Group, the Official Committee of Unsecured Creditors and Ernst & Young Inc. in its capacity as Monitor, Respondents
And between
National Automobile, Aerospace, Transportation and General Workers Union of Canada (CAW-Canada) and its Locals 27, 1525, 1530, 1535, 1837, 1839, 1905 and/or 1915, George Borosh and other retirees of Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation, Appellants, and
Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation, the Board of Directors of Nortel Networks Corporation and Nortel Networks Limited, the Informal Nortel Noteholder Group, the Official Committee of Unsecured Creditors and Ernst & Young Inc. in its capacity as Monitor, Respondents

[2009] O.J. No. 4967

2009 ONCA 833

59 C.B.R. (5th) 23

77 C.C.P.B. 161

99 O.R. (3d) 708

[2010] CLLC para. 210-005

256 O.A.C. 131

2009 CarswellOnt 7383

Dockets: C50986, C50988

Ontario Court of Appeal
Toronto, Ontario

S.T. Goudge, K.N. Feldman and R.A. Blair JJ.A.

Heard: October 1, 2009.
Judgment: November 26, 2009.

(49 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Application of Act -- Appeal by union and former employees of company under protection from dismissal of motion for directions dismissed -- Appellants sought direction requiring company to make periodic retirement and severance payments to former employees as required by collective agreement and provincial employment standards legislation -- Appellate court upheld finding that payments were not exempted from stay provisions of protection order -- Payments sought by union were deferred compensation for past services rather than compensation for current services exempted from the stay -- Payments sought by former employees under provincial standards legislation were not exempted under application of doctrine of paramountcy -- Companies' Creditors Arrangement Act, ss. 11, 11.3(a) -- Employment Standards Act, s. 11(5).

Constitutional law -- Constitutional validity of legislation -- Interpretive and constructive doctrines -- Paramountcy doctrine -- Appeal by former employees of company under protection from dismissal of motion for directions dismissed -- Former employees sought direction requiring company to make retirement and severance payments to former employees as required by provincial employment standards legislation -- Appellate court upheld finding that payments were not exempted from stay provisions of protection order under application of doctrine of paramountcy -- To find otherwise would defeat intent of stay provisions providing for restructuring for benefit of all stakeholders -- Companies' Creditors Arrangement Act, ss. 11 -- Employment Standards Act, s. 11(5).

Employment law -- Employment standards legislation -- Constitutional issues -- Appeal by former employees of company under protection from dismissal of motion for directions dismissed -- Former employees sought direction requiring company to make retirement and severance payments to former employees as required by provincial employment standards legislation -- Appellate court upheld finding that payments were not exempted from stay provisions of protection order under application of doctrine of paramountcy -- To find otherwise would defeat intent of stay provisions providing for restructuring for benefit of all stakeholders -- Companies' Creditors Arrangement Act, ss. 11 -- Employment Standards Act, s. 11(5).

Two appeals by the former employees of Nortel, and the union, CAW-Canada, from dismissal of their motions for directions. The Nortel companies were granted protection under the Companies' Creditors Arrangement Act (CCAA). The order provided for a stay of all proceedings against Nortel and a suspension of all rights and remedies against Nortel. The collective agreement between Nortel and the union obliged Nortel to make periodic payments to former employees that had retired or been terminated. Nortel ceased making the periodic payments following the protection order. The payments at issue for the union were monthly payments under the Retirement Allowance Plan, payments under the Voluntary Retirement Option and termination and severance payments. The payments at issue for former employees included payments immediately payable pursuant to the Employment Standards Act (ESA) in respect of termination, severance and vacation pay, payments for continuation of benefit plans, certain pension benefit payments and a transitional retirement allowance. The appellants brought a motion for directions requesting an order directing Nortel to resume the periodic payments. The union submitted that the collective agreement was not divisible into separate obligations to current and former employees, and thus the periodic payments fell within the scope of compensation for services exempted from the protection order under s. 11.3(a) of the CCAA. The former employees submitted that the effect of the protection order could not override payments owed under the ESA. In dismissing both motions, the judge distinguished crystallization of the periodic payment obligations under the collective agreement from the provision of a service within the meaning of s. 11.3, as the services of former employees were provided pre-filing of the protection order. The union and the former employees appealed.

HELD: Appeals dismissed. The periodic payments sought by the union were not excluded from the stay provisions of the protection order under s. 11.3(a) of the CCAA. The payments required for current services provided by Nortel's continuing employees did not encompass the periodic retirement or severance payments owed to former employees. Such payments were best characterized as deferred compensation under predecessor collective agreements rather than compensation for services currently being performed for Nortel. In addition, the vested interest of former employees in such payments was inconsistent with current services being the source of the obligation to pay. The statutory payments sought by former employees were not excluded from the stay provisions of the protection order. The stay provisions of the CCAA were intended to freeze Nortel's debt obligations in order to permit restructuring for the benefit of all stakeholders. Upon consideration of the doctrine of paramountcy, such intent would be frustrated if the order did not apply to termination and severance payments owed under the provincial ESA to terminated employees in respect of past services. The effect of the stay related to the timing of the statutory payments rather than the interrelationship between ESA and the CCAA in respect of ultimate payment of Nortel's statutory obligations.

Statutes, Regulations and Rules Cited:

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3,

Companies' Creditors Arrangement Act, R.S.C. 1985 c. C-36, s. 11, s. 11(3), s. 11(4), s. 11.3(a)

Employment Standards Act, 2000, S.O. 2000, c. 41, s. 11(5)

Appeal From:

On appeal from the order of Justice Geoffrey B. Morawetz of the Superior Court of Justice, dated June 18, 2009, with reasons reported at (2009), 55 C.B.R. (5th) 68, [2009] O.J. No. 2558.

Counsel:

Mark Zigler, Andrew Hatnay and Andrea McKinnon, for the appellants, Nortel Networks Former Employees.

Barry E. Wadsworth, for the appellant, CAW-Canada.

Suzanne Wood and Alan Mersky, for the respondents, Nortel Networks Limited, Nortel Networks Corporation, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation.

Lyndon A.J. Barnes and Adam Hirsh, for the respondents, Board of Directors of Nortel Networks Corporation and Nortel Networks Limited.

Benjamin Zarnett, for the monitor Ernst & Young Inc.

Gavin H. Finlayson, for the Informal Nortel Noteholder Group.

Thomas McRae, for the Nortel Canadian Continuing Employees.

Massimo Starnino, for the Superintendent of Financial Services.

Alex MacFarlane and Jane Dietrich, for the Official Committee of Unsecured Creditors

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The judgment of the Court was delivered by

1 **S.T. GOUDGE and K.N. FELDMAN JJ.A.**:-- On January 14, 2009, the Nortel group of companies (referred to in these reasons as "Nortel") applied for and was granted protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985 c. C-36, ("*CCAA*").

2 In order to provide Nortel with breathing space to permit it to file a plan of compromise or arrangement with the court, that order provided, *inter alia*, a stay of all proceedings against Nortel, a suspension of all rights and remedies against Nortel, and an order that during the stay period, no person shall discontinue, repudiate, or cease to perform any contract or agreement with Nortel.

3 The CAW-Canada ("Union") represents employees of Nortel at two sites in Ontario. The Union and Nortel are parties to a collective agreement covering both sites. On April 21, 2009, the Union and a group of former employees of Nortel ("Former Employees") each brought a motion for directions seeking certain relief from the order granted to Nortel on January 14, 2009. On June 18, 2009, Morawetz J. denied both motions.

4 The Union and the Former Employees both appealed from that decision. Their appeals were heard one after the other on October 1, 2009. The appeal of the Former Employees was supported by a group of Canadian non-unionized employees, whose employment with Nortel continues. Nortel was supported in opposing the appeals by the board of directors of two of the Nortel companies, an informal Nortel noteholders group, and the Official Committee of Unsecured Creditors of Nortel.

5 We will address each of the two appeals in turn.

THE UNION APPEAL

Background

6 The collective agreement between the Union and Nortel sets out the terms and conditions of employment of the 45 employees that have continued to work for Nortel since January 14, 2009. The collective agreement also obliges Nortel to make certain periodic payments to unionized former employees who have retired or been terminated from Nortel. The three kinds of periodic payments at issue in this proceeding are monthly payments under the Retirement Allowance Plan ("RAP"), payments under the Voluntary Retirement Option ("VRO"), and termination and severance payments to unionized employees who have been terminated or who have severed their employment at Nortel.

7 Since the January 14, 2009 order, Nortel has continued to pay the continuing employees their compensation and benefits as required by the collective agreement. However, as of that date, it ceased to make the periodic payments at issue in this case.

8 The Union's motion requested an order directing Nortel to resume those periodic payments as required by the collective agreement. The Union's argument hinges on s. 11.3(a) of the *CCAA*. At the time this appeal was argued, it read as follows:[1]

> 11.3 No order made under section 11 shall have the effect of
>
> (a) prohibiting a person from requiring immediate payment for goods, services, use of leased or licensed property or other valuable consideration provided after the order is made.

9 The Union's argument before the motion judge was that the collective agreement is a bargain between it and Nortel that ought not to be divided into separate obligations and therefore the "compensation" for services performed under it must include all of Nortel's monetary obligations, not just those owed specifically to those who remain actively employed. The Union argued that the contested periodic payments to Former Employees must be considered part of the compensation for services provided after January 14, 2009, and therefore exempted from the order of that date by s. 11.3(a) of the *CCAA*.

10 The motion judge dismissed this argument. The essence of his reasons is as follows at para. 67:

> The flaw in the argument of the Union is that it equates the crystallization of a payment obligation under the Collective Agreement to a provision of a service

> within the meaning of s. 11.3. The triggering of the payment obligation may have arisen after the Initial Order but it does not follow that a service has been provided after the Initial Order. Section 11.3 contemplates, in my view, some current activity by a service provider post-filing that gives rise to a payment obligation post-filing. The distinction being that the claims of the Union for termination and severance pay are based, for the most part, on services that were provided pre-filing. Likewise, obligations for benefits arising from RAP and VRO are again based, for the most part, on services provided pre-filing. The exact time of when the payment obligation crystallized is not, in my view, the determining factor under section 11.3. Rather, the key factor is whether the employee performed services after the date of the Initial Order. If so, he or she is entitled to compensation benefits for such current service.

11 The Union challenges this conclusion.

12 In this court, neither the Union nor any other party argues that Nortel's obligation to make the contested periodic payments should be decided by arbitration under the collective agreement rather than by the court.

13 Nor does the Union argue that any of the unionized former employees, who would receive these periodic payments, have themselves provided services to Nortel since the January 14, 2009 order.

14 Rather, the Union reiterates the argument it made at first instance, namely that these periodic payments are protected by s. 11.3(a) of the *CCAA* as payment for service provided after the January 14, 2009 order was made by the Union members who have continued as employees of Nortel.

15 In our opinion, this argument must fail.

Analysis

16 Two preliminary points should be made. First, as the motion judge wrote at para. 47 of his reasons, the acknowledged purpose of the *CCAA* is to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors, to the end that the company is able to continue in business. The primary instrument provided by the *CCAA* to achieve its purpose is the power of the court to issue a broad stay of proceedings under s. 11. That power includes the power to stay the debt obligations of the company. The order of January 14, 2009 is an exercise of that power, and must be read in the context of the purpose of the legislation. Nonetheless, it is important to underline that, while that order stays those obligations, it does not eliminate them.

17 Second, we also agree with the motion judge when he stated at para. 66:

> In my view, section 11.3 is an exception to the general stay provision authorized by section 11 provided for in the Initial Order. As such, it seems to me that section 11.3 should be narrowly construed.

18 Because of s. 11.3(a) of the *CCAA*, the January 14, 2009 order cannot stay Nortel's obligation to make immediate payment for the services provided to it after the date of the order.

19 What then does the collective agreement require of Nortel as payment for the work done by its continuing employees? The straightforward answer is that the collective agreement sets out in detail the compensation that Nortel must pay and the benefits it must provide to its employees in return for their services. That bargain is at the heart of the collective agreement. Indeed, as counsel for the Union candidly acknowledged, the typical grievance, if services of employees went unremunerated, would be to seek as a remedy not what might be owed to former employees but only the payment of compensation and benefits owed under the collective agreement to those employees who provided the services. Indeed, that package of compensation and benefits represents the commercially reasonable contractual obligation resting on Nortel for the supply of services by those continuing employees. It is that which is protected by s. 11.3(a) from the reach of the January 14, 2009 order: see *Re: Mirant Canada Energy Marketing Ltd.* (2004), 36 Alta. L.R. (4th) 87 (Q.B.).

20 Can it be said that the payment required for the services provided by the continuing employees of Nortel also extends to encompass the periodic payments to the former employees in question in this case? In our opinion, for the following reasons the answer is clearly no.

21 The periodic payments to former employees are payments under various retirement programs, and termination and severance payments. All are products of the ongoing collective bargaining process and the collective agreements it has produced over time. As Krever J.A. wrote regarding analogous benefits in *Metropolitan Police Service Board v. Ontario Municipal Employees Retirement Board et al.* (1999), 45 O.R. (3d) 622 (C.A.) at 629, it can be assumed that the cost of these benefits was considered in the overall compensation package negotiated when they were created by predecessor collective agreements. These benefits may therefore reasonably be thought of as deferred compensation under those predecessor agreements. In other words, they are compensation deferred from past agreements but provided currently as periodic payments owing to former employees for prior services. The services for which these payments constitute "payment" under the *CCAA* were those provided under predecessor agreements, not the services currently being performed for Nortel.

22 Moreover, the rights of former employees to these periodic payments remain currently enforceable even though those rights were created under predecessor collective agreements. They become a form of "vested" right, although they may only be enforceable by the Union on behalf of the former employees: see *Dayco (Canada) Ltd. v. CAW-Canada*, [1993] 2 S.C.R. 230 at 274. That is entirely inconsistent with the periodic payments constituting payment for current services. If current service was the source of the obligation to make these periodic payments then, if there were no current services being performed, the obligation would evaporate and the right of the former employees to receive the periodic payments would disappear. It would in no sense be a "vested" right.

23 In summary, we can find no basis upon which the Union's position can be sustained. The periodic payments in issue cannot be characterized as part of the payment required of Nortel for the services provided to it by its continuing employees after January 14, 2009. Section 11.3(a) of the *CCAA* does not exclude these payments from the effect of the order of that date.

24 The Union's appeal must be dismissed.

THE FORMER EMPLOYEES' APPEAL

Background

25 The Former Employees' motion was brought by three men as representatives of former employees including pensioners and their survivors. On the motion their claim was for an order varying the Initial Order to require Nortel to pay termination pay, severance pay, vacation pay, an amount for continuation of the Nortel benefit plans during the notice period in accordance with the

Employment Standards Act, 2000, S.O. 2000, c. 41 ("*ESA*") and any other provincial employment legislation. The representatives also sought an order varying the Initial Order to require Nortel to pay the Transitional Retirement Allowance ("TRA") and certain pension benefit payments to affected former employees. The motion judge described the motion by the former employees as "not dissimilar to the CAW motion, such that the motion of the former employees can almost be described as a "Me too motion."

26 After he dismissed the union motion, the motion judge turned to the "me too" motion of the former employees. The former employees wanted to achieve the same result as the unionized employees. The motion judge described their argument as based on the position that Nortel could not contract out of the *ESA* of Ontario or another province. However, as he noted, rather than trying to contract out, it was acknowledged that the *ESA* applied, except that immediate payment of amounts owing as required by the *ESA* were stayed during the stay period under the Initial Order, so that the former employees could not enforce the acknowledged payment obligation during that time. The motion judge concluded that on the same basis as the union motion, the former employees' motion was also dismissed.

27 For the purposes of the appeal, the former employees narrowed their claim only to statutory termination and severance claims under the *ESA* that were not being paid by Nortel pursuant to the Initial Order, and served a Notice of Constitutional Question. The appellant asks this court to find that judges cannot use their discretion to order a stay under the *CCAA* that has the effect of overriding valid provincial minimum standards legislation where there is no conflict between the statutes and the doctrine of paramountcy has not been triggered.

28 Neither the provincial nor the federal governments responded to the notice on this appeal.

29 Paragraphs 6 and 11 of the Initial Order (as amended) provide as follows:

> 6. THIS COURT ORDERS that each of the Applicants, either on its own or on behalf of another Applicant, *shall be entitled but not required to pay* the following expenses whether incurred prior to, on or after the date of this Order:
>
> (a) all outstanding and future wages, salaries and employee benefits (including but not limited to, employee medical and similar benefit plans, relocation and tax equalization programs, the Incentive Plan (as defined in the Doolittle affidavit) and employee assistance programs), current service, special and similar pension benefit payments, vacation pay, commissions and employee and director expenses, in each case incurred in the ordinary course of business and consistent with existing compensation policies and arrangements;
>
> 11. THIS COURT ORDERS that each of the Applicants shall have the right to:
>
> ...
>
> (b) terminate the employment of such of its employees or temporarily lay off such employees as it deems appropriate *and to deal with the consequences thereof in the Plan or on further order of the Court*.
>
> ...

> all of the foregoing to permit the Applicants to proceed with an orderly restructuring of the Business. [Emphasis added.]

30 Pursuant to these paragraphs, from the date of the Initial Order, Nortel stopped making payments to former employees as well as employees terminated following the Initial Order for certain retirement and pension allowances as well as for statutory severance and termination payments. The *ESA* sets out obligations to provide notice of termination of employment or payment in lieu of notice and severance pay in defined circumstances. By virtue of s. 11(5), those payments must be made on the later of seven days after the date employment ends or the employee's next pay date.

31 As the motion judge stated, it is acknowledged by all parties on this motion that the *ESA* continues to apply while a company is subject to a *CCAA* restructuring. The issue is whether the company's provincial statutory obligations for virtually immediate payment of termination and severance can be stayed by an order made under the *CCAA*.

32 Sections 11(3), dealing with the initial application, and (4), dealing with subsequent applications under the *CCAA* are the stay provisions of the Act. Section 11(3) provides:

> 11. (3) A court may, on an initial application in respect of a company, make an order on such terms as it may impose, effective for such period as the court deems necessary not exceeding thirty days,
>
> (a) staying, until otherwise ordered by the court, all proceedings taken or that might be taken in respect of the company under an Act referred to in subsection 1; [the Bankruptcy and Insolvency Act and the Winding Up Act]
>
> (b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company;
>
> (c) prohibiting, until otherwise ordered by the court, the commencement of or proceeding with any other action, suit or proceeding against the company.

Analysis

33 As earlier noted, the stay provisions of the *CCAA* are well recognized as the key to the successful operation of the *CCAA* restructuring process. As this court stated in *Stelco Inc. (Re)* (2005), 75 O.R. (3d) 5 at para. 36:

> In the CCAA context, Parliament has provided a statutory framework to extend protection to a company while it holds its creditors at bay and attempts to negotiate a compromised plan of arrangement that will enable it to emerge and continue as a viable economic entity, thus benefiting society and the company in the long run, along with the company's creditors, shareholders, employees and other stakeholders. The s. 11 discretion is the engine that drives this broad and flexible statutory scheme...

34 Parliament has carved out defined exceptions to the court's ability to impose a stay. For example, s. 11.3(a) prohibits a stay of payments for goods and services provided after the initial order, so that while the company is given the opportunity and privilege to carry on during the *CCAA* restructuring process without paying its existing creditors, it is on a pay-as-you-go basis only. In contrast, there is no exception for statutory termination and severance pay.[2] Furthermore, as the respondent Boards of Directors point out, the recent amendments to the *CCAA* that came into force on

September 18, 2009 do not address this issue, although they do deal in other respects with employee-related matters.

35 As there is no specific protection from the general stay provision for *ESA* termination and severance payments, the question to be determined is whether the court is entitled to extend the effect of its stay order to such payments based on the constitutional doctrine of paramountcy: *Crystalline Investments Ltd. v. Domgroup Ltd.*, [2004] 1 S.C.R. 60 at para. 43.

36 The scope, intent and effect of the operation of the doctrine of paramountcy was recently reviewed and summarized by Binnie and Lebel JJ. in *Canadian Western Bank v. Alberta*, [2007] 2 S.C.R. 3 at paras. 69-75. They reaffirmed the "conflict" test stated by Dickson J. in *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161:

> In principle, there would seem to be no good reasons to speak of paramountcy and preclusion except where there is actual conflict in operation as where one enactment says "yes" and the other says "no"; "the same citizens are being told to do inconsistent things"; compliance with one is defiance of the other. [p. 191]

37 However, they also explained an important proviso or gloss on the strict conflict rule that has developed in the case law since *Multiple Access*:

> Nevertheless, there will be cases in which imposing an obligation to comply with provincial legislation would in effect frustrate the purpose of a federal law even though it did not entail a direct violation of the federal law's provisions. The Court recognized this in Bank of Montreal v. Hall, [1990] 1 S.C.R. 121, in noting that Parliament's "intent" must also be taken into account in the analysis of incompatibility. The Court thus acknowledged that the impossibility of complying with two enactments is not the sole sign of incompatibility. The fact that a provincial law is incompatible with the purpose of a federal law will also be sufficient to trigger the application of the doctrine of federal paramountcy. This point was recently reaffirmed in Mangat and in Rothmans, Benson & Hedges Inc. v. Saskatchewan, [2005] 1 S.C.R. 188, 2005 SCC 13. (para. 73)

38 Therefore, the doctrine of paramountcy will apply either where a provincial and a federal statutory provision are in conflict and cannot both be complied with, or where complying with the provincial law will have the effect of frustrating the purpose of the federal law and therefore the intent of Parliament. Binnie and Lebel JJ. concluded by summarizing the operation of the doctrine in the following way:

> To sum up, the onus is on the party relying on the doctrine of federal paramountcy to demonstrate that the federal and provincial laws are in fact incompatible by establishing either that it is impossible to comply with both laws or that to apply the provincial law would frustrate the purpose of the federal law. (para. 75)

39 The *CCAA* stay provision is a clear example of a case where the intent of Parliament, to allow the court to freeze the debt obligations owing to all creditors for past services (and goods) in order to permit a company to restructure for the benefit of all stakeholders, would be frustrated if the court's stay order could not apply to statutory termination and severance payments owed to terminated employees in respect of past services.

40 The record before the court indicates that the motion judge made the initial order and the amended order in the context of the insolvency of a complex, multinational conglomerate as part of co-ordinated proceedings in a number of countries including the U.S. In June 2009, an Interim Funding and Settlement Agreement was negotiated which, together with the proceeds of certain ongoing asset sales, is providing funds necessary in the view of the court appointed Monitor, for the ongoing operations of Nortel during the next few months of the *CCAA* oversight operation. This funding was achieved on the basis that the stay applied to the severance and termination payments. The Monitor advises that if these payments were not subject to the stay and had to be funded, further financing would have to be found to do that and also maintain operations.

41 In that context, the motion judge exercised his discretion to impose a stay that could extend to the severance and termination payments. He considered the financial position of Nortel, that it was not carrying "business as usual" and that it was under financial pressure. He also considered that the *CCAA* proceeding is at an early stage, before the claims of creditor groups, including former employees and others have been considered or classified for ultimate treatment under a plan of arrangement. He noted that employees have no statutory priority and their claims are not secured claims.

42 While reference was made to the paramountcy doctrine by the motion judge, it was not the main focus of the argument before him. Nevertheless, he effectively concluded that it would thwart the intent of Parliament for the successful conduct of the *CCAA* restructuring if the initial order and the amended order could not include a stay provision that allowed Nortel to suspend the payment of statutory obligations for termination and severance under the *ESA*.

43 The respondents also argued that if the stay did not apply to statutory termination and severance obligations, then the employees who received these payments would in effect be receiving a "super-priority" over other unsecured or possibly even secured creditors on the assumption that in the end there will not be enough money to pay everyone in full. We agree that this may be the effect if the stay does not apply to these payments. However, that could also be the effect if Nortel chose to make such payments, as it is entitled to do under paragraph 6 (a) of the amended initial order. Of course, in that case, any such payments would be made in consultation with appropriate parties including the Monitor, resulting in the effective grant of a consensual rather than a mandatory priority. Even in this case, the motion judge provided a "hardship" alleviation program funded up to $750,000, to allow payments to former employees in clear need. This will have the effect of granting the "super-priority" to some. This is an acceptable result in appropriate circumstances.

44 However, this result does not in any way undermine the paramountcy analysis. That analysis is driven by the need to preserve the ability of the *CCAA* court to ensure, through the scope of the stay order, that Parliament's intent for the operation of the *CCAA* regime is not thwarted by the operation of provincial legislation. The court issuing the stay order considers all of the circumstances and can impose an order that has the effect of overriding a provincial enactment where it is necessary to do so.

45 Morawetz J. was satisfied that such a stay was necessary in the circumstances of this case. We see no error in that conclusion on the record before him and before this court.

46 Another issue was raised based on the facts of this restructuring as it has developed. It appears that the company will not be restructured, but instead its assets will be sold. It is necessary to continue operations in order to maintain maximum value for this process to achieve the highest prices and therefore the best outcome for all stakeholders. It is true that the basis for the very broad stay power has traditionally been expressed as a necessary aspect of the restructuring process, leading to a plan of arrangement for the newly restructured entity. However, we see no reason in the present circumstances why the same analysis cannot apply during a sale process that requires the business to be carried on as a going concern. No party has taken the position that the *CCAA* process is no longer available because it is not proceeding as a restructuring, nor has any party taken steps to turn the proceeding into one under the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.

47 The former employee appellants have raised the constitutional question whether the doctrine of paramountcy applies to give to the *CCAA* judge the authority, under s. 11 of the Act, to order a stay of proceedings that has the effect of overriding s. 11(5) of the *ESA*, which requires almost immediate payment of termination and severance obligations. The answer to this question is yes.

48 We note again that the question before this court was limited to the effect of the stay on the timing of required statutory payments under the *ESA* and does not deal with the inter-relation of the *ESA* and the *CCAA* for the purposes of the plan of arrangement and the ultimate payment of these statutory obligations.

49 The appeal by the former employees is also dismissed.

S.T. GOUDGE J.A.
K.N. FELDMAN J.A.
R.A. BLAIR J.A.:-- I agree.

cp/e/ln/qlaim/qlaxw/qlsxs/qlced/qlhcs/qlcas/qljyw/qlhcs

1 The analogous section to the former s. 11.3(a) is now found in s. 11.01(a) of the recently amended *CCAA*.

2 The issue of post-initial order employee terminations, and specifically whether any portion of the termination or severance that may be owed is attributable to post-initial order services, was not at issue in this motion. In *Windsor Machine & Stamping Ltd. (Re)* [2009] O.J. No. 3195, decided one month after this motion, the issue was discussed more fully and Morawetz J. determined that it could be decided as part of a post-filing claim. Leave to appeal has been filed.

Tab 2

Case Name:

Canwest Global Communications Corp. (Re)

IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, C-36, as amended
AND IN THE MATTER OF a proposed plan of compromise or arrangement of Canwest Global Communications Corp. and the other applicants listed on Schedule "A"

[2009] O.J. No. 5379

61 C.B.R. (5th) 200

2009 CarswellOnt 7882

Court File No. CV-09-8241-OOCL

Ontario Superior Court of Justice
Commercial List

S.E. Pepall J.

Heard: December 8, 2009.
Judgment: December 15, 2009.

(52 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Claims -- Application in this Companies' Creditors Arrangement Act matter for an order declaring that the relief sought by the "GS Parties" was subject to an Oct. 6, 2009 stay of proceedings granted -- Cross-motion by the GS Parties for an order lifting the stay so that they could pursue their motion challenging pre-filing conduct of the CMI entities, etc., dismissed -- The substance and subject matter of the motion were certainly encompassed by the stay -- The balance of convenience, the assessment of relative prejudice and the relevant merits favoured the position of the CMI Entities on the lift stay motion.

Bankruptcy and insolvency law -- Proceedings -- Practice and procedure -- Stays -- Application in this Companies' Creditors Arrangement Act matter for an order declaring that the relief sought by the "GS Parties" was subject to an Oct. 6, 2009 stay of proceedings granted -- Cross-motion by the

GS Parties for an order lifting the stay so that they could pursue their motion challenging pre-filing conduct of the CMI entities, etc., dismissed -- The substance and subject matter of the motion were certainly encompassed by the stay -- The balance of convenience, the assessment of relative prejudice and the relevant merits favoured the position of the CMI Entities on the lift stay motion.

Application by the CCAA applicants and the "CMI entities" for an order declaring that the relief sought by the "GS parties" was subject to the stay of proceedings granted on Oct. 6, 2009. Cross-motion by GS Parties for an order lifting the stay so they could pursue their motion challenging pre-filing conduct of the CMI entities, etc. The Ad Hoc Committee of Noteholders and the Special Committee of the Board of Directors supported the position of the CMI Entities. In essence, the GS Parties' motion sought to undo the transfer of the CW Investments Co. shares from 441 to CMI or to require CMI to perform and not disclaim the shareholders agreement as though the shares had not been transferred.

HELD: GS Parties' motions dismissed, save for a portion dealing with para. 59 of the initial order on consent; CMI Entities' motion granted with the exception of a strike portion, which was moot. The first issue was caught by the stay of proceedings and the second was properly addressed if and when CMI sought to disclaim the shareholders agreement. The substance of the GS Parties' motion was a "proceeding" subject to the stay under para. 15 of the initial order prohibiting the commencement of all proceedings against or in respect of the CMI Entitites, or affecting the CMI business or property. The relief sought would also involve "the exercise of any right or remedy affecting the CMI business or the CMI property" which was stayed under para. 16 of the initial order. The substance and subject matter of the motion were certainly encompassed by the stay. The real question was whether the stay ought to be lifted in this case. If the stay were lifted, the prejudice to CMI would be great and the proceedings contemp lated by the GS Parties would be extraordinarily disruptive. The GS Parties were in no worse position than any other stakeholder who was precluded from relying on rights that arise upon an insolvency default. The balance of convenience, the assessment of relative prejudice and the relevant merits favoured the position of the CMI Entities on the lift stay motion. The onus to lift the stay was on the moving party. The stay was performing the essential function of keeping stakeholders at bay in order to give CMI Entities a reasonable opportunity to develop a restructuring plan.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 32, s. 11.02

Counsel:

Lyndon Barnes, Alex Cobb and Shawn Irving for the CMI Entities.

Alan Mark and Alan Merskey for the Special Committee of the Board of Directors of Canwest.

David Byers and Maria Konyukhova for the Monitor, FTI Consulting Canada Inc.

Benjamin Zarnett and Robert Chadwick for the Ad Hoc Committee of Noteholders.

K. McElcheran and G. Gray for GS Parties.

Hugh O'Reilly and Amanda Darrach for Canwest Retirees and the Canadian Media Guild.

Hilary Clarke for Senior Secured Lenders to LP Entities.

Steve Weisz for CIT Business Credit Canada Inc.

REASONS FOR DECISION

S.E. PEPALL J.:--

Relief Requested

1 The CCAA applicants and partnerships (the "CMI Entities") request an order declaring that the relief sought by GS Capital Partners VI Fund L.P., GSCP VI AA One Holding S.ar.1 and GS VI AA One Parallel Holding S.ar.1 (the "GS Parties") is subject to the stay of proceedings granted in my Initial Order dated October 6, 2009. The GS Parties bring a cross-motion for an order that the stay be lifted so that they may pursue their motion which, among other things, challenges pre-filing conduct of the CMI Entities. The Ad Hoc Committee of Noteholders and the Special Committee of the Board of Directors support the position of the CMI Entities. All of these stakeholders are highly sophisticated. Put differently, no one is a commercial novice. Such is the context of this dispute.

Background Facts

2 Canwest's television broadcast business consists of the CTLP TV business which is comprised of 12 free-to-air television stations and a portfolio of subscription based specialty television channels on the one hand and the Specialty TV Business on the other. The latter consists of 13 specialty television channels that are operated by CMI for the account of CW Investments Co. and its subsidiaries and 4 other specialty television channels in which the CW Investments Co. ownership interest is less than 50%.

3 The Specialty TV Business was acquired jointly with Goldman Sachs from Alliance Atlantis in August, 2007. In January of that year, CMI and Goldman Sachs agreed to acquire the business of Alliance Atlantis through a jointly owned acquisition company which later became CW Investments Co. It is a Nova Scotia Unlimited Liability Corporation ("NSULC").

4 CMI held its shares in CW Investments Co. through its wholly owned subsidiary, 4414616 Canada Inc. ("441"). According to the CMI Entities, the sole purpose of 441 was to insulate CMI from any liabilities of CW Investments Co. As a NSULC, its shareholders may face exposure if the NSULC is liquidated or becomes bankrupt. As such, 441 served as a "blocker" to potential liability. The CMI Entities state that similarly the GS parties served as "blockers" for Goldman Sachs' part of the transaction.

5 According to the GS Parties, the essential elements of the deal were as follows:

(i) GS would acquire at its own expense and at its own risk, the slower growth businesses;

(ii) CW Investments Co. would acquire the Specialty TV Business and that company would be owned by 441 and the GS Parties under the terms of a Shareholders Agreement;

(iii) GS would assist CW Investments Co. in obtaining separate financing for the Specialty TV Business;

(iv) Eventually Canwest would contribute its conventional TV business on a debt free basis to CW Investments Co. in return for an increased ownership stake in CW Investments Co.

6 The GS Parties also state that but for this arrangement, Canwest had no chance of acquiring control of the Specialty TV Business. That business is subject to regulation by the CRTC. Consistent with policy objectives, the CRTC had to satisfy itself that CW Investments Co. was not controlled either at law or in fact by a non-Canadian.

7 A Shareholders Agreement was entered into by the GS parties, CMI, 441, and CW Investments Co. The GS Parties state that 441 was a critical party to this Agreement. The Agreement reflects the share ownership of each of the parties to it: 64.67% held by the GS Parties and 35.33% held by 441. It also provides for control of CW Investments Co. by distribution of voting shares: 33.33% held by the GS Parties and 66.67% held by 441. The Agreement limits certain activities of CW Investments Co. without the affirmative vote of a director nominated to its Board by the GS Parties. The Agreement provides for call and put options that are designed to allow the GS parties to exit from the investment in CW Investments Co. in 2011, 2012, and 2013. Furthermore, in the event of an insolvency of CMI, the GS parties have the ability to effect a sale of their interest in CW Investments Co. and require as well a sale of CMI's interest. This is referred to as the drag-along provision. Specifically, Article 6.10(a) of the Shareholders Agreement states:

> Notwithstanding the other provisions of this Article 6, if an Insolvency Event occurs in respect of CanWest and is continuing, the GS Parties shall be entitled to sell all of their Shares to any *bona fide* Arm's Length third party or parties at a price and on other terms and conditions negotiated by GSCP in its discretion provided that such third party or parties acquires all of the Shares held by the

> CanWest Parties at the same price and on the same terms and conditions, and in such event, the CanWest Parties shall sell their Shares to such third party or parties at such price and on such terms and conditions. The Corporation and the CanWest Parties each agree to cooperate with and assist GSCP with the sale process (including by providing protected purchasers designated by GSCP with confidential information regarding the Corporation (subject to a customary confidentiality agreement) and with access to management).

8 The Agreement also provided that 441 as shareholder could transfer its CW Investments Co. shares to its parent, CMI, at any time, by gift, assignment or otherwise, whether or not for value. While another specified entity could not be dissolved, no prohibition was placed on the dissolution of 441. 441 had certain voting obligations that were to be carried out at the direction of CMI. Furthermore, CMI was responsible for ensuring the performance by 441 of its obligations under the Shareholders Agreement.

9 On October 5, 2009, pursuant to a Dissolution Agreement between 441 and CMI and as part of the winding-up and distribution of its property, 441 transferred all of its property, namely its 352,986 Class A shares and 666 Class B preferred shares of CW Investments Co., to CMI. CMI undertook to pay and discharge all of 441's liabilities and obligations. The material obligations were those contained in the Shareholders Agreement. At the time, 441 and CW Investments Co. were both solvent and CMI was insolvent. 441 was subsequently dissolved.

10 For the purposes of these two motions only, the parties have agreed that the court should assume that the transfer and dissolution of 441 was intended by CMI to provide it with the benefit of all the provisions of the CCAA proceedings in relation to contractual obligations pertaining to those shares. This would presumably include both the stay provisions found in section 11 of the CCAA and the disclaimer provisions in section 32 .

11 The CMI Entities state that CMI's interest in the Specialty TV Business is critical to the restructuring and recapitalization prospects of the CMI Entities and that if the GS parties were able to effect a sale of CW Investments Co. at this time, and on terms that suit them, it would be disastrous to the CMI Entities and their stakeholders. Even the overhanging threat of such a sale is adversely affecting the negotiation of a successful restructuring or recapitalization of the CMI Entities.

12 On October 6, 2009, I granted an Initial Order in these proceedings. CW Investments Co. was not an applicant. The CMI Entities requested a stay of proceedings to allow them to proceed to develop a plan of arrangement or compromise to implement a consensual "pre-packaged" recapitalization transaction. The CMI Entities and the Ad Hoc Committee of 8% Noteholders had agreed on terms of such a transaction that were reflected in a support agreement and term sheet. Those noteholders who support the term sheet have agreed to vote in favour of the plan subject to certain conditions one of which is a requirement that the Shareholders Agreement be amended.

13 The Initial Order included the typical stay of proceedings provisions that are found in the standard form order promulgated by the Commercial List Users Committee. Specifically, the order stated:

> 15. THIS COURT ORDERS that until and including November 5, 2009, or such later date as this Court may order (the "Stay Period"), no proceeding or enforcement process in any court or tribunal (each, a "Proceeding") shall be commenced or continued against or in respect of the CMI Entities, the Monitor or the CMI CRA or affecting the CMI Business or the CMI Property, except with the written consent of the applicable CMI Entity, the Monitor and the CMI CRA (in respect of Proceedings affecting the CMI Entities, the CMI Property or the CMI Business), the CMI CRA (in respect of Proceedings affecting the CMI Entities, the CMI property or the CMI Business), the CMI CRA (in respect of Proceedings affecting the CMI CRA), or with leave of this Court, and any and all Proceedings currently under way against or in respect of the CMI Entities or the CMI CRA or affecting the CMI Business or the CMI Property are hereby stayed and suspended pending further Order of this Court. In the case of the CMI CRA, no Proceeding shall be commenced against the CMI CRA or its directors and officers without prior leave of this Court on seven (7) days notice to Stonecrest Capital Inc.
>
> 16. THIS COURT ORDERS that during the Stay Period, all rights and remedies of any individual, firm, corporation, governmental body or agency, or any other entities (all of the foregoing, collectively being "Persons" and each being a "Person") against or in respect of the CMI Entities, the Monitor and/or the CMI CRA, or affecting the CMI Business or the CMI Property, are hereby stayed and suspended except with the written consent of the applicable CMI Entity, the Monitor and the CMI CRA (in respect of rights and remedies affecting the CMI Entities, the CMI Property or the CMI Business), the CMI CRA (in respect of rights or remedies affecting the CMI CRA), or leave of this Court, provided that nothing in this Order shall (i) empower the CMI Entities to carry on any business which the CMI Entities are not lawfully entitled to carry on, (ii) exempt the CMI Entities from compliance with statutory or regulatory provisions relating to health, safety or the environment, (iii) prevent the filing of any registration to preserve or perfect a security interest, or (iv) prevent the registration of a claim for lien.

14 The GS parties were not given notice of the CCAA application. On November 2, 2009, they brought a motion that, among other things, seeks to set aside the transfer of the shares from 441 to CMI or, in the alternative, require CMI to perform and not disclaim the Shareholders Agreement as if the shares had not been transferred. On November 10, 2009 the GS parties purported to revive 441 by filing Articles of Revival with the Director of the CBCA. The CMI Entities were not notified nor was any leave of the court sought in this regard. In an amended notice of motion dated

November 19, 2009 (the "main motion"), the GS Parties request an order:

(a) Setting aside and declaring void the transfer of the shares from 441 to CMI;
(b) declaring that the rights and remedies of the GS Parties in respect of the obligations of 441 under the Shareholders Agreement are not affected by these CCAA proceedings in any way whatsoever;
(c) in the alternative to (a) and (b), an order directing CMI to perform all of the obligations that bound 441 immediately prior to the transfer;
(d) in the alternative to (a) and (b), an order declaring that the obligations that bound 441 immediately prior to the transfer, may not be disclaimed by CMI pursuant to section 32 of the CCAA or otherwise; and
(e) if necessary, a trial of the issues arising from the foregoing.

15 They also requested an order amending paragraph 59 of the Initial Order but that issue has now been resolved and I am satisfied with the amendment proposed.

16 The CMI Entities then brought a motion on November 24, 2009 for an order that the GS motion is stayed. As in a game of chess, on December 3, 2009, the GS Parties served a cross-motion in which, if required, they seek leave to proceed with their motion.

17 In furtherance of their main motion, the GS Parties have expressed a desire to examine 4 of the 5 members of the Special Committee of the Board of Directors of Canwest. That Committee was constituted, among other things, to oversee the restructuring. The GS Parties have also demanded an extensive list of documentary production. They also seek to impose significant discovery demands upon the senior management of CanWest.

Issues

18 The issues to be determined on these motions are whether the relief requested by the GS Parties in their main motion is stayed based on the Initial Order and if so, whether the stay should be lifted. In addition, should the relief sought in paragraph 1(e) of the main motion be struck.

Positions of Parties

19 In brief, the parties' positions are as follows. The CMI Entities submit that the GS Parties' motion is a "proceeding" that is subject to the stay under paragraph 15 of the Initial Order. In addition, the relief sought by them involves "the exercise of any right or remedy affecting the CMI Business or the CMI Property" which is stayed under paragraph 16 of the Initial Order. The stay is consistent with the purpose of the CCAA. They submit that the subject matter of the motion should be caught so as to prevent the GS parties from gaining an unfair advantage over other stakeholders of the CMI Entities and to ensure that the resources of the CMI Entities are devoted to developing a viable restructuring plan for the benefit of all stakeholders. They also state that CMI's interest in

CW Investments Co. is a significant portion of its enterprise value. They state further that their actions were not in breach of the Shareholders Agreement and in any event, debtor companies are able to organize their affairs in order to benefit from the CCAA stay. Furthermore, any loss suffered by the GS Parties can be quantified.

20 In paragraph 1(e) of the main motion, the GS parties seek to prevent CMI from disclaiming the obligations of 441 that existed immediately prior to the transfer of the shares to CMI. If this relief is not stayed, the CMI Entities submit that it should be struck out pursuant to Rule 25.11(b) and (c) as premature and improper. They also argue that section 32 of the CCAA provides a procedure for disclaimer of agreements which the GS Parties improperly seek to circumvent.

21 Lastly, the CMI Entities state that the bases on which a CCAA stay should be lifted are very limited. Most of the grounds set forth in *Re Canadian Airlines Corp.*[1] which support the lifting of a stay are manifestly inapplicable. As to prejudice, the GS parties are in no worse position than any other stakeholder who is precluded from relying on rights that arise on an insolvency default. In contrast, the prejudice to the CMI Entities would be debilitating and their resources need to be devoted to their restructuring. The GS Parties' rights would not be lost by the passage of time. The GS Parties' motion is all about leverage and a desire to improve the GS Parties' negotiating position submits counsel for the CMI Entities.

22 The Ad Hoc Committee of Noteholders, as mentioned, supports the CMI Entities' position. In examining the context of the dispute, they submit that the Shareholders Agreement permitted and did not prohibit the transfer of 441's shares. Furthermore, the operative obligations in that agreement are obligations of CMI, not 441. It is the substance of the GS Parties' claims and not the form that should govern their ability to pursue them and it is clearly encompassed by the stay. The Committee relies on *Chef Ready Foods Ltd. v. Hongkong Bank of Canada*[2] in support of their position on timing.

23 The Special Committee also supports the CMI Entities. It submits that the primary relief sought by the GS parties is a declaration that their contracts to and with CW Investments cannot or should not be disclaimed. The debate as to whether 441 could properly be assimilated into CMI is no more than an alternate argument as to why such disclaimer can or cannot occur. They state that the subject matter of the GS Parties' motion is premature.

24 The GS Parties submit that the stay does not prevent parties affected by the CCAA proceedings from bringing motions within the CCAA proceedings themselves. The use of CCAA powers and the scope of the stay provided in the Initial Order and whether it applies to the GS Parties' motion are proper questions for the court charged with supervising the CCAA process. They also argue that the motion would facilitate negotiation between key parties, raises the important preliminary issue of the proper scope and application of section 32 of the CCAA, and avoids putting the Monitor in the impossible position of having to draw legal conclusions as to the scope of CMI's power to disclaim. The court should be concerned with pre-filing conduct including the reason for the share transfer, the timing, and CMI's intentions.

25 Even if the stay is applicable, the GS parties submit that it should be lifted. In this regard, the court should consider the balance of convenience, the relative prejudice to parties, and where relevant, the merits of the proposed action. The court should also consider whether the debtor company has acted and is acting in good faith. The GS Parties were the medium by which the Specialty TV Business became part of Canwest. Here, all that is being sought is a reversal of the false and highly prejudicial start to these restructuring proceedings. It is necessary to take steps now to protect a right that could be lost by the passage of time. The transfer of the shares exhibited bad faith on the part of Canwest. 441 insulated CW Investments Co. and the Specialty TV Business from the insolvency of CMI and thereby protected the contractual rights of the GS Parties. The manifest harm to the GS Parties that invited the motion should be given weight in the court's balancing of prejudices. Concerns as to disruption of the restructuring process could be met by imposing conditions on the lifting of a stay as, for example, the establishment of a timetable.

Discussion

(a) Legal Principles

26 First I will address the legal principles applicable to the granting and lifting of a CCAA stay.

27 The stay provisions in the CCAA are discretionary and are extraordinarily broad. Section 11.02 (1) and (2) states:

> 11.02 (1) A court may, on an initial application in respect of a debtor company, make an order on any terms that it may impose, effective for the period that the court considers necessary, which period may not be more than 30 days,
>
> (a) staying, until otherwise ordered by the court, all proceedings taken or that might be taken in respect of the company under the Bankruptcy and Insolvency Act or the Winding-up and Restructuring Act;
> (b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company; and
> (c) prohibiting, until otherwise ordered by the court, the commencement of any action, suit or proceeding against the company.
> (2) A court may, on an application in respect of a debtor company other than an initial application, make an order, on any terms that it may impose,
> (a) staying until otherwise ordered by the court, for any period that the court considers necessary, all proceedings taken or that might be taken in respect of the company under an Act referred to in paragraph (1)(a);
> (b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company; and

(c) prohibiting, until otherwise ordered by the court, the commencement of any action, suit or proceeding against the company.

28 The underlying purpose of the court's power to stay proceedings has frequently been described in the case law. It is the engine that drives the broad and flexible statutory scheme of the CCAA: *Re Stelco Inc*[3] and the key element of the CCAA process: *Re Canadian Airlines Corp.*[4] The power to grant the stay is to be interpreted broadly in order to permit the CCAA to accomplish its legislative purpose. As noted in *Re Lehndorff General Partner Ltd.*[5], the power to grant a stay extends to effect the position of a company's secured and unsecured creditors as well as other parties who could potentially jeopardize the success of the restructuring plan and the continuance of the company. As stated by Farley J. in that case,

> "It has been held that the intention of the CCAA is to prevent any manoeuvres for positioning among the creditors during the period required to develop a plan and obtain approval of creditors. Such manoeuvres could give an aggressive creditor an advantage to the prejudice of others who are less aggressive and would undermine the company's financial position making it even less likely that the plan will succeed. ... The possibility that one or more creditors may be prejudiced should not affect the court's exercise of its authority to grant a stay of proceedings under the CCAA because this affect is offset by the benefit to all creditors and to the company of facilitating a reorganization. The court's primary concerns under the CCAA must be for the debtor and *all* of the creditors."[6] (Citations omitted)

29 The all encompassing scope of the CCAA is underscored by section 8 of the Act which precludes parties from contracting out of the statute. See *Chef Ready Foods Ltd. v. Hongkong Bank of Canada*[7] in this regard.

30 Two cases dealing with stays merit specific attention. *Campeau v. Olympia & York Developments Ltd.*[8] was a decision granted in the early stages of the evolution of the CCAA. In that case, the plaintiffs brought an action for damages including the loss of share value and loss of opportunity both against a company under CCAA protection and a bank. The statement of claim had been served before the company's CCAA filing. The plaintiff sought to lift the stay to proceed with its action. The bank sought an order staying the action against it pending the disposition of the CCAA proceedings. Blair J. examined the stay power described in the CCAA, section 106 of the Courts of Justice Act[9] and the court's inherent jurisdiction. He refused to lift the stay and granted the stay in favour of the bank until the expiration of the CCAA stay period. Blair J. stated that the plaintiff's claims may be addressed more expeditiously in the CCAA proceeding itself.[10] Presumably this meant through a claims process and a compromise of claims. The CCAA stay precludes the litigating of claims comparable to the plaintiff's in *Campeau*. If it were otherwise, the stay would have no meaningful impact.

31 The decision of *Chef Ready Foods Ltd. v. Hongkong Bank of Canada* is also germane to the case before me. There, the Bank demanded payment from the debtor company and thereafter the debtor company issued instant trust deeds to qualify for protection under the CCAA. The bank commenced proceedings on debenture security and the next day the company sought relief under the CCAA. The court stayed the bank's enforcement proceedings. The bank appealed the order and asked the appellate court to set aside the stay order insofar as it restrained the bank from exercising its rights under its security. The B.C. Court of Appeal refused to do so having regard to the broad public policy objectives of the CCAA.

32 As with the imposition of a stay, the lifting of a stay is discretionary. There are no statutory guidelines contained in the Act. According to Professor R.H. McLaren in his book "Canadian Commercial Reorganization: Preventing Bankruptcy"[11], an opposing party faces a very heavy onus if it wishes to apply to the court for an order lifting the stay. In determining whether to lift the stay, the court should consider whether there are sound reasons for doing so consistent with the objectives of the CCAA, including a consideration of the balance of convenience, the relative prejudice to parties, and where relevant, the merits of the proposed action: *ICR Commercial Real Estate (Regina) Ltd. v. Bricore Land Group Ltd.*[12]. That decision also indicated that the judge should consider the good faith and due diligence of the debtor company.[13]

33 Professor McLaren enumerates situations in which courts will lift a stay order. The first six were cited by Paperny J. in 2000 in *Re Canadian Airlines Corp.*[14] and Professor McLaren has added three more since then. They are:

1. When the plan is likely to fail.
2. The applicant shows hardship (the hardship must be caused by the stay itself and be independent of any pre-existing condition of the applicant creditor).
3. The applicant shows necessity for payment (where the creditors' financial problems are created by the order or where the failure to pay the creditor would cause it to close and thus jeopardize the debtor's company's existence).
4. The applicant would be significantly prejudiced by refusal to lift the stay and there would be no resulting prejudice to the debtor company or the positions of creditors.
5. It is necessary to permit the applicant to take steps to protect a right which could be lost by the passing of time.
6. After the lapse of a significant time period, the insolvent is no closer to a proposal than at the commencement of the stay period.
7. There is a real risk that a creditor's loan will become unsecured during the stay period.
8. It is necessary to allow the applicant to perfect a right that existed prior to the commencement of the stay period.
9. It is in the interests of justice to do so.

(b) Application

34 Turning then to an application of all of these legal principles to the facts of the case before me, I will first consider whether the subject matter of the main motion of the GS Parties is captured by the stay and then will address whether the stay should be lifted.

35 In analyzing the applicability of the stay, I must examine the substance of the main motion of the GS Parties and the language of the stay found in paragraphs 15 and 16 of my Initial Order.

36 In essence, the GS Parties' motion seeks to:

(i) undo the transfer of the CW Investments Co. shares from 441 to CMI or
(ii) require CMI to perform and not disclaim the Shareholders Agreement as though the shares had not been transferred.

37 It seems to me that the first issue is caught by the stay of proceedings and the second issue is properly addressed if and when CMI seeks to disclaim the Shareholders Agreement.

38 The substance of the GS Parties' motion is a "proceeding" that is subject to the stay under paragraph 15 of the Initial Order which prohibits the commencement of all proceedings against or in respect of the CMI Entities, or affecting the CMI Business or the CMI Property. The relief sought would also involve "the exercise of any right or remedy affecting the CMI Business or the CMI Property" which is stayed under paragraph 16 of the Initial Order.

39 When one examines the relief requested in detail, the application of the stay is clear. The GS Parties ask first for an order setting aside and declaring void the transfer of the shares from 441. As the shares have been transferred to the CMI Entities presumably pursuant to section 6.5(a) of the Shareholders Agreement, this is relief "affecting the CMI Property". Secondly, the GS Parties ask for a declaration that the rights and remedies of the GS Parties in respect of the obligations of 441 are not affected by the CCAA proceedings. This relief would permit the GS Parties to require CMI to tender the shares for sale pursuant to section 6.10 of the Shareholders Agreement. This too is relief affecting the CMI Entities and the CMI Property. Thirdly, they ask for an order directing CMI to perform all of the obligations that bound 441 prior to the transfer. This represents the exercise of a right or remedy against CMI and would affect the CMI Business and CMI Property in violation of paragraph 16 of the Initial Order. This is also stayed by virtue of paragraph 15. Fourthly, the GS Parties seek an order declaring that the obligations that bound 441 prior to the transfer may not be disclaimed. This both violates paragraph 16 of the Initial Order and also seeks to avoid the express provisions contained in the recent amendments to the CCAA that address disclaimer.

40 Accordingly, the substance and subject matter of the GS Parties' motion are certainly encompassed by the stay. As Mr. Barnes for the CMI Entities submitted, had CMI taken the steps it did six months ago and the GS Parties commenced a lawsuit, the action would have been stayed. Certainly to the extent that the GS Parties are seeking the freedom to exercise their drag along rights, these rights should be captured by the stay.

41 The real question, it seems to me, is whether the stay should be lifted in this case. In considering the request to lift the stay, it is helpful to consider the context and the provisions of the Shareholders Agreement. In his affidavit sworn November 24, 2009, Mr. Strike, the President of Corporate Development & Strategy Implementation of Canwest Global and its Recapitalization Officer, states that the joint acquisition from Alliance Atlantis was intensely and very carefully negotiated by the parties and that the negotiation was extremely complex and difficult. "Every aspect of the deal was carefully scrutinized, including the form, substance and precise terms of the Initial Shareholders Agreement." The Shareholders Agreement was finalized following the CRTC approval hearing. Among other things:

- Article 2.2 (b) provides that CMI is responsible for ensuring the performance by 441 of its obligations under the Shareholders Agreement.
- Article 6.1 contains a restriction on the transfer of shares.
- Article 6.5 addresses permitted transfers. Subsection (a) expressly permits each shareholder to transfer shares to a parent of the shareholder. CMI was the parent of the shareholder, 441.
- Article 6.10 provides that notwithstanding the other provisions of Article 6, if an insolvency event occurs (which includes the commencement of a CCAA proceeding), the GS Parties may sell their shares and cause the Canwest parties to sell their shares on the same terms. This is the drag along provision.
- Article 6.13 prohibits the liquidation or dissolution of another company[15] without the prior written consent of one of the GS Parties[16].

42 The recital of these provisions and the absence of any prohibition against the dissolution of 441 indicate that there is a good arguable case that the Shareholders Agreement, which would inform the reasonable expectations of the parties, permitted the transfer and dissolution.

43 The GS Parties are in no worse position than any other stakeholder who is precluded from relying on rights that arise upon an insolvency default. As stated in *San Francisco Gifts Ltd.*[17]:

> "The Initial Order enjoined all of San Francisco's landlords from enforcing contractual insolvency clauses. This is a common prohibition designed, at least in part, to avoid a creditor frustrating the restructuring by relying on a contractual breach occasioned by the very insolvency that gave rise to proceedings in the first place."[18]

44 Similarly, in *Norcen Energy Resources Ltd.*[19], one of the debtor's joint venture partners in certain petroleum operations was unable to rely on an insolvency clause in an agreement that provided for the immediate replacement of the operator if it became bankrupt or insolvent.

45 If the stay were lifted, the prejudice to CMI would be great and the proceedings contemplated by the GS Parties would be extraordinarily disruptive. The GS Parties have asked to examine 4 of the 5 members of the Special Committee. The Special Committee is a committee of the Board of Directors of Canwest. Its mandate includes, among other things, responsibility for overseeing the implementation of a restructuring with respect to all, or part of the business and/or capital structure of Canwest. The GS Parties have also requested an extensive list of documentary production including all documents considered by the Special Committee and any member of that Committee relating to the matters at issue; all documents considered by the Board of Directors and any member of the Board of Directors relating to the matters at issue; all documents evidencing the deliberations, discussions and decisions of the Special Committee and the Board of Directors relating to the matters at issue; all documents relating to the matters at issue sent to or received by Leonard Asper, Derek Burney, David Drybrough, David Kerr, Richard Leipsic, John Maguire, Margot Micillef, Thomas Strike, and Hap Stephen, the Chief Restructuring Advisor appointed by the court. As stated by Mr. Strike in his affidavit sworn November 24, 2009,

> "The witnesses that the GS Parties propose to examine include the most senior executives of the CMI Entities; those who are most intensely involved in the enormously complex process of achieving a successful going concern restructuring or recapitalization of the CMI Entities. Myself, Mr. Stephen, Mr. Maguire and the others are all working flat out on trying to achieve a successful restructuring or recapitalization of the CMI Entities. Frankly, the last thing we should be doing at this point is preparing for a forensic examination, in minute detail, over events that have taken place over the past several months. At this point in the restructuring/recapitalization process, the proposed examination would be an enormous distraction and would significantly prejudice the CMI Entities' restructuring and recapitalization efforts."

46 While Mr. McElcheran for the GS Parties submits that the examinations and the scope of the examinations could be managed, in my view, the litigating of the subject matter of the motion would undermine the objective of protecting the CMI Entities while they attempt to restructure. The GS Parties continue to own their shares in CW Investments Co. as does CMI. CMI continues to operate the Specialty TV Business. Furthermore, CMI cannot sell the shares without the involvement of the Monitor and the court. None of these facts have changed. The drag along rights are stayed (although as Mr. McElcheran said, it is the cancellation of those rights that the GS Parties are concerned about.)

47 A key issue will be whether the CMI Parties can then disclaim that Agreement or whether they should be required to perform the obligations which previously bound 441. This issue will no doubt arise if and when the CMI Entities seek to disclaim the Shareholders Agreement. It is premature to address that issue now. Furthermore, section 32 of the CCAA now provides a detailed process for disclaimer. It states:

> 32.(1) Subject to subsections (2) and (3), a debtor company may -- on notice given in the prescribed form and manner to the other parties to the agreement and the monitor -- disclaim or resiliate any agreement to which the company is a party on the day on which proceedings commence under this Act. The company may not give notice unless the monitor approves the proposed disclaimer or resiliation.
>
> (2) Within 15 days after the day on which the company gives notice under subsection (1), a party to the agreement may, on notice to the other parties to the agreement and the monitor, apply to a court for an order that the agreement is not to be disclaimed or resiliated.
>
> (3) If the monitor does not approve the proposed disclaimer or resiliation, the company may, on notice to the other parties to the agreement and the monitor, apply to a court for an order that the agreement be disclaimed or resiliated.
>
> (4) In deciding whether to make the order, the court is to consider, among other things,
>
> (a) whether the monitor approved the proposed disclaimer or resiliation;
>
> (b) whether the disclaimer or resiliation would enhance the prospects of a viable compromise or arrangement being made in respect of the company; and
>
> (c) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.

48 Section 32, therefore, provides the scheme and machinery for the disclaimer of an agreement. If the monitor approves the disclaimer, another party may contest it. If the monitor does not approve the disclaimer, permission of the court must be obtained. It seems to me that the issues surrounding any attempt at disclaimer in this case should be canvassed on the basis mandated by Parliament in section 32 of the amended Act.

49 In my view, the balance of convenience, the assessment of relative prejudice and the relevant merits favour the position of the CMI Entities on this lift stay motion. As to the issue of good faith, the question is whether, absent more, one can infer a lack of good faith based on the facts outlined in the materials filed including the agreed upon admission by the CMI Entities. The onus to lift the stay is on the moving party. I decline to exercise my discretion to lift the stay on this basis.

50 Turning then to the factors listed by Professor McLaren, again I am not persuaded that based on the current state of affairs, any of the factors are such that the stay should be lifted. In light of this determination, there is no need to address the motion to strike paragraph 1(e) of the GS Parties' main motion.

51 The stay of proceedings in this case is performing the essential function of keeping stakeholders at bay in order to give the CMI Entities a reasonable opportunity to develop a restructuring plan. The motions of the GS Parties are dismissed (with the exception of that portion dealing with paragraph 59 of the Initial Order which is on consent) and the motion of the CMI Entities is granted with the exception of the strike portion which is moot.

52 The Monitor, reasonably in my view, did not take a position on these motions. Its counsel, Mr. Byers, advised the court that the Monitor was of the view that a commercial resolution was the best way to resolve the GS Parties' issues. It is difficult to disagree with that assessment.

S.E. PEPALL J.

* * * * *

Schedule A

[Editor's note: Schedule A was not attached to the copy received from the Court and therefore is not included in the judgment.]

1 (2000), 19 C.B.R. (4th) 1.

2 [1990] B.C.J. No. 2384 (C.A.) at p. 4.

3 (2005), 75 O.R. (3d) 5 (C.A.) at para. 36.

4 (2000), 19 C.B.R. (4th) 1.

5 (1993), 17 C.B.R. (3d) 24.

6 Ibid, at p. 32.

7 Supra, note 2

8 (1992) 14 C.B.R. (3d) 303.

9 R.S.O. 1990, c. C.43.

10 Supra, note 6 at paras. 24 and 25.

11 (Aurora: Canada Law Book, looseleaf) at para. 3.3400.

12 (2007), 33 C.B.R. (5th) 50 (Sask. C.A.) at para. 68.

13 Ibid, at para. 68.

14 Supra, note 3.

15 This was 4414641 Canada Inc. but not 4414616 Canada Inc., the company in issue before me.

16 Specifically, GS Capital Partners VI Fund, L.P.

17 5 C.B.R. (5th) 92 at para. 37.

18 Ibid, at para. 37.

19 (1988), 72 C.B.R. (N.S.) 1.

Tab 3

Case Name:

Royal Bank of Canada v. Cow Harbour Construction Ltd.

IN THE MATTER OF the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended
In the Matter of the Companies' Creditors Arrangement Act, RSC 1985, c C-36, as amended
AND IN THE MATTER OF a Plan of Arrangement of Cow Harbour Construction Ltd.
Between
Royal Bank of Canada, Plaintiff, and
Cow Harbour Construction Ltd. and 1134252 Alberta Ltd., Defendants

[2012] A.J. No. 141

2012 ABQB 59

75 C.B.R. (5th) 99

[2012] 8 W.W.R. 209

59 Alta. L.R. (5th) 215

19 P.P.S.A.C. (3d) 31

98 B.L.R. (4th) 236

529 A.R. 147

211 A.C.W.S. (3d) 265

2012 CarswellAlta 198

Dockets: 1003 11241, 1003 05560; Bkcy Action No.: 24-115359

Registry: Edmonton

Alberta Court of Queen's Bench
Judicial District of Edmonton

K.D. Yamauchi J.

Heard: November 2-3, 2011.
Judgment: January 23, 2012.

(222 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Claims -- Eligible financial contract -- Application by equipment lessors for proportionate share of funds held by court-appointed receiver allowed in part -- Receiver held funds that would have been paid under applicants' leases -- Applicants sought order that leases fell under section 11.01(a) of Companies' Creditors Arrangement Act -- Factors listed in Re Smith Brothers Contracting Ltd. applied to leases to determine whether true lease or financing lease -- True leases included options for fair market value purchases and provided for return of equipment at end of lease -- Financing leases occurred where aggregate of rental payments was more than value of leased equipment.

Application by equipment lessors for their proportionate share of funds held by the court-appointed receiver of Cow Harbour Construction Ltd. ("Cow Harbour"). The receiver held funds set aside as monies that would have been paid under the applicants' leases. The applicants applied for an order determining which of their leases fell within subsection 11.01(a) of the Companies' Creditors Arrangement Act (the "CCAA"). There were disputed leases with Scott Capital Group Inc. ("Scott Capital"), Caterpillar Financial Services Limited ("CFSL"), Wajax Industries ("Wajax"), Kempenfelt Vehicle Leasing ("Kempenfelt"), Concentra Financial ("Concentra"), Alter Moneta and Key Equipment Finance Canada Ltd. ("Key Equipment").

HELD: Application allowed in part. Subsection 11.01(a) of the CCAA was to be narrowly construed. The factors listed in Re Smith Brothers Contracting Ltd. were applied to each of the disputed leases to determine whether they were true leases or financing leases. The Scott Capital, CFSL, Wajax and Concentra leases were true leases. They included options for fair market value purchases, but the equipment had to be returned at the end of the lease or contained no obligation to exercise the purchase option. The Kempenfelt, Alter Moneta and Key Equipment leases were financing leases. The aggregate of rental payments was more than the original cost of the equipment. The Key Equipment lease guaranteed a below market option price.

Statutes, Regulations and Rules Cited:

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 178(1) (d)

Companies' Creditors Arrangement Act, RSC 1985, c C-36, s. 11, s. 11.01(a), s. 11.02, s. 11.3

Conditional Sales Act, RSA 1970, c 61,

Income Tax Act, RSC 1985, c one (5th Supp.),

Counsel:

Walker W. MacLeod, for GE.

Joseph J. Bellissimo, for Scott Capital.

Kentigern A. Rowan, Q.C. and Stephanie A. Wanke, for Wajax.

Ryan Zahara, for Caterpillar Financial.

Jeremy H. Hockin, for Kempenfelt Vehicle Leasing (a Division of Equirex Vehicle Leasing 2007 Inc.), Alter Moneta Corporation, Concentra Financial, and Key Equipment.

Reasons for Judgment

K.D. YAMAUCHI J.:--

I. Nature of the Matter

1 Various equipment lessors (collectively, the Applicants) have applied for what they claim to be their proportionate share of funds that PricewaterhouseCoopers Inc. (PWC) currently holds, pending this Court's determination of whether their leases were subject to section 11.01(a) of the *Companies' Creditors Arrangement Act*, RSC 1985, c C-36 (*CCAA*). PWC is the court-appointed receiver and manager of the assets, property and undertaking of Cow Harbour Construction Ltd. (Cow Harbour).

II. Procedural History

2 On April 7, 2010, Cow Harbour obtained a stay of proceedings against it (Initial Order) under *CCAA* s. 11.02. This Court extended the Initial Order from time to time by a number of subsequent court orders. Pursuant to the Initial Order, this Court appointed Deloitte LLP as monitor under the *CCAA* (Monitor).

3 Cow Harbour's primary business consisted of overburden removal and general contracting services for oil extraction companies in Fort McMurray, Alberta. Its assets consisted mainly of earth moving and hauling equipment. Much of the equipment that Cow Harbour used in its operations was leased from various parties.

4 On May 21, 2010, this Court directed the Monitor to provide all interested parties with a list of those leases which it had classified as ones entitling the respective lessors to receive ongoing monthly payments pursuant to *CCAA* s. 11.01. This Court gave any party who claimed to have such a lease, but whose claim was not included in the Monitor's list, until June 2, 2010 to advise the Monitor that it was disputing the classification, failing which it was barred from subsequently asserting that its lease entitled it to those ongoing monthly payments.

5 Disputes were registered in relation to a total of 58 leases (Disputed Leases).

6 Also on May 21, 2010, this Court directed Cow Harbour to pay over to the Monitor's counsel monies representing all monthly payments from April 1, 2010, that Cow Harbour would have paid to lessors under the Disputed Leases, or leases which had not yet been categorized (Disputed Lease Funds). This Court directed the Monitor's counsel to hold the Disputed Lease Funds pending resolution of disputes pertaining to categorization of the Disputed Leases.

7 It became clear as matters progressed that Cow Harbour was not going to be able to restructure it affairs through refinancing, compromise or an equity restructuring. Rather, the proceedings evolved into a liquidation. PWC was appointed as transaction facilitator to assist the various parties in their negotiations. Acting in that capacity, PWC negotiated a potential sale of certain of Cow Harbour's assets to Aecon Group Inc. (Aecon). On August 10, 2010, PWC's acceptance of Aecon's letter of intent received this Court's endorsement, subject to the parties later applying for court approval of an asset purchase agreement and vesting order.

8 On August 25, 2010, the Royal Bank of Canada (RBC) successfully applied for a receivership order, pursuant to which this Court appointed PWC as receiver and manager of the assets, property and undertaking of Cow Harbour (Receiver). This Court then approved the asset purchase agreement and granted a vesting order in Aecon's favour. The transaction contemplated by the asset purchase agreement closed on August 26, 2010.

9 The Disputed Lease Funds were transferred to the Receiver pending resolution of the disputes over classification of the Disputed Leases.

10 RBC was paid out in full through the *CCAA* and receivership proceedings. The secured creditor holding the next general security over Cow Harbour's assets, property and undertaking is GE Capital Equipment Financing G.P. (GE).

11 The Receiver has settled many of the issues between Cow Harbour and various third parties, including many of the lessors under the Disputed Leases. However, it continues to hold back a portion of the Disputed Lease Funds until this Court's determination of entitlement to those funds.

III. Issue

12 The Applicants ask this Court to determine which of the remaining Disputed Leases fall within *CCAA* s. 11.01(a). This, in turn, will determine which party or parties are entitled to a portion of the Disputed Lease Funds.

IV. Law

A. Legislation

13 Section 11.01(a) of the *CCAA* provides:

> 11.01 No order made under section 11 or 11.02 has the effect of
>
> (A) prohibiting a person from requiring immediate payment for ... use of leased ... property or other valuable consideration provided after the order is made.

14 Section 11.02 of the *CCAA* provides for a stay of proceedings. It states:

> 11.02(1) A court may, on an initial application in respect of a debtor company, make an order on any terms that it may impose, effective for the period that the court considers necessary, which period may not be more than 30 days,
>
> (a) staying, until otherwise ordered by the court, all proceedings taken or that might be taken in respect of the company under the *Bankruptcy and Insolvency Act* or the *Winding-up and Restructuring Act*;

(b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company; and

(c) prohibiting, until otherwise ordered by the court, the commencement of any action, suit or proceeding against the company.

B. General Legal Principles

15 Section 11.02 of the *CCAA* allows a court to order a stay of proceedings on an initial application under the *CCAA* in respect of a debtor company. This is in keeping with the general policy underlying the *CCAA*, which is to allow a debtor corporation to restructure its corporate or financial affairs in a way that will permit it to continue on as a going concern, without being hampered by those who wish to enforce their previously bargained for rights. As the Ontario Court of Appeal commented in ***Re Nortel Networks Corp.***, 2009 ONCA 833 at para 16, 59 CBR (5th) 23 [***Nortel***], "[t]he primary instrument provided by the *CCAA* to achieve its purpose is the power of the court to issue a broad stay of proceedings under s. 11. That power includes the power to stay the <u>debt obligations</u> of the company" (emphasis added). Courts have given the *CCAA* a wide and liberal construction to facilitate this policy objective (see *e.g.* ***Chef Ready Food Ltd. v. HongKong Bank of Canada*** (1990), 51 BCLR (2d) 84 (CA)).

16 While a debtor corporation is proceeding through the *CCAA* restructuring process, it must still carry on its business. It hardly seems fair to require a person to continue to supply the debtor corporation with goods or services, or to allow the debtor corporation to continue to use leased property, without that person being compensated for those goods, services or use. Section 11.01(a) of the *CCAA* allows for that compensation.

17 As noted in ***Re Smith Brothers Contracting Ltd.*** (1998), 53 BCLR (3d) 264 at para 3 (SC) [***Smith Brothers***], Parliament added what is now s. 11.01 to the *CCAA* as part of a set of amendments proclaimed in force on September 30, 1997. Suche J. in ***Re Winnipeg Motor Express Inc.***, 2009 MBQB 204, 243 Man R (2d) 31 [***Re Winnipeg***], leave to appeal to CA refused, 2009 MBCA 110, [2009] 12 WWR 224, suggested that Parliament may have added this provision to clarify the point made in ***Quintette Coal Ltd. v. Nippon Steel Corp.*** (1990), 51 BCLR (2d) 105 (CA) [***Quintette***], that a stay would never be used to enforce the continuous supply of goods or services without payment for current deliveries. She also commented that the amendment brought the *CCAA* in line with the *Bankruptcy and Insolvency Act*, RSC 1985, c B-3 [*BIA*], which contains a similar provision relating to proposals.

18 To further facilitate the policy objective of the *CCAA*, courts have given *CCAA* s. 11.01(a), which is an exception to the stay provision, a narrow construction (***Nortel*** at para 17). They have differentiated between a "true lease," in which the debtors' corporation is paying for use of the property, and a debt obligation clothed in the guise of a lease, i.e., a financing lease in which the debtors' corporation is "earning equity" in the property. Courts and writers have used the term "financing lease," "security lease," "financial leasing arrangement" or similar terms to describe the latter type of arrangement (referred to here as a financing lease). It is only the debtor corporation's obligations under a true lease that courts have excepted from the stay of proceedings, not its obligations under a financing lease (***Smith Brothers*** at para 61).

19 Canadian courts have accepted the conclusion of Bauman J. (as he then was) in ***Smith Brothers*** that a true lease, being a bailment of property, falls within the *CCAA* s. 11.01(a) exception, while a financing lease does not. They also have endorsed his approach to distinguishing between the two types of arrangements (see *e.g.* ***Re International Wallcoverings Ltd.*** (1999), 28 CBR (4th) 48 (Ont Ct Jus (Gen Div)) [***International Wallcoverings***]; ***Re Sharp-Rite Technologies Ltd.***, 2000 BCSC 122. In ***Re PSINET Ltd.*** (2001), 26 CBR (4th) 288 at para 19 (Ont SCJ) [***PSINET***], Swinton J. stated:

> In my view, ***Smith Brothers Contracting Ltd.*** was correct in determining that [*CCAA* s. 11.01(a)] is to apply to payments for the use of property provided after the stay order -- that is, where a party provides new credit to the debtor following the stay. The payments under the leases here are not that type of payment. These leases are clearly financing arrangements, whose purpose is to secure a loan which was provided before the stay order was made, and the payments owing are repayments for that loan. Therefore, the leases here do not fall within [*CCAA* s. 11.01(a)] of the Act, and the order of Farley J. which prohibits the company from making payments under them is consistent with the purpose of the Act. Any other determination would give the RBC an unfair advantage when compared to other creditors of the applicants, who are bound by the stay.

20 While initially having questioned in oral reasons on August 25, 2010, whether it might be worthwhile to re-examine the approach that Bauman J. took in ***Smith Brothers***, this Court concluded the approach was sound, given that *CCAA* s. 11.01(a) is to be narrowly construed. The substance and not the form of the arrangement between the debtor corporation and the other contracting party is of importance and, unless there is a sound policy reason for doing so, the court should not give an advantage to one creditor over another.

21 Why did this Court initially question the reasoning in ***Smith Brothers***?

22 Bauman J. relied heavily on Professor Ronald CC Cuming's article, "True Leases and Security Leases Under Canadian Personal Property Security Acts" (1983) 7 Can Bus LJ 251, in arriving at his conclusions. As is apparent from the title, Professor Cuming's article dealt with differentiating leases for purposes of personal property security legislation, not insolvency legislation.

23 The *CCAA* does not expressly incorporate personal property security legislation concepts. Unlike such legislation, the *CCAA* does not distinguish between a true lease and a financing lease.

24 The way in which courts have used personal property security legislation concepts when they are dealing with *CCAA* proceedings, and the tension that this approach creates, was discussed by Professor Roderick J. Wood in his article, "The Definition of Secured Creditor in Insolvency Law" (2010) 25 BFLR 341.

25 Professor Wood recognized that the *CCAA* does not expressly deem a lessor in a financing lease transaction to be a "secured creditor" rather than an owner of the goods. He remarked that the definitions of "secured creditor" and "security interest" in insolvency law (the *CCAA* and *BIA*) do not adopt personal property security legislation terminology (at p 347). He noted that courts have held that the broader definition of the term "secured creditor" in the *Income Tax Act*, RSC 1985, c one (5th Supp.) (*ITA*) does not encompass lessors under a financing lease. Professor Wood recognized the difficulty in interpreting the definition of "a secured creditor" in the *CCAA* as including a lessor under a title retention device such as a financing lease, given that courts have not done so in the context of the broader definition in the *ITA*. He expressed the view that the best way to resolve this tension would be for Parliament to clarify federal insolvency legislation, suggesting at p. 356 that:

> It would also produce a proper dovetailing of the federal insolvency provisions. For example, the insolvency statutes provide that a stay of proceedings does not prevent a lessor from requiring immediate payment for use of the leased property. This gives the lessor the ability to collect post-commencement lease payments. Courts have held that this provision only applies to true leases and not to security leases. The latter are treated in the same manner as other security interests and the debtor is able to retain possession of the goods without the need to satisfy the post commencement payments. This further demonstrates that the division between true leases and security leases that is produced by the application of the substance test of the *PPSA* is being recognized in insolvency law, and that an amendment of the definition of secured creditor to reflect this fact is the most sensible solution.

26 When examining ***Smith Brothers*** closely, it appears that Bauman J. was simply saying that the logic that Professor Cuming applied when differentiating between true leases and financing leases in the context of personal property security legislation applies equally to *CCAA* proceedings. Said differently, *CCAA* s. 11.01(a) protects parties who provide goods and services to the debtor corporation after a court grants an initial order, but not "creditors" to whom the debtor corporation has "debt obligations." This would put the latter in a better position *vis-a-vis* the debtor corporation than the debtor corporation's other creditors.

27 As previously stated, this Court is of the view that Bauman J's decision with respect to this issue is in keeping with the *CCAA*'s underlying policy objectives.

28 It is arguable, however, that Blair J. in ***International Wallcoverings*** left the door open for a court to find that a financing lease could fall within *CCAA* s. 11.01(a), when he said at para 4:

> While I would not go so far as to say, [*CCAA* s. 11.01(a)] requires payment under all leasing arrangements, or (on the other hand) that it could never encompass a financial leasing arrangement, I am satisfied that in the particular circumstances of this case the reasoning of ***Smith Brothers*** is applicable and that the arrangements in question are more akin to equipment purchase financing arrangements ...

29 He used the ***Smith Brothers*** true lease/financing lease analysis in reaching his conclusion. He did not speculate as to the type of situation where *CCAA* s. 11.01(a) might encompass a financing lease arrangement.

30 ***Winnipeg Motor*** could be considered one such case, and, as the result, is contrary to what might be expected when using the ***Smith Brothers*** analysis.

31 ***Winnipeg Motor*** dealt with the proper distribution of interim financing and administrative charges incurred after the court granted an initial order under the *CCAA*. The monitor recommended that the charges be distributed among the secured creditors based on a *pro rata* recovery. Two parties claimed to be true lessors. The court referred to the distinction made in ***Smith Brothers*** between true leases and financing leases. It commented that the exclusion of financing leases from *CCAA* s.

11.01(a) makes perfect sense based on the notion of ownership, as a financing lessor cannot seek the benefits of ownership when it has given it away (assuming the lessee has been acquiring equity in the leased goods). It also suggested that the narrow construction of *CCAA* s. 11.01(a) as limiting the obligation of the debtor to make payments for "use" is consistent with the idea that a supplier cannot be expected to continue to provide its product without payment.

32 The court in ***Winnipeg Motor*** noted the financing lessors' complaint that they had been unduly prejudiced by the stay of proceedings. They argued that not only were they not being paid while the debtor corporation was using their assets for the benefit of the other stakeholders, but the debtor corporation was deteriorating their underlying security in the process. They maintained that this violated one of the fundamental objectives of the stay of proceedings: preventing one creditor from obtaining an advantage over other creditors during the stay period. The court at paras 60-62 suggested that the fact true lessors were entitled to be paid aggravated the problem, stating:

> It is difficult to know how this situation can be remedied, given that the whole point of the *CCAA* is to relieve a company of ongoing financial burden to allow it the opportunity to restructure. In this case, for example, [the debtor corporation] would not have succeeded had it been obliged to pay for its equipment during the entirety of the restructuring.
>
> On the particular facts of this case, this issue became somewhat easier to address given the nature of [the debtor corporation's] business. Equipment to a transportation company is akin to raw goods to a manufacturer, and I was of the opinion that if [the debtor corporation] was going to be viable, at a certain point it would have to demonstrate it could pay for the essential means of production. Otherwise, there would be no purpose to continue the stay. Accordingly, I ordered that financing leases would be paid as of August 1, 2008.
>
> I say all this not to justify or revisit the basis for my earlier decision, but to get to the point that in considering what is equitable, undue prejudice is a reason to adjust what would otherwise be a uniform approach. I am satisfied that equipment lessors in a business operation such as [the debtor corporation's] do suffer undue prejudice. In this case, however, the equipment lessors were paid as of August 1. Being financing leases, those payments were not just for use, but included some amount on account of equity. I conclude, then, that the undue prejudice suffered has been recognized, *albeit* not totally, perfectly or precisely, but, in my view, in an amount sufficient amount to justify the uniform application of the methodology proposed by the monitor.

33 Of interest, the court in ***Winnipeg Motor*** required one of the debtor corporation's true lessors to contribute to the court-ordered charges, as it had derived the same benefit from the *CCAA* proceedings as the financing lessors.

34 In ***Re Clayton Construction Co. Ltd.***, 2009 SKQB 397, 59 CBR (5th) 213 [***Clayton Construction***], the debtor corporation sought an extension of a *CCAA* stay of proceedings. Rothery J. granted the extension, but also allowed the payment of interest that the debtor corporation owed to nine of its equipment lessors as a means of compensating them for the use and depreciation of their equipment. The debtor corporation required the equipment to complete its contracts. The court determined that the monthly interest payments to the equipment lessors would not prejudice the other creditors. The major secured creditor had benefited from the accounts receivable generated by the debtor's use of the equipment and the unsecured creditors likely would not have received any benefit, had the equipment lessors withdrawn their support for the restructuring process.

35 ***Winnipeg Motor*** and ***Clayton Construction*** might be responses to the non-peer reviewed journal articles that criticize the ***Smith Brothers*** approach that courts have taken to the issue before this Court (see *e.g.* Steven J. Weisz, Linc A. Rogers & Stacy McLean, "Striking an Imbalance: The Treatment of Equipment Lessors Under Section 11.3 of the *CCAA*" (2003) 20:5 Nat'l Insolv Rev 45 at 48-49; Jeffrey C. Cahart, "Should There be Special Rules in Commercial Reorganizations for Equipment Lessors?" (2002) 15:2 Comm Insol R 13; Harvey G. Chaiton and John R. Hutchins, "Equipment Lessors in Restructurings: Hostage Lenders" (2009) 21 Comm Insol R 3).

36 One of the themes that runs through these articles is that it is unfair for courts to allow creditors that hold general security to gain a benefit from the debtor corporation's use of the leased equipment during the stay period. Cahart commented at p. 15:

> ... it is simply unfair to allow a debtor to continue to use (and to depreciate) a piece of (perhaps essential) equipment which the debtor only has because of the equipment lessor's financing while the debtor pursues a reorganization and/or a sale as a going concern (as has happened in so many *CCAA* cases) possibly over a very extended period. Again, unlike lenders with more general security, equipment lessors (usually) only have recourse to a specific asset. Is it fair to allow, for instance, a mining company under *CCAA* protection to continue to use a specialized leased truck, continue to wear it down and to diminish its value, for 11 months for free, while the company pursues sale as a going concern and/or reorganization based on the company's going concern value? Among other things, the availability of the truck to the company over time: (i) contributes to the going concern value of the company (and the preservation of which is at the heart of what the *CCAA* is trying to achieve); and (ii) allows the company to produce product which is turned into cash and which goes to pay down an operating lender. Yet under the current jurisprudence, the relevant equipment lessor probably receives nothing during the stay period - not even its regular monthly payments, let alone any kind of "premium" for its contribution to the going concern value or to the ability of the company to generate cash.

37 The problem, however, is that one creditor should not receive "an unfair advantage when compared to other creditors of the applicants, who are bound by the stay" (***PSINET*** at para 19). If some creditors are to be bound by the stay of proceedings, all creditors must be bound. Any contrary approach invariably would lead to every creditor attempting to argue that its interests are being prejudiced by the stay of proceedings in one way or another, with the end result that the stay of proceedings would prove meaningless.

38 ***Smith Brothers*** concluded that courts must differentiate between true leases and financing leases. Is this what the legislation says?

39 If certain portions of *CCAA* s. 11.01(a) are emphasized, the legislation could be read differently. For example, *CCAA* s. 11.01(a) might be read as stating that: "No order made under section 11 or 11.02 has the effect of prohibiting a person from requiring immediate <u>payment for</u> ... use of <u>leased</u> ... <u>property</u> ... <u>provided after the order is made</u>" (emphasis added). In other words, the phrase "provided after the order is made" might refer to "leased property." In that case, lessors of pre-stay leases, whether true or financing, would be subject to the stay of proceedings. Only lessors of property leased post-stay could demand that the debtor corporation make its lease payments. This would be in keeping with judicial interpretation of the balance of *CCAA* s. 11.01(a). For example, a supplier may provide goods or services to the debtor corporation post-stay on the basis of "cash on delivery."

40 This type of interpretation would not be unusual, as Canadian courts, including the Alberta Court of Appeal, have taken such a grammatical-interpretative approach when they have considered, for example, *BIA* s. 178(1)(d). That section provides:

> 178(1) An order of discharge does not release the bankrupt from
>
> ...
>
> (d) any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity ...

41 The question has arisen whether the words "while acting in a fiduciary capacity" qualify only the word "defalcation" or whether they qualify all of the listed factors, including fraud, embezzlement, misappropriation and defalcation. Courts have held that the latter is the proper interpretation (see *e.g*. ***Confederation Life Insurance Co. v. Waselenak***, [1998] 5 WWR 712, 57 Alta LR (3d) 3 (QB), affd 2000 ABCA 136; ***166404 Canada Inc. v. Coulter*** (1998), 4 CBR (4th) 1 (Ont CA), leave to appeal to SCC refused, [1998] S.C.C.A. No. 231, (1998), 223 NR 395 (note); ***Ross & Associates v. Palmer***, 2001 MBCA 17, 22 CBR (4th) 140; ***Re Brant*** (1984), 52 CBR (NS) 317 (Ont SC)).

42 Including all pre-stay leases in the stay of proceedings would be in keeping with the broad and liberal interpretation that courts have given to the *CCAA*, which is to provide the debtor corporation with "breathing space" in which to determine whether it is in a position to restructure its affairs and to facilitate its survival. Including only post-stay leases under *CCAA* s. 11.01(a) also would be in keeping with the narrow interpretation of transactions that are excepted from the stay of proceedings. It would simplify *CCAA* proceedings involving equipment leases.

43 This interpretation, however, does not give weight to the word "use" in *CCAA* s. 11.01(a). In making the true lease/financing lease distinction, Bauman J. in ***Smith Brothers*** and courts in subsequent cases have sought to do just that. They have read the section as stating, "No order made under section 11 or 11.02 has the effect of prohibiting a person from requiring immediate <u>payment for</u> ... <u>use</u> of leased ... property ... <u>provided after the order is made</u>" (emphasis added). In other words, it is "use" of the leased property which is provided after a court makes the initial order.

44 A true lease, in essence, is a bailment contract such that ownership of the leased goods remains with the bailor/lessor and the bailee/lessee pays for "use" of those goods. In ***Punch v. Savoy's Jewellers Ltd.*** (1986), 54 OR (2d) 383 at para 17 (CA), the court defined bailment as follows:

> ... Bailment has been defined as the delivery of personal chattels on trust, usually on a contract, express or implied, that the trust shall be executed and the chattels be delivered in either their original or an altered form as soon as the time for

> which they were bailed has elapsed. It is to be noted that the legal relationship of bailor and bailee can exist independently of a contract. It is created by the voluntary taking into custody of goods which are the property of another.

(See also ***Visscher v. Triple Broek Holdings Ltd.***, 2006 ABQB 259, 399 AR 184 at paras 27-28; ***Letourneau v. Otto Mobiles Edmonton (1984) Ltd***., 2002 ABQB 609, 315 AR 232 at para 23).

45 The central character of a true lease is "payment for use." Bauman J. in ***Smith Brothers*** at para 48 adopted the following statement in Professor Cuming's above-referenced article to expand on this principle:

> Under a true lease, the lessor surrenders his possessory right in chattels to the lessee in return for an undertaking by the lessee to perform certain acts which usually involve the payment of money to the lessor. The lessee has obligations, but the transaction cannot be characterized as a security agreement because the interest of the lessor is not related to those obligations. In other words, the lessor does not remain owner merely to ensure or to induce performance of the lessee's obligations. He remains owner because a bailment contract does not involve the transfer of ownership to the bailee.

46 Bauman J. concluded in ***Smith Brothers*** at para 61:

> It is only payments for the use of leased property that are excepted from a s. 11 stay order under [*CCAA* s. 11.01(a)]. Payments for use and equity are not. Similarly payments for use and equity and an option to purchase are not. This is another reason to conclude ... [*CCAA* s. 11.01(a)] is not inclusive of all forms of lease.

47 This is a curious statement inasmuch as it might be seen as suggesting that a court should identify what portion of the lease payments made under the instrument is for use rather than for acquisition of equity (and, perhaps, of the option to purchase). This approach is not in keeping with other statements that Bauman J. made in ***Smith Brothers***. In this Court's view, the instrument is either a financing lease or a true lease. There is no room for finding the instrument to be a hybrid of the two, as this unnecessarily confuses the issue.

48 As acknowledged by Suche J. in ***Winnipeg Motor*** at para 31, " ... the true nature of arrangements involving the supply of equipment can be very difficult to peg." There can be a fine line between what is considered a true lease and a financing lease.

49 The determination of whether an arrangement is a true lease for purposes of *CCAA* s. 11.01(a) involves a functional analysis of the relationship between the parties based on substance as opposed to form (***Smith Brothers*** at para 26; ***Re Philip Services Corp.***, (1999) 15 CBR (4th) 107 at para 2 (Ont SCJ [Commercial List] [***Philip Services***])).

50 Professors Ronald CC Cuming and Roderick J. Wood in their *Alberta Personal Property Security Act Handbook*, 4th ed (Toronto: Carswell, 1998) at 53 [*Handbook*] emphasized the need to examine the relationship between the lessor and lessee to determine if it reflects indicia of a financing arrangement. They noted, however, that they were not referring to the traditional indicia prescribed by the common law, but rather those which would be relevant to someone examining the economic realities of the transaction.

51 In ***Smith Brothers*** at para 67, Bauman J. referred to the following non-exhaustive list of considerations mentioned by Master Powers sitting as a Registrar in Bankruptcy in ***Re Bronson*** (1995), 34 CBR (3d) 255 [***Bronson***], aff'd (1996), 39 CBR (3d) 33 (BCSC). This list includes factors considered by American courts in determining whether a document is a true lease or a security agreement, as summarized in *Teaching Material for Personal Property Security Transactions Governed by Personal Property Security Acts* by Professor Cuming in September 1991:

1. Whether there was an option to purchase for a nominal sum;
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment;
3. Whether the nature of the lessor's business was to act as a financing agency;
4. Whether the lessee paid a sales tax incident to acquisition of the equipment;
5. Whether the lessee paid all other taxes incident to ownership of the equipment;
6. Whether the lessee was responsible for comprehensive insurance on the equipment;
7. Whether the lessee was required to pay any and all licence fees for operation of the equipment and to maintain the equipment at his expense;
8. Whether the agreement placed the entire risk of loss upon the lessee;
9. Whether the agreement included a clause permitting the lessor to accelerate the payment of rent upon default of the lessee and granted remedies similar to those of a mortgagee;
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease;
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment;
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement;
13. Whether there was a default provision in the lease inordinately favourable to the lessor;
14. Whether there was a provision in the lease for liquidated damages;
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor;
16. Whether the aggregate rental approximated the value of purchase price of the equipment. [See also ***PSINET*** at para 12.]

52 Other courts have added that the right of the lessee to an "option to purchase" can be established through the course of conduct between the parties, if not expressly provided for in the document itself (***Philip Services*** at paras 4-5). As well, leases that are "bundled together" for financing purposes may be construed as financing transactions and not as true leases, because the transactions really involve payment for financing the acquisition of the assets rather than payment for use (***Philip Services*** at para 9).

53 Neither Professor Cuming nor the court in ***Smith Brothers*** said that a lease must contain all of the foregoing indicia to be classified as a financing lease. Indeed, the main factor on which Bauman J. relied in deciding that the arrangement before him was a financing lease was the default clause.

54 A court may use some or all of the ***Smith Brothers*** factors when assessing whether a particular transaction is a true lease or a financing arrangement. It is the substance of the transaction that is determinative.

55 Michael E Burke, in his article "Ontario *Personal Property Security Act* Reform: Significant Policy Changes" (2009) 48 Can Bus LJ 289 at 291-97, undertook an empirical review of the authorities and discussed the relative weight courts have placed on these factors. He stated at 291-92:

> First, from the universe of factors or indicia that have been mentioned in the jurisprudence, some factors or indicia (referred to in this paper as "primary factors") are clearly more important than other factors or indicia (referred to in this paper as "secondary factors"). Second, the presence of a primary factor in a lease will often be determinative of the characterization of the agreement. Third, secondary factors generally have a corroborative value and are not in and of themselves determinative of the characterization. Accordingly, the presence of a number of secondary factors that are indicative of a characterization that is contrary to the characterization indicated by the primary factor will not be sufficient to overturn the weighting given by a court to the primary factor. Fourth, in those situations where the primary factor is ambiguous or absent, then the relative weighting given by a court to the secondary factors will be relevant in determining the characterization of the lease in question.

56 Topolniski J. in ***Re 843504 Alberta Ltd.***, 2011 ABQB 448 at para 63, 80 CBR (5th) 177 [***843504***] identified what Burke at 292-94 referred to as "primary factors: "

> (a) Relevance of the purchase option price - whether the purchase option price is nominal or reflective of fair market value.
> (b) Mandatory purchase options - whether there is a mandatory purchase option that obligates the lessee to purchase the equipment at the end of the term.
> (c) Open-end leases/guaranteed residual clauses - whether the lessee is liable for any deficiency in the sale of the equipment at the end of the term.
> (d) Sale-leaseback transactions - whether the transaction is structured as a sale and leaseback.

57 Topolniski J. then identified (at para 65) what Burke (at 295-98) referred to as "secondary factors":

> (a) The ability to replace/exchange leased equipment is indicative of a true lease.
> (b) The lessor's ability to accelerate payments and the residual value are generally inconsistent with a true lease. However, it is equally consistent with a true lease if the acceleration clause limits the lessor's damages to the present value of the remaining rents, plus the present value of the residual value at the end of the term, minus the value of net proceeds from a sale of

the assets. If the acceleration clause is more narrowly crafted, it favours a security lease.

(c) A full payment lease may be indicative of either form of lease, depending on the language of the provision.

(d) A security deposit is indicative of a security lease.

(e) A substantial down payment is indicative of a security lease.

(f) Covenants relating to maintenance, insurance and risk of loss can be indicators of either type of lease. They are weak evidence of a security lease.

(g) Whether the lessor uses different forms for different types of transactions may be some evidence of intention.

58 Burke also identified (at 297) some factors, such as the exclusion of warranties on the lessor's part, as "red herrings" because their presence (or lack of presence) in a lease is equivocal: see also Weisz, Rogers & McLean at 48-49.

59 On an application for leave to appeal this Court's assessment that a particular agreement at issue in these proceedings was a financing lease, the Alberta Court of Appeal in ***De Lage Landen Financial Services Canada Inc. v. Royal Bank of Canada***, 2010 ABCA 394 at para 60 [***De Lage Landen (CA)***], refusing leave to appeal 2010 ABQB 637, 37 Alta LR (5th) 82 [***De Lage Landen (QB)***] expressly rejected the suggestion that there should be a hierarchy of factors that a court should use to determine if a lease is a true lease or a financing lease. In denying the leave application, Ritter J.A. stated at para 15:

> The applicant points to a British Columbia decision which suggests in *obiter* that there should be a hierarchy of factors used to determine if a lease is a true lease or a financing lease. In my view, this *obiter* runs contrary to current trends about how to weigh the factors in a legal test and about the deference afforded to courts of first instance in this respect. <u>If one factor trumps the others, there is simply no point in including the others in the test</u>. [Emphasis added].

60 During the present hearing before this Court, counsel spent a significant amount of time attempting to rationalize ***843504*** and ***De Lage Landen (CA)***. In this Court's view, there is no conflict between the two. Topolniski J. in ***843504*** cited the Court of Appeal's decision in ***De Lage Landen (CA)*** and quoted (at para 60) this Court's observation in ***De Lage Landen (QB)*** at para 32 that:

> ... no one factor "is the *sine qua non* for determining whether a document is a true lease or a financing lease. One must look at the whole document to get a flavour of the [parties'] intentions ..."

While Topolniski J. referred to Burke's discussion of how courts weigh certain factors and outlined the results in her case of applying his "primary" and "secondary" factors, she did not necessarily endorse the view that there is a "hierarchy" of factors in every case.

61 Topolniski J. considered (at para 64) a provision in the lease before her which provided that:

* the lessee could return the vehicle at the end of the six-month minimum lease term;
* once the lessee returned the vehicle, the lessor would sell the vehicle;

* the lessee would keep the surplus if the sale proceeds exceeded the termination book value; and
* if the sale proceeds did not exceed the termination book value, the lessee would be liable for the shortfall.

She found this provision was indicative of a security lease since it rendered the lessee liable for a deficiency on the vehicle's sale at the end of the term.

62 Topolniski J. also applied Burke's "secondary" factors to the lease that was before her. There would have been no point in her doing so had she accepted that the lessee's liability for the deficiency trumped any and all secondary factors. She concluded that the secondary factors were not determinative of the proper characterization of the lease (at para 67). The presence of some secondary factors was insufficient to outweigh the clear effect of the primary factors in her case.

63 GE suggests that Topolniski J. acknowledged that the presence of a primary factor often can be determinative of the characterization, while absence or ambiguity in respect of the primary factors can make weighing of the secondary factors more relevant. In fact, Topolniski J. did not make such a statement. She simply quoted the Burke article where Burke made that argument.

64 GE argues that while the presence of one of Burke's "primary" factors is significant, absence or ambiguity in respect of a primary factor is not determinative. It simply means that other factors will be more important in the analysis. For example, GE submits that the presence of an option to purchase at nominal value is a primary factor, and while its presence likely will result in the agreement being characterized as a financing lease, the absence of such an option or, indeed, the presence of an option to purchase at fair market value, means that focus must be directed to the other factors. GE suggests that this approach is consistent with authorities which hold that agreements without an option to purchase may still be classified as financing leases when the other indicia of financing leases are present.

65 The proper approach is more holistic than the one advocated by GE. While the presence or absence of one or more factors may loom larger than others, in all instances the inquiry remains focussed on determining the intention of the parties and is based on an interpretation of the entire agreement. As stated by the Alberta Court of Appeal in ***De Lage Landen (CA)***, one factor cannot trump others in terms of the legal test. Courts must review the entire agreement and they must consider all factors. That is not to say, however, that certain factors may not have greater probative value than others in terms of the particular agreement before the court. In such a case, the court might give those factors greater weight. In all cases, the court must examine the various ***Smith Brothers*** factors and any other factors it considers material and relevant, balance those factors in the context of the entire agreement, and make a determination as to whether the agreement before it as a financing lease or a true lease. This is not a scientific exercise.

66 Counsel for several of the Applicants argue that payments that Cow Harbour made under leases containing an option to purchase were payments for "use," as the "purchase price" was not due and payable until Cow Harbour exercised the option to purchase or the lease came to an end and the lessee chose to pay the purchase price at a nominal sum. They cite ***Ed Miller Sales & Rentals Ltd. v. Alberta*** (1982), 42 AR 350 (QB) [***Ed Miller***] in support of this position. Purvis J, in that case, relied in turn on ***Ramsay v. Pioneer Machinery Co.*** (1981), 28 AR 429 (CA) [***Ramsay***].

67 The issues in ***Ramsay*** were whether a transaction fell within the *Conditional Sales Act*, RSA 1970, c 61 and, if it did, whether the conditional seller could recover the purchase price through the sale of the equipment or by suing the conditional buyer. This was called the "seize or sue" provision. The Alberta Court of Appeal stated at para 20:

> ... Until the option is exercised the lessor is not pursuing his "right to recover the purchase price". If he chooses to recover the chattel he is exercising his right of possession on default, which is a right independent of any money claim. I have no hesitation in saying that [the seize or sue provision] is not applicable unless the lessor is seeking to recover the purchase money and he cannot seek to recover the purchase money until the option is exercised. It may be that a "lessor" who is found to be, in substance, a "conditional sales vendor" should be treated as a vendor claiming his purchase price within the section, but that is not this case.

68 In ***Ed Miller***, the court considered whether lessors holding leases with options to purchase could maintain a priority claim to a builders' lien fund. The court applied the analysis in ***Ramsay*** in finding that until the lessees exercised the options to purchase, the lessors were not "sellers" under the *Conditional Sales Act* and, " ... [t]hey are not attempting to recover a purchase price, but are attempting to establish priority against a lien fund for rental for equipment" (at para 49). As a result, the court held that the lessors' claims were not for payment of purchase moneys but for rental and, as a result, they were entitled to advance a claim for a lien for a reasonable and just rental of the equipment while used on the contract site (at para 50).

69 The now repealed *Conditional Sales Act* contained specific provisions concerning registration and remedies available to conditional sellers. The courts, when considering that statute, were more interested in the structure of the transaction than the parties' intention. In fact, the court in ***Ed Miller*** commented, "Stevenson J.A. [in ***Ramsay***] found that it was sufficient to bring the transaction within the relevant sections of the *Conditional Sales Act* if it was established that the lessee merely had it within his power to acquire ownership. It was not necessary to establish intention" (at para 43).

70 When a court undertakes the true lease/financing lease analysis under the *CCAA*, substance, including the parties' intention, is one of the paramount considerations. The form the transaction takes is not. The "all or nothing" argument advanced by certain of the Applicants could just as easily result in all lessors of true and financing leases being precluded from receiving anything during the stay of proceedings.

71 Accordingly, it is of the utmost importance that this Court examine each lease individually to determine whether it falls within the category of a true lease or a financing lease.

72 Finally, it is a fundamental principle of contractual interpretation that a court must interpret an agreement as at the date it was made, as the exercise is intended to discern the intention of the parties at the time the contract was formed (***McDonald Crawford v. Morrow***, 2004 ABCA 150 at para 72, 348 AR 118).

V. Specific Leases

A. Scott Capital Group Inc. (Scott Capital) Leases

1. <u>The leases</u>

73 Five of the Disputed Leases are between Cow Harbour and Scott Capital. The lease details are as follows:

Lease number	Date day/month/year	Term (months)	Capital Cost of Items	Monthly Rental	Option Price	Security Deposit
6049520 Schedule 001	1/10/2009	60	$559,951	$10,469	25% of original capital cost	$55,995 = 10% of original capital cost
6049520 Schedule 002	30/10/2009	48	$801,250	$18,184	20% of original capital cost	$160,250 = 20% of original capital cost
6049520 Schedule 003	18/12/2009	48	$234,000	$5,295	Fair market value	$46,800 = 20% of original capital cost
6049520 Schedule 004	4/2/2010	48	$664,832	$16,717	Fair market value	$132,966 = 20% of original capital cost
6049520 Schedule 005	5/2/2010	48	$286,020	$7,190	Fair market value	$57,204 = 20% of original capital cost

74 All of the Scott Capital leases are subject to the terms of the Scott Capital Master Equipment Lease that the parties entered into on October 1, 2009 (Scott Master Lease). Scott Capital's affiant deposed that the Scott Master Lease had been in effect for 30 years, with the last revision having been made about ten years ago. He confirmed that Scott Capital used the same form for what Scott Capital intended to be true leases and financing leases. The number 6049520 refers to the Scott Master Lease to which all of the Scott Capital leases being considered are subject. This Court will refer to each lease by its Schedule number.

75 Scott Capital leased eight pieces of heavy equipment or vehicles to Cow Harbour under these five leases. It entered into all of these leases with Cow Harbour within six months prior to Cow Harbour's *CCAA* filing. In the case of the Schedule 001 lease, the equipment was only commissioned for use by Cow Harbour in July 2010, which was well into the *CCAA* proceedings.

76 The evidence of Scott Capital's affiant was that Cow Harbour sourced the equipment, negotiated the sale price and approached a broker to seek assistance with acquisition of the assets. The broker then contacted Scott Capital and the equipment went straight from the third party vendor to Cow Harbour.

77 Scott Capital's affiant deposed that Scott Capital generally structured its leases as true leases. His due diligence on Cow Harbour suggested that Cow Harbour might be in a precarious financial position. As a result, Scott Capital had no intention of providing "financing leases" to Cow Harbour. He deposed that Scott Capital made it clear to Cow Harbour, and Cow Harbour accepted and acknowledged at the time they negotiated the leases, that the lease options to purchase were to be at fair market value.

78 All of the leases identify the option price as being fair market value. In three of the leases, that value is not specified. In the other two, the fair market value of the equipment is pre-estimated and agreed by the parties to be a particular percentage of the original capital cost of the equipment (25 percent in the Schedule 001 lease and 20 percent in the Schedule 002 lease).

79 The security deposits that Scott Capital required Cow Harbour to pay under the leases amounted to 10 percent of the capital cost of the equipment in the case of the Schedule 001 lease and 20 percent of the capital cost of the equipment in the other four leases.

2. <u>Lease-specific arguments of the parties</u>

(a) Scott Capital

80 Scott Capital asserts that it did not structure its leases in such a way that Cow Harbour was financing its purchase of the equipment or accruing equity in the equipment over the lease term. Rather, Scott Capital structured the leases to ensure that the use, condition and value of the equipment were being controlled and maintained, as Scott Capital expected that Cow Harbour would return the equipment to it at the end of the lease terms. As the affiant stated on cross-examination:

> A. You will see that the terms on these leases are different. And part of that is because we feel that certain equipment may be perhaps more abused. Certain equipment naturally has a different life than other equipment.
>
> But that type of an analysis is factored into whether or not we will enter into a 48-month lease or perhaps a 60-month lease. If we think that equipment will be used gingerly, then we will perhaps enter into a longer-term lease. If we think that equipment will be used harshly in harsh conditions, we want to put it on a shorter-term lease. There always has to be value on that equipment in the event that it's returned.
>
> [Transcript of the cross-examination of Brian Jagt, 26 October 2010, p. 20, ll 21-34.]

81 The Schedule 003, Schedule 004 and Schedule 005 leases, in addition to other detailed terms concerning the maintenance and condition of the equipment, specified usage maximums in the return provisions of the lease. Scott Capital did this with specific care and concern for the equipment's condition, having regard to how Cow Harbour intended to use the equipment. The affiant explained that Scott Capital was concerned about the number of hours that Cow Harbour intended to use the equipment, rather than the number of kilometres of recorded use, as Scott Capital anticipated that the buses and trucks would be running constantly but not travelling great distances.

82 The purchase option prices set out in the Schedule 001 and the Schedule 002 leases (25 and 20 percent, respectively, of the original capital cost of the equipment) were not arbitrary figures. Rather, Scott Capital determined those prices and Cow Harbour agreed to those prices as a reasonable pre-estimate of the equipment's fair market value at the end of the lease term, based on Cow Harbour's anticipated use and the nature of the use.

83 Scott Capital points out that the present value of the rentals under each lease was less than 90 percent of the original equipment cost.

(b) Monitor

84 The Monitor suggests that the Schedule 001 and Schedule 002 leases are best characterized as financing leases because, among other factors, the end of term purchase option price appears to be arbitrary and bears no direct connection to the actual value of the leased equipment at the time Cow Harbour was to exercise the option. In other words, Cow Harbour appears to have acquired equity in the leased equipment because the fair market value of the leased equipment at the time Cow Harbour was to exercise the option may exceed the purchase option price.

85 In addition, the Schedule 001 and Schedule 002 leases overwhelmingly exhibit other indicia of a financing lease, as discussed in ***Smith Brothers***, which militates against them being considered true leases. Specifically, the leases contain the ***Smith Brothers*** financing lease factors 3 to 10 and 13 to 16.

86 The Monitor points out that the aggregate rental under the Schedule 001 and Schedule 002 leases approximated the value of the purchase price of the equipment, factoring in interest and carrying costs (***Smith Brothers*** factor 16), as the equipment in the Schedule 001 lease originally was valued at $559,951 plus applicable tax, while the total amount to be paid by Cow Harbour during the course of the term was $628,140 plus applicable tax. In the Schedule 002 lease, the equipment originally was valued at $801,249.96 plus applicable tax, while the total amount to be paid by Cow Harbour over the course of the term was $1,033,079.83 plus applicable tax.

87 In the Schedule 003, Schedule 004 and Schedule 005 leases, the end of term purchase option was referred to as "fair market value" (with no approximated value of what that value might be). While this factor militates in favour of each such lease being characterized as a true lease, the Monitor notes that, as in ***Bronson***, these leases contained default provisions which guaranteed to Scott Capital the residual value of the equipment. These three leases contained financing lease ***Smith Brothers*** factors 3 to 10 and 13 to 15.

(c) GE

88 GE takes the position that the Scott Master Lease bears the indicia of a financing lease as ***Smith Brothers*** factors 4 to 11 and 13 to 15 are present.

89 It says the present value of the rental payments is irrelevant. The more important factor is that the aggregate cost of the rental payments exceeded the value of the equipment at the commencement of the lease.

90 GE points to the evidence of Scott Capital's affiant that the amount of the security deposit that Cow Harbour paid at the outset of the Schedule 002 lease was equal to the amount of the purchase option at the conclusion of the term. It contends this was equivalent to a nominal purchase option price and suggestive of a financing lease as Cow Harbour, at the outset of the lease, paid the amount of the purchase price due at the conclusion of the lease.

91 GE maintains that, if this Court accepts Scott Capital's assertion that the purchase price options in the Schedule 003, Schedule 004 and Schedule 005 leases were for fair market value, it would be accepting form over substance. Scott Capital's affiant confirmed that the amount of the security deposit that Cow Harbour paid in respect of each of these three leases at the outset of the leases was equal to Scott Capital's internal estimate of the remaining value of the equipment at the conclusion of the leases. Said differently, Cow Harbour, at the outset of the lease, paid what was estimated to be the equipment's remaining value at the conclusion of the lease, leaving Cow Harbour with a nominal purchase option.

3. Decision

92 Applying the ***Smith Brothers*** criteria to the five Scott Capital leases reveals the following:

1. Whether there was an option to purchase for a nominal sum - No, the purchase price was reflective of fair market value (see discussion below).
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - The affiant acknowledged financing leases are a small portion of its business.
4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment -Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes.
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - Yes.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Yes.
14. Whether there was a provision in the lease for liquidated damages - Yes.
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.

16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes.

93 What do these results establish?

94 Scott Capital's affiant conceded that Cow Harbour sourced the equipment and then approached a broker to seek assistance with acquisition of the assets. The broker would then contact Scott Capital. The way in which the leases came about is more reflective of a financing lease transaction than a true lease situation. However, it is important for this Court to examine the structure of each transaction to characterize properly the agreement.

95 All of the leases had purchase options. This Court must attempt to value the purchase price option as at the date Cow Harbour and Scott Capital executed the lease agreements. As stated in the *Handbook* at 55:

> A clause in a lease giving the option to purchase the goods at less than their expected market value (<u>as determined at the date of execution</u>) indicates that the lessee has acquired an equity in the goods not unlike that which he would have acquired under an instalment purchase contract. [Emphasis added.]

96 In ***Re Ontario Equipment (1979) Ltd.*** (1981), 33 OR (2d) 648 at para 9 (HCJ), aff'd (1982), 35 OR (2d) 194 (CA), Henry J.considered the nature of the option to purchase to be a critical factor in distinguishing between true leases and financing leases in personal property security legislation cases, stating:

> The test in determining whether an agreement is a true lease or a conditional sale is whether the option to purchase at the end of the lease term is for a substantial sum or a nominal amount ... If the purchase price bears a resemblance to the fair market price of the property, then the rental payments were in fact designated to be in compensation for the use of the property and the option is recognized as a real one. On the other hand, where the price of the option to purchase is substantially less than the fair market value of the leased equipment, the lease will be construed as a mere cover for an agreement of conditional sale.

97 Whether a purchase option price is nominal is fact-specific. A purchase option for a nominal sum is indicative of a financing lease. On the other hand, a purchase option at fair market value is highly suggestive of a true lease. The rationale, according to Burke, is that, "[i]f the lessee is required to pay the actual value of the property at the end of the lease at a time when the property still has value, then the lease payments cannot reasonably be said to have been payments towards an equity interest in the property" (at 293).

98 However, as noted by the Master in ***Bronson*** at para 55 and confirmed by the British Columbia Supreme Court in that case (at para 7), the mere existence of a fair market value purchase option price in the agreement is not necessarily determinative of whether the agreement is a true lease or a financing transaction.

99 In ***Smith Brothers***, Bauman J. commented that simply because the lessee can purchase the equipment at its fair market value at the end of the lease does not prevent a court from characterizing the transaction as a financing transaction if the end of the lease term is roughly equivalent to the end of the equipment's useful life (at para 76).

100 Professors Cuming and Wood explained in their *Handbook* at 55 that:

> A clause in a lease giving the lessee the option to purchase the goods at less than their expected market value (as determined at the date of execution) indicates that the lessee has acquired an equity in the goods not unlike that which he would have acquired under an instalment purchase contract. The economic reality is that it is quite predictable the lessee will pay this amount to the lessor. Consequently, the transaction is likely to be characterized as a security agreement. However, the fact that at the end of a lease term roughly equivalent to the useful life of the goods the lessee can purchase the goods at their then market value does not prevent characterization of the transaction as a security agreement. If one or more of the major indicia of a security agreement are present, the transaction may be a security agreement. Accordingly, if the lease is for all or the greater part of the useful life of the leased equipment and the lessee is obligated to pay rental equivalent to the capital cost of the goods and an appropriate credit charge, the fact that the lessee is given the right to buy the goods at the end of the term for their then small market price should play no role in the characterization process. A consideration of the option price is relevant to the characterization of the transaction only if the option can be exercised at a time when the goods have significant commercial value. It may be possible to show that the option price was not designed to ensure that the lessor is fairly compensated for his interest in the goods, but was included for some other purpose (such as satisfying income tax authorities). This provides strong evidence that the parties recognize that by the time the option is exercised the lessor has been fully compensated through rental payments and that it matters little to either the lessor or the lessee that the option is or is not exercised.

101 In the Schedule 001 and Schedule 002 leases, the purchase option price was expressed to be the "fair market value" of the equipment, pre-estimated and agreed by the parties to be 25 percent and 20 percent, respectively, of its original capital cost. These percentages equated to purchase prices of $139,987.75 (Schedule 001 lease) and $160,249.99 (Schedule 002 lease). These are not nominal amounts.

102 Scott Capital's affiant deposed that Scott Capital used a "combination of past experience, extensive equipment knowledge, market knowledge and the application or intended use of the equipment to determine the value of any purchase option at lease end such that it is a reasonable estimate of fair market value."

103 The Schedule 003, Schedule 004 and Schedule 005 leases all stated that the purchase option price was "fair market value." There is no evidence to suggest that the parties meant or intended otherwise.

104 This Court finds that the options were for fair market value or a reasonable pre-estimate of such.

105 There was no evidence that 60 months in the case of the Schedule 001 lease or 48 months in the case of the Schedule 002, Schedule 003, Schedule 004 and Schedule 005 leases was roughly equivalent to the end of the useful life of the equipment involved in those leases. In fact, Scott Capital's affiant stated that Scott Capital structured the leases to ensure there was value in the equipment at the end of the lease term.

106 These leases did not contain any mechanism, either in a default situation or at full term, whereby the surplus value of the equipment would go to Cow Harbour. If, at the end of the term of each lease, Cow Harbour did not exercise the purchase option to acquire the equipment, Cow Harbour had to return the equipment to Scott Capital. Scott Capital could then deal with the equipment as it saw fit for its own benefit and account. Cow Harbour was not responsible under any of these leases for any deficiency or shortfall on the sale of the equipment at the end of the term.

107 The Scott Master Lease s 13(f) contained a default clause allowing for liquidated damages to consist of the present value of rents owing to the end of the term, plus the present value of the residual value of the equipment "which Lessor expected to receive at the expiry of the term of the lease, which is equal to the Fair Market Value of the Equipment as set out in the Equipment Schedule ...," minus the net proceeds from a sale or lease of the equipment. The lease schedules stated that if Cow Harbour defaulted in its obligations under the lease, Scott Capital would retain the security deposit as liquidated damages.

108 The default provisions in ***DaimlerChrysler Services Canada Inc. v. Cameron***, 2007 BCCA 144 [***DaimlerChrysler***], rev'g 2006 BCSC 1992, 32 CBR (5th) 188 were similar (other than retention of the security deposit). The court found that the lease secured the payment of the residual value by the lessee in the contingency of default (at para 28). The court went on at para 37 to say:

> ... the basis for calculating damages does not distinguish a true lease from a security lease. The ability to claim accelerated damages in *Langille* was not a consequence of the character of the lease, i.e., a true lease or a security lease. Rather, it was simply the proper measure of damages for breach of a chattel lease. Generally, the basis for calculating damages can provide only some insight as to whether an impugned lease secures payment or performance of an obligation. I emphasize that it cannot serve as a decisive factor.

109 The Chambers Judge had concluded in ***DaimlerChrysler*** that the transaction was a security lease, following ***Bronson***, which found that the default clause secured payment of both the lease payments and the option price. On appeal, the court determined that the chambers judge had placed undue weight on the default provision as it can have only corroborative effect (at para 46).

110 According to Burke at 294:

> If, however, the lessee's residual value guarantee only applies in the case of an early termination of the lease, whether voluntarily by the lessee or by the lessor as a result of the occurrence of a default, but not at the end of the scheduled lease term, then such a residual value guarantee will not constitute a primary factor that is indicative of a security lease.

111 In the case before this Court, the default provisions contained in the Scott Capital leases are equivocal.

112 The aggregate of rental payments for each of these leases is greater than the original capital cost of the equipment. Professors Cuming and Wood expressed their view in the *Handbook* that if the lessee must pay the equivalent of the lessor's capital investment plus a credit charge at the rate existing at the date of the agreement, there is strong but not conclusive evidence of a secured sale (at 54). However, Burke commented at 296:

> If a lessee is required to pay what is the equivalent of the original cost of the leased property (i.e., the lessor's capital investment), plus a finance charge based on the rate existing at the date of the lease agreement, it does not necessarily follow that such an agreement is a security lease, especially if the lease contains a true fair market value purchase option.
>
> In such a lease, it is possible that the lessee has simply agreed to pay a premium for the use of the leased property.

113 The Schedule 003, Schedule 004 and Schedule 005 leases contain specific use limitations with corresponding excess use charges. In ***DaimlerChrysler***, the Chambers Judge found that excess kilometre charges and maintenance obligations were indicative of a true lease as they protected the lessor against reduction of market value on expiry of the lease term due to excess "wear and tear" (at para 25). Burke, however, considered such provisions equally consistent with a financing lease, as they suggest that the lessee bears some risks of ownership (at 296). This Court finds that those provisions are equivocal in the case of the Scott Capital leases.

114 All five Scott Capital leases required substantial security deposits. The evidence of Scott Capital's affiant on cross-examination was that for four of the five Scott Capital leases, the amount of the security deposit was equivalent to the purchase option price in the lease or the anticipated purchase option price (transcript of the cross-examination of Brian Jagt, 26 October 2010, pp 43-45). He explained that in terms of the Schedule 003, Schedule 004 and Schedule 005 leases (which have purchase options simply stated to be at "fair market value"), the security deposit was based on the "estimated" fair market value of the equipment, but that this was just Scott Capital's internal estimate (transcript of the cross-examination of Brian Jagt, 26 October 2010, pp 39-42). Scott Capital did not provide this information to Cow Harbour. Cow Harbour had the ability to purchase the equipment at the end of the term of the lease for the "fair market value," irrespective of whether that amount turned out to be less than, equal to, or greater than the amount of the security deposit.

115 During cross-examination, the Scott Capital affiant gave the following evidence:

> Q. And would I be correct in stating as well that typically if a purchaser or if a lessee does exercise an option to purchase the equipment at the end of the lease, the deposit will be utilized in some fashion to acquire the equipment?
>
> A. It depends on the customer. Some customers want us to reimburse in the form of a cheque their security deposit, and then they pay us a separate cheque for the full amount if they purchase it. And other customers just tell us to net it against their purchase option, making sure that the bill of sale records the correct gross purchase price and then with the reflection that the other amount has been applied.
>
> Q. And was there any discussion with Cow Harbour at any point in time with respect to how the deposit, whether the deposit would be utilized for the purchase price of the asset if Cow Harbour did exercise an option to purchase?
>
> A. There was no discussion with Cow Harbour.

> [Transcripts of the cross-examination of Brian Jagt, 26 October 2010, p 25, ll 8-26.]

116 This Court finds that Scott Capital's estimated fair market value at the end of the lease term was a reasonable "security deposit" amount to protect against its risk that Cow Harbour might not return the equipment to it when the lease ended because of some total loss event or that Cow Harbour would return the equipment to Scott Capital in such poor condition that the equipment no longer had value. In such cases, the security deposit would have served its stated purpose of being a recourse for Scott Capital's damages under the lease.

117 There are certainly indicia of a financing arrangement. There are hypothetical situations under which Cow Harbour could indeed have built up equity and paid only the residual amount of the equipment's capital cost plus a financing charge; *e.g.* if it defaulted in its obligations under the leases. Those hypothetical situations did not occur, however, and based on the wording of the leases, Cow Harbour was paying for use of the equipment.

118 Although the security deposits are relatively substantial, there was no obligation on Cow Harbour's part to forfeit the security deposits at the end of the lease term. It could simply return the equipment and demand the security deposits (less any additional charges that it had incurred in the meantime). This is especially so with respect to the Schedule 001 lease, where the purchase option price was 25 percent of the equipment's original capital cost, while the security deposit was ten percent. Although Burke suggested (at 296) that a substantial security deposit is indicative of a financing lease in that the lessee is required to post collateral to obtain the equipment, considering the whole of the Scott Capital lease agreements, this factor is not determinative and, in fact, it assists Scott Capital in its position.

119 For the foregoing reasons, this Court concludes that the Scott Capital leases are true leases.

B. Caterpillar Financial Services Limited (CFSL) Lease

1. <u>The Lease</u>

120 Cow Harbour leased a Caterpillar off-highway truck from CFSL pursuant to a lease dated March 27, 2006. According to CFSL's affiant, the original cost of the truck was $2,235,456. The amount shown in the floating rate addendum was $500 more, which CFSL's affiant explained was a fee payable by Cow Harbour (transcript of the cross examination of Renee Bertha Fournier, 21 October 2011, p. 7, ll 32-41). The lease term was 60 months. The lease required Cow Harbour to pay irregular monthly payments pursuant to the terms of the irregular payment schedule attached to the CFSL lease (6 months at $100,000 and 54 months at $28,397.86). The aggregate amount of those rents was about $2,133,485.

121 If Cow Harbour exceeded the maximum hours of use of the equipment, it was to pay an excess hour charge.

122 The CFSL lease contained an end of term purchase option price of $524,535.

2. Lease-specific arguments of the parties

(a) CFSL

123 CFSL argues that the most probative factor is that the purchase option price was neither a nominal sum nor arbitrarily selected. Rather, it calculated the purchase option price after considering factors such as depreciation, historic resale market for like equipment, application, exchange rate and annual hours of usage. The purchase option price represented 102 percent of the standard residual amount, which CFSL calculated to be $514,250, and was more than 15 percent of the value of the truck at the commencement of the term.

124 According to CFSL, the purchase option price was an amount intended to represent a reasonable pre-estimate of the fair market value of the truck at the end of the lease term. It relies on the statement by Burke (at 293) that, "[i]f the lessee is required to pay the actual value of the property at the end of the lease at a time when the property still has value, then the lease payments cannot reasonably be said to have been payments towards an equity interest in the property." CFSL says that the term of the lease did not exceed 75 percent of the economic useful life of the truck, which it estimated to be 120 months.

125 The net present value of the rental payments is $1,865,621.73, which is less than 90 percent of the equipment's value at the beginning of the term. CFSL points out that the rental payments could not be applied in satisfaction of the purchase option price.

126 CFSL maintains that other factors point to this being a true lease, including:

* the lack of any requirement for a security deposit or down payment
* Cow Harbour was not required to pay the equivalent of the original cost of the truck, plus a financing charge based on a rate existing at the date of the CFSL lease
* Cow Harbour was required to maintain certain minimum standards of repair with respect to the truck.

CFSL submits that the latter factor is consistent with it attempting to protect its interest in the residual value of the truck on its return at the end of the lease.

127 Cow Harbour was not required to make a residual payment at the end of the lease term or to guarantee residual value. Cow Harbour could exercise the option or return the truck to CFSL.

128 CFSL asserts that the presence of other factors, such as the inability of Cow Harbour to exchange or replace the truck; a default provision favourable to CFSL; and the inclusion of the floating rate addendum, should be given less weight in comparison with the fair market value option to purchase. Equipment lessors are in the business of making money and the floating rate addendum simply reflects its cost of capital or a return of investment.

129 CFSL relies on ***DaimlerChrysler*** in arguing that the acceleration of rent on default is equivocal.

130 CFSL submits that given Cow Harbour's operations, the specialized equipment it was leasing and the relatively remote location of the oil sands site where it was working, it was only logical that CFSL would impose the obligation for insurance, maintenance and the risk of loss on Cow Harbour. Accordingly, these are neutral factors.

(b) Monitor

131 The Monitor contends that the CFSL lease is best characterized as a financing lease because, among other factors, the end of term purchase option price (approximately 23 percent of the original value of the equipment) appears to be arbitrary and bears no direct connection to the actual value of the leased equipment at the time Cow Harbour exercises the option. In other words, Cow Harbour appears to have acquired equity in the leased equipment because the fair market value of the leased equipment at the time when the option could be exercised might exceed the purchase option price. This leads to the conclusion that the lease is a financing agreement and/or a lease pursuant to which payments are made for "use and equity."

132 The Monitor suggests that the CFSL lease exhibits other indicia of a financing lease, as discussed in ***Smith Brothers***, which militates against it being considered a true lease. Specifically, ***Smith Brothers*** factors 4 to 6, 8, 9 and 13 to 16 are present in the CFSL lease. The Monitor notes that the equipment originally was valued at $2,235,956 plus applicable tax, while the total amount that Cow Harbour was to pay during the course of the term was $2,658,019.44 plus applicable tax. Therefore, the aggregate rentals approximated the value of the purchase price of the equipment factoring in interest and carrying costs.

(c) GE

133 GE focuses on the floating rate addendum, which provided that the rental payments were subject to an interest rate adjustment. It says this resulted in the lease operating like a credit or loan agreement. GE notes that:

* CFSL charged interest to Cow Harbour equivalent to its cost of acquiring the truck;
* the interest rate that CFSL charged fluctuated over the term of the lease, according to the cross-examination of CFSL's affiant (transcript of the cross-examination of Renee Bertha Fournier, 21 October 2011, p.6, ll 5-8);
* Cow Harbour had the option, at any time over the term of the lease, to lock into a fixed interest rate equal to the rate of interest charged to CFSL on fixed rate loans (transcript of the cross-examination of Renee Bertha Fournier, 21 October 2011, p.8, ll 30-41; p.9, ll 1-4);
* at the end of the lease, Cow Harbour's final rent payment was subject to a credit or debit adjustment on the interest rate fluctuation over the term of the lease.

GE suggests that this is the most significant evidence the lease was a financing arrangement.

3. Decision

134 The following results from applying the ***Smith Brothers*** criteria to the CFSL lease:

1. Whether there was an option to purchase for a nominal sum - No, the purchase price was reflective of fair market value.

2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - It acted as both a financing and a leasing company, according to its affiant.
4. Whether the lessee paid sales tax incidental to acquisition of the equipment - The lessee was to pay any taxes due on its exercise of the sale option.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes.
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Not specifically in the lease agreement
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - No.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Yes.
14. Whether there was a provision in the lease for liquidated damages - Yes
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes, if interest payments are added to the rent.

135 Cow Harbour selected the truck and CFSL acquired the truck to lease to Cow Harbour.

136 This Court finds that the purchase option price for the CFSL equipment was a reasonable pre-estimate of the truck's fair market value at the end of the 60-month lease term. It was approximately 23 percent of the truck's original price. Based on CFSL's estimate that the truck had an economic useful life of 120 months, it was reasonable for CFSL to believe that the truck would still have value at the end of the lease term. No evidence was led which would suggest otherwise.

137 The lease did not require Cow Harbour to pay a security deposit or down payment. While CFSL was entitled to accelerate rental payments on default, Cow Harbour was not responsible for the residual value, if any, of the truck.

138 The aggregate rent was about five percent less than the truck's original value. However, as is apparent from the floating rate amortization schedule attached to the lease, the rent payments and option purchase price together amounted to the capital cost of the truck, plus a seven percent interest rate (Toronto Dominion prime plus 1.50 percent).

139 GE argues that a "payment for use" contract will not impose an obligation on the lessee to pay interest on the funds that the lessor uses to acquire the leased equipment. However, in this

Court's view, it is just as likely that such a charge will be included in a true lease, *albeit* it may be incorporated in the overall rental amount rather than being identified as interest or a financing charge.

140 Some of the terminology that CFSL used in the floating rate addendum suggests that it is an addendum to a financing lease agreement. The terminology includes "principal balance," which is defined as "equal to the amount of credit extended of $2,235,956.00, as adjusted by amortization during the term of the Contract" (emphasis added). Also, "gross lease" was defined as meaning "the total Amount of Credit Extended and Aggregate Finance Charge(s) payable hereunder" (emphasis added). These definitions, however, are not definitive and this Court must look at the lease as a whole.

141 Cow Harbour was not obliged to exercise the purchase option. If it did, the purchase option price was a significant amount and CFSL was not guaranteed the residual value of the truck unless Cow Harbour exercised the option. This Court finds that Cow Harbour simply agreed to pay a premium for the use of the leased property.

142 In looking at the CFSL lease as a whole, this Court holds that it was a true lease.

C. Wajax Industries (Wajax) Leases

1. The Leases

143 Wajax had three leases with Cow Harbour, as set out below:

Lease number (Monitor's Report)	Date day/month/year	Initial Term (months)	Original Cost of Equipment	Monthly Rental	Option Price	Assessed Value June 2010
196	12/11/2008	6	$439,810	$16,500	$439,810, less a % of rent payments	$130,000
198	8/4/2009	6	$1,681,500	$40,000	$1,681,500, less a % rent payments	$450,000
197	8/4/2009	6	$991,860	$30,000	$991,860, less a % of rent payments	$175,000

144 The leases were for a maximum six-month initial term, with month-to-month extensions allowed after the initial term. Cow Harbour could exercise the option to purchase at any time during the initial term of the lease, or within 6 months after that, if CFSL extended the term of the lease.

145 Cow Harbour was responsible to pay the specified monthly rental, unless it used the equipment for more than 200 hours in a month, in which case it was required to pay overtime charges.

146 The option to purchase was for the original cost of the equipment, but if Cow Harbour exercised it during the initial six-month term, 85 percent of the rental payments that Cow Harbour had made was to be credited towards the purchase price. Wajax had the sole option to extend the option to purchase for a further six-month term. If Cow Harbour exercised the option during the second six-month term, Wajax was to credit towards the purchase price 85 percent of the rental payments that Cow Harbour had made during the first six month term and 50 percent of the rental payments that Cow Harbour had made during the second six-month term.

147 Cow Harbour did not exercise the option to purchase during the initial six-month term and Wajax did not extend the option to purchase beyond that term. At the date this Court granted the Initial Order, Cow Harbour no longer had an option to purchase the equipment.

2. <u>Lease specific arguments of the parties</u>

(a) Wajax

148 Wajax's affiant deposed that Wajax is not in the business of providing equipment financing. He stated that, in this case, Wajax entered into short-term rental agreements with Cow Harbour to accommodate Cow Harbour's need for the equipment and to permit Cow Harbour time to find third party financing for payment of the purchase price.

149 The affiant stated that Wajax set the rental rate with a view to covering the equipment's depreciation during the rental period, as Cow Harbour could have returned the equipment after the initial six-month term without incurring any further obligation to Wajax.

150 Wajax emphasizes that the focus on this application should be on whether the lease agreements secured payment of the purchase price for the equipment. Wajax suggests that this Court should bear in mind the distinctions between leasing consumer goods to an individual versus leasing a large piece of equipment that generates revenue for a business.

151 Wajax submits that the percentage of the rental payments credit that Cow Harbour would have received had it elected to exercise the option to purchase the equipment was minimal when compared to the purchase price for the equipment. It asserts this credit was not "equity" given the equipment's depreciation, as demonstrated by the Ritchie Brothers valuations that were undertaken in these proceedings and the evidence of Wajax's affiant.

152 Wajax notes that there was no mandatory purchase option and no liability for any deficiency on the sale of the equipment following the expiry of the lease. It says these were not sale-leaseback transactions. Under the leases, Wajax could replace the equipment with a comparable piece of equipment if Cow Harbour did not exercise the purchase option during the first six months. Further, if Cow Harbour defaulted, Wajax was entitled only to the amounts that Cow Harbour owed to it under the agreement plus 30 percent of the aggregate rental charges for the unexpired portion of the term as a pre-estimate of liquidated damages. Wajax maintains this was a weak default clause.

153 Wajax points out that the assessed fair market value of the equipment in June of 2010 was significantly less than the purchase option price, even after the second term. As a result, Cow Harbour had not built up equity in the equipment through the lease agreements.

(b) Monitor

154 The Monitor acknowledges that the Wajax leases could be characterized as financing leases or true leases, depending on the approach used in performing the characterization analysis.

155 The Monitor says the Wajax leases were not security agreements under a personal property security analysis. However, it maintains that Cow Harbour made payments for use of and earned equity in the equipment during the first six months of the leases. This militates in favour of the leases being considered financing leases.

156 The Monitor notes that the six-month purchase option period had expired under each of the leases, and Wajax had not given any indication of its election to extend the purchase option period. Therefore, it would appear that Cow Harbour no longer had any equity in the leased equipment, which would militate in favour of each lease being considered a true lease.

(c) GE

157 GE contends that the Wajax leases bear several indicia of financing leases, including Cow Harbour's:

* obligation to pay all taxes incidental to ownership;
* responsibility for insuring the equipment;
* responsibility for payment of license fees for maintenance of the equipment;
* bearing the entire risk of loss

As well, it asserts that the default provisions were inordinately favourable to Wajax, and the leases contained a provision providing for liquidated damages.

158 GE contends that the rental payments earned Cow Harbour a significant equity interest in the equipment over the term of the leases. It says that the most significant factor is that Wajax intended to sell the equipment to Cow Harbour pursuant to the leases, as confirmed by Wajax's affiant. As well, Cow Harbour previously had purchased a number of pieces of the same type of equipment from Wajax.

3. <u>Decision</u>

159 Application of the ***Smith Brothers*** criteria to the Wajax leases reveals the following:

1. Whether there was an option to purchase for a nominal sum - No, the option purchase price was reflective of fair market value.
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - Yes, but contingent on the option to purchase being exercised.
3. Whether the nature of the lessor's business was to act as a financing agency - No.
4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.

5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes.
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes, but only 30 percent of the aggregate rental charges for the unexpired portion of the term, as a pre-estimate of liquidated damages.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Wajax is the exclusive dealer for Hitachi equipment in Canada. The equipment was new when it provided the equipment to Cow Harbour.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - No. However, rent for the minimum rental period was payable before delivery of the equipment.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - No (see discussion below).
14. Whether there was a provision in the lease for liquidated damages - Yes (see discussion below).
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - No.

160 The parties' intent in this case was that Cow Harbour would purchase the equipment, which was the subject of these leases, if it could find a third party to finance its purchase of the equipment.

161 If Cow Harbour exercised the option to purchase within the first six-month term of the leases, it would be credited with 85 percent of the rental payments made. Professors Cuming and Wood commented in the *Handbook* at 56 on this type of situation:

> Some leases provide that rental payments made up to the point when the option is exercised are to be "credited" to the lessee and deducted from the amount payable under the option. Under an economic realities test, the amount "credited" to the lessee has little significance; it remains necessary to determine if the amount of new money to be paid by the lessee represents the reasonably expected fair market value of the goods at the time of exercise of the option. If the new money is equal to or near the market value of the goods, the "credit" is of no significance. If the amount of new money is significantly less than the market value of the goods, the term providing for the credit is an overt recognition that the debtor has purchased an "equity" in the goods through his lease payments. It is inevita-

ble that, as a rational person, the lessee will exercise the option in order to realize that equity.

162 This Court finds that the purchase option price or "new money" in this case was a reasonable pre-estimate of what the market value of the equipment would be if and when Cow Harbour exercised the option, taking into account depreciation, which was reflected by the rental "credit." These were relatively short term leases. In any event, the six-month option had expired for each lease and Wajax did not extend them for a second term.

163 While there was a default clause in each case which allowed for acceleration of rents, it was only for 30 percent of the aggregate rental charges for the unexpired portion of the term. Further, Cow Harbour had no liability for deficiency on sale of the leased property at the end of the term.

164 Accordingly, this Court finds that the Wajax leases were true leases.

D. Kempenfelt Vehicle Leasing (a Division of Equirex Vehicle Leasing 2007 Inc.) (Kempenfelt) Leases

1. The Leases

165 Kempenfelt had four leases with Cow Harbour, as described below:

Lease number	Date day/month/year	Initial Term (months)	Original Cost of Equipment	Monthly Rental	Option Price
ZNCS1001	2/2/ 2010	66	$202,738.90	$4,122.95 (plus one initial payment of $20,468)	$20,268 at 60 months, FMV at 66 months
ZNEW1002	10/2/2010	66	$145,000.00	$2,979.99 (plus one initial payment of $14,700)	$14,500 at 60 months, FMV at 66 months
ZEX1002	2/2/ 2010	66	$101,369.00	$2,061.48 (plus one initial payment of $10,334)	$10,134 at 60 months, FMV at 66 months
ZNEY1002	10/2/2010	66	$101,369.00	$2,061.48 (plus one initial payment of $10,334)	$10,134 at 60 months, FMV at 66 months

166 All the leases required Cow Harbour to make an initial payment, roughly equivalent to 10 percent of the original cost of the equipment, and approximately the same amount as the purchase option price. These payments are not identified as security deposits. However, clause 20 of each lease makes reference to a security deposit, which is refundable at the termination date of the lease, provided Cow Harbour has not defaulted under the lease.

2. <u>Lease-specific arguments of the parties</u>

(a) Kempenfelt

167 Kempenfelt takes the position that all of these leases fall within C*CAA* s. 11.01(a). In the alternative, Burke's primary/secondary factor approach applies, as the ***Smith Brothers*** factors are not equally probative of the issue as to whether the leases are true leases or financing leases.

168 Kempenfelt points out that under each lease, Cow Harbour was entitled to purchase the leased equipment for approximately 10 percent of its original value at the end of 60 months, or at fair market value at the end of the 66-month term. Kempenfelt's affiant deposed that the purchase option price was the estimated fair market value of the equipment at the conclusion of the lease term. She did not specify how Kempenfelt arrived at, or calculated, that value.

169 Kempenfelt notes that the leases contained a guaranteed residual clause, but only if Cow Harbour defaulted or on early termination of the leases. Kempenfelt contends that the acceleration of rents on default is typical of both true leases and financing leases. It says the leases were not full payment leases. Cow Harbour was not required to pay a security deposit or down payment. All payments were described in the leases as "rent."

(b) Monitor

170 The Monitor submits that the leases are best characterized as financing leases because the 60-month purchase option price (approximately 10 percent of the original value of the equipment) appears to be arbitrary and bears no direct connection to what the actual value of the leased equipment might be at the time Cow Harbour exercised the option.

171 The Monitor says the leases overwhelmingly exhibit other ***Smith Brothers*** indicia of a financing lease. Specifically, ***Smith Brothers*** financing lease factors 3 to 7, 9, 10 and 13 to 15 are present in the Kempenfelt leases. The Monitor asserts that the aggregate rental approximated the value of the purchase price of the equipment, factoring in interest and carrying costs. It points out that under the terms of lease ZNCS1001, the equipment originally was valued at $202,738 plus applicable tax, while the total amount Cow Harbour was to pay during the lease term, including the initial payment, was $288,459.95 plus applicable tax. In both leases ZEX1002 and ZNEY1002, the equipment originally was valued at $101,369 plus applicable tax, while the total amount Cow Harbour was to pay during the lease term of each lease, including the initial payment, was $144,330.30 plus applicable tax. In lease ZNEW1002, the equipment originally was valued at $145,000 plus applicable tax, while the total amount Cow Harbour was to pay during the lease term, including the initial payment, was $208,399.35 plus applicable tax.

(c) GE

172 GE contends that the Kempenfelt leases are full payment leases. GE notes that the aggregate cost of the rental payments exceeded the equipment's original cost in each case.

173 GE notes that the purchase option price exercisable after 60 payments was less than the remaining payments due under the leases. Therefore, the economic reality was that Cow Harbour would be inclined to purchase the equipment for that lower price.

3. <u>Decision</u>

174 The following are the results of applying the ***Smith Brothers*** criteria to the Kempenfelt leases:

1. Whether there was an option to purchase for a nominal sum - See discussion below.
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - Yes.

4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - The leases refer to a security deposit in clause 20.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Kempenfelt was permitted to accelerate rent on default.
14. Whether there was a provision in the lease for liquidated damages - Yes.
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes.

175 Each lease referred to a security deposit and stated that Cow Harbour would not earn any interest on the deposit. Kempenfelt was to return the security deposit to Cow Harbour on the termination of the lease. The leases, however, did not identify any security deposit, unless it was meant to be the first payment, which in each case was approximately 10 percent of the original value of the equipment, or five times the other monthly rental payments.

176 The aggregate of the rental payments, not including the initial payment, was more than the original cost of the equipment in each case. The purchase option price available at 60 months was approximately the same as the remaining five monthly rental payments, less interest.

177 At the end of the term of each lease, the lessee could return the equipment to Kempenfelt or exercise the option to purchase the equipment at fair market value.

178 This Court finds that the option served merely as window dressing. The economic reality was that Cow Harbour would have exercised the 60-month option, whether the first payment was considered a security deposit or actual rent.

179 Considering all of the ***Smith Brothers*** factors, this Court concludes that the Kempenfelt leases were financing leases.

E. Concentra Financial (Concentra) Lease

1. <u>The Lease s</u>

180 Concentra's lease 7958-1, dated February 24, 2006, was for a new off-highway mining truck. The original cost of the truck was $2,335,456, according to the Monitor's brief. The vendor was shown as Finning (Canada). The initial term of the lease was 60 months. The lease required one payment of $100,000 and 59 monthly payments of $35,224.79. The end of term resale value was identified as $415,000.

181 Under clause 10 of lease 7958-1, Cow Harbour unconditionally guaranteed the end of term minimum resale value of the equipment, on or at expiry of the lease or any renewal term.

182 Attached as part of an appendix to the Monitor's 13th Report was a Concentra lease credit approval relating to this equipment. Concentra approved a "loan" of $2,075,000, with an "origination fee" of $21,000 and contract initiation fee of $5,188. Monthly rental was shown as $35,224.78, with the term being 60 months. Approval was said to be subject to a "rental" payment in advance of $100,000. Also attached was a Capital City Savings amortization schedule for a $2,075,000 loan, at a nominal annual rate of 8.321 percent, compounded monthly, showing the payments noted above in the lease document, plus a $415,000 payment on February 20, 2011. The copies of these document that this Court reviewed were not signed and Concentra's affiant was not cross-examined on them.

183 The other lease is referred to as "Alter Moneta Equipment Schedule Number 2 to Master Lease No. CCB5314A." It is dated April 18, 2007 and was assigned to Concentra by Alter Moneta Corporation on September 27, 2007. The subject of the lease was a new CAT off-highway truck and accessories, the net price of which was shown as $2,558,295. The term of the lease was 60 months. The payment schedule addendum provided for an initial payment of $683,295 and 59 monthly payments of $40,372.39 each. The lease contained an option to purchase for $1 at the end of the initial lease term or end of any renewal period

2. <u>Lease-specific arguments of the parties</u>

(a) Concentra

184 Concentra notes that under clause 9 of lease 7958-1, if either party elected not to renew the lease or elected to cancel it during the renewal period, the lessee could return the equipment to Concentra.

185 Concentra suggests the default clause is typical, presumably meaning it is equivocal.

186 Lease 7958-1 did not have an option to purchase. Nor was there a mandatory option requirement. There was no ability for the lessee to exchange equipment. Concentra concedes the $100,000 payment was a down payment.

187 In terms of the Alter Moneta Corporation assigned lease, Concentra argues that even an option at a nominal purchase price is irrelevant until such time as Cow Harbour exercises the option (***Ed Miller***; see this Court's discussion above). Concentra notes that the option did not state that it was mandatory. As well, there was a guaranteed residual clause. Concentra contends that it is a matter of interpretation whether the termination options or the end of term options make the lease open-ended. The lease was not stated to be a full payment lease and there was no security deposit. The down payment was only about 20 to 25 percent of the equipment's initial acquisition cost.

(b) Monitor

188 The Monitor says that lease 7958-1 is best characterized as a financing lease because, among other things, it contained a "guaranteed residual clause" in clause 10, thereby constituting it a security agreement under a personal property security analysis. The Monitor asserts that because it is a security agreement under a personal property security analysis, it falls outside of the scope of *CCAA* s. 11.01(a).

189 As well, the Monitor submits that lease 7958-1 overwhelmingly exhibits the ***Smith Brothers*** indicia of a financing lease. Specifically, ***Smith Brothers*** factors 3 to10 and 13 to16 are present. It notes that the equipment originally was valued at $2,335,456 plus applicable tax, while the total amount that Cow Harbour was to pay during the course of the lease term was $2,593,261.84 plus applicable tax. Therefore, the aggregate rental approximated the value of the purchase price of the equipment, factoring in interest and carrying costs.

(c) GE

190 GE takes the position that both leases have indicia of financing leases. Under lease 7958-1, Cow Harbour guaranteed the end of term resale value of the equipment ($415,000) to Concentra, which suggests this is financing lease.

191 GE says the Alter Moneta Corporation assigned lease was substantively identical to the Alter Moneta Corporation lease (discussed below) in having a mandatory end of term purchase obligation for $1. This also points to it being a financing lease.

3. <u>Decision</u>

192 The following are the results of applying the ***Smith Brothers*** criteria to the Concentra leases:

1. Whether there was an option to purchase for a nominal sum - No option to purchase in lease 7958-1, but end of term resale value guaranteed; nominal option price for the Alter Moneta Corporation assigned lease.
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - Yes.
4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.

9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - There was a down payment for both leases.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Yes.
14. Whether there was a provision in the lease for liquidated damages - Yes.
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes, in terms of lease 7958-1, but the aggregate would not account for financing charges on the full amount. However, the aggregate was equal to a lesser amount with monthly compounded interest. Yes, in terms of the Alter Moneta Corporation assigned lease.

193 Lease 7958-1 did not contain an option to purchase. At the end of the term, end of any renewal period, or on default, Cow Harbour was required to pay the residual value of the equipment. Cow Harbour, however, also was required to return the equipment to Concentra. If Concentra sold the equipment and the sale yielded an amount less than the end of term minimum resale value, Cow Harbour was responsible for the deficiency (at Concentra's option), but was not entitled to any surplus.

194 Burke stated at 294 that:

> Where the lessee is liable under an open-end lease for any deficiency in the sale of the leased property following its return at the end of the scheduled lease term, the current line of authority is to treat such a lease as a security lease, because a lessor is "guaranteed" to receive a minimum return on the transaction.

195 Burke cited ***Crop & Soil Services, Inc. v. Oxford Leaseway Ltd.*** (2000), 48 OR (3d) 291 (CA) as authority for this proposition. That case, however, and those referred to in it, involved situations where the lessee was entitled, as well, to any surplus on the sale of the equipment.

196 Burke suggested (at 296) that a substantial down payment is indicative of a financing lease in that the lessee may be viewed as acquiring an equity interest in the leased property.

197 The parties presented no evidence that 60 months was the anticipated useful life of the truck. There was no purchase option. Even though Concentra had a residual value guarantee and Cow Harbour made a substantial down payment, Cow Harbour was required to return the truck at the end of the lease term or renewal period, and it was not entitled to any surplus above the end of term minimum resale value, this Court finds that the Concentra lease was a true lease.

198 The aggregate of rents for the Alter Moneta Corporation assigned lease was approximately $3,065,266, which was greater than the $2,558,295 net price. A substantial down payment was required. The assigned lease contained an option to purchase for $1. The economic reality is that Cow Harbour would have exercised that option. The lease contained other lesser indicia of a financing lease. This Court concludes that the Alter Moneta assigned lease was a financing lease.

F. Alter Moneta Corporation (Alter Moneta) Lease

1. The Lease

199 The lease dated January 21, 2008 between Alter Moneta and Cow Harbour was Equipment Schedule No. 003 to Master Lease No. CCB5314A.

200 The net price of the leased equipment, a new 2008 Caterpillar off-highway truck, was shown as $2,737,433. The lease term was 60 months. Addendum 4 to the lease called for an initial payment of $273,743.30 and 59 monthly payments of $53,116.94.

201 At the end of the initial term or renewal period, Cow Harbour, if not in default, had the option to purchase the lessor's interest and title in the equipment for $1 or to renew the lease for a further 12 months for the same monthly lease payment.

2. Lease-specific arguments of the parties

(a) Alter Moneta

202 Alter Moneta advanced the same arguments as those advanced in relation to the Alter Moneta lease that Alter Moneta assigned to Concentra. In particular, it argued that the nominal purchase option price was irrelevant until such time as Cow Harbour exercised the option.

203 Alter Moneta notes that the option to purchase was not mandatory, there was no residual guarantee clause and the document did not relate the amount of payments to the purchase price. Alter Moneta says that the document refers to all payments as rent, but the initial payment is different from the others.

(b) GE

204 GE notes that the aggregate value of the rental payments over the term of the lease ($3,407,643) exceeded the cost of the leased equipment ($2,737,433).

205 GE asserts that, inasmuch as the option to purchase was for $1, the economic reality is that Cow Harbour would have bought the leased equipment.

3. Decision

206 The following results from application of the ***Smith Brothers*** criteria to the Alter Moneta lease:

1. Whether there was an option to purchase for a nominal sum - Yes, the option purchase price was $1 at the end of the term.
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - Yes.

4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - There is a large down payment required, although it is referred to as "rent."
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Yes.
14. Whether there was a provision in the lease for liquidated damages - Yes.
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes.

207 The aggregate of the lease payments was greater than the net price of the equipment. Cow Harbour was required to make a substantial down payment. The lease contained an option to purchase for $1. Alter Moneta's affiant deposed that the option was for the estimated fair market value of the equipment at the end of the lease term. If it is seen as a nominal purchase option price, the economic reality is that Cow Harbour would have exercised that option. If it is a reflection that the equipment was expected to be at the end of its useful life at the conclusion of the lease, Alter Moneta, in essence, was giving credit to Cow Harbour for its purchase of the equipment. The lease contained other ***Smith Brothers*** indicia of a financing lease.

208 As with the Alter Moneta lease that Alter Moneta assigned to Concentra, this Court concludes that this lease was a financing lease.

G. Key Equipment Finance Canada Ltd. (Key Equipment) Lease

1. <u>The Lease</u>

209 Key Equipment was the assignee of a lease agreement dated November 15, 2006 between Alter Moneta and Cow Harbour (assigned June 27, 2008) relating to a hydraulic excavator. The agreement was described as Equipment Schedule No. 001 to Master Lease No. CCB5314A

210 The equipment's value at the time of the lease agreement was stated to be $1,484,277.99. The lease term was 60 months. Addendum 4 to the lease agreement called for an initial payment of $148,429.80, with 59 monthly payments of $26,777.34.

211 Addendum 3 to the lease provided that if the lease had not been terminated earlier and if the lessee was not in default, the "Lessee shall... elect for one of the following options" (emphasis added). The three options were to: (1) purchase the equipment on November 15, 2011 (the option date) for $148,429.80 plus taxes (the purchase option price), which was said to be the estimated fair market value of the equipment at that date; (2) find a third party to purchase the equipment on the option date for the purchase option price; or (3) rent the equipment for a further period and periodic rent to be established by the lessor acting reasonably.

212 Clause 27 of the Master Lease provided that if there was a substantial adverse change in Cow Harbour's financial circumstances, the lessor could terminate the lease, at the lessor's sole option.

2. Lease-specific arguments of the parties

(a) Key Equipment

213 Key Equipment argues that the purchase option price was not nominal. Instead, it was an amount to which the parties agreed at the outset to be the estimated fair market value of the equipment at the end of the lease term. Key Equipment takes no position on whether the option can be characterized as mandatory.

214 Key Equipment points out that the termination provision in clause 27 of the Master Lease is common to all Alter Moneta leases (including this one and the one Alter Moneta assigned to Concentra). Key Equipment says that the lease agreement did not contain a guaranteed residual clause and it is a matter of interpretation whether the renewal provision made this an open-ended lease. The lease did not state that it is a full payment lease. Key Equipment submits that all payments under the lease were rent.

(b) Monitor

215 The Monitor submits that this lease was a financing lease since the end of term purchase option price (approximately 10 percent of the original value of the equipment) appears to be arbitrary, rather than bearing some connection to what the actual value of the equipment might be at the time Cow Harbour could exercise the option.

216 The Monitor maintains that the lease overwhelmingly exhibits other ***Smith Brothers*** indicia of a financing lease, which militates against it being considered a true lease. Specifically, ***Smith Brothers*** factors 3 to 10 and 13 to 16 are present, indicating a financing lease. The Monitor points out that the equipment originally was valued at $1,484,297.99 plus applicable tax while the total amount Cow Harbour was to pay during the course of the term was $1,728,292.86 plus applicable tax. Therefore, the aggregate rental approximated the value of the purchase price of the equipment, factoring in interest and carrying costs.

(c) GE

217 GE notes that the aggregate of rental payments exceeded the cost of the equipment, which suggests that this lease agreement was a financing lease. It points out that Cow Harbour was required to purchase the equipment at an option purchase price of $148,429.80 plus tax, find a purchaser for it at the purchase option price, or renew the lease. Cow Harbour could not return the equipment to Key Equipment.

3. Decision

218 Application of the ***Smith Brothers*** factors to the Key Equipment lease produces the following results:

1. Whether there was an option to purchase for a nominal sum - There was an option, but it was not for a nominal sum.
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment - No.
3. Whether the nature of the lessor's business was to act as a financing agency - Yes.
4. Whether the lessee paid sales tax incidental to acquisition of the equipment - Yes.
5. Whether the lessee paid all other taxes incidental to ownership of the equipment - Yes.
6. Whether the lessee was responsible for comprehensive insurance on the equipment - Yes.
7. Whether the lessee was required to pay any licence fees for operation of the equipment at its expense - Yes.
8. Whether the agreement placed the entire risk of loss on the lessee - Yes.
9. Whether the agreement included a clause permitting the lessor to accelerate payment of rent on default by the lessee and granted remedies similar to those of a mortgage - Yes.
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease - Yes.
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment - There was a substantial down payment.
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a UCC financing statement - Not applicable.
13. Whether there was a default provision in the lease inordinately favourable to lessor - Yes.
14. Whether there was a provision in the lease for liquidated damages - Yes.
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor - Yes.
16. Whether the aggregate rentals approximated the value of the purchase price of the equipment - Yes.

219 The purchase option price in this case was approximately 10 percent of the original cost of the equipment, which is not a nominal amount. The parties agreed that this was a pre-estimate of the market value of the equipment at the end of the lease term. Ordinarily, a fair market value option would be highly suggestive of a true lease. In this case, however, Key Equipment was guaranteed the option price, as Cow Harbour was required to exercise the option, find a third party who would pay the option price, or renew the lease for a term and at a rate selected at the sole option of Key Equipment. This was equivalent to a mandatory purchase option. Cow Harbour could not return the equipment to Key Equipment. As Burke stated (at 294):

> ... leases that do not provide the lessee with the option to return the equipment (i.e., the only available options to a lessee at the end of the scheduled term of the lease are either to purchase the leased property or to renew the lease) can be expected to be construed as conditional sales, because the inability of the lessee to return the leased property at the end of the term will likely be construed as effectively requiring the lessee to acquire the leased property.

220 The Key Equipment lease also contained other indicia of a financing lease. This Court concludes that it was a financing lease.

VI. Conclusions

221 This Court categorizes the Disputed Leases as follows:

A. Scott Capital's leases were true leases.
B. CFSL's lease was a true lease.
C. Wajax's leases were true leases.
D. Kempenfelt's leases were financing leases.
E. Concentra's lease was a true lease. The Alter Moneta lease assigned to Concentra was a financing lease.
F. Alter Moneta lease was a financing lease.
G. The Alter Moneta lease assigned to Key Equipment was a financing lease.

222 The true leases are subject to *CCAA* s. 11.01(a).

K.D. YAMAUCHI J.

cp/e/qlcct/qljxr/qlhcs/qlgpr/qlhcs/qlcas/qlgpr

Tab 4

Case Name:

Nortel Networks Corp. (Re)

RE: IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as Amended
AND IN THE MATTER OF a Plan of Compromise or Arrangement of Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation, Applicants
APPLICATION UNDER the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as Amended

[2009] O.J. No. 2558

55 C.B.R. (5th) 68

75 C.C.P.B. 233

2009 CarswellOnt 3583

178 A.C.W.S. (3d) 305

2009 CanLII 31600

Court File No. 09-CL-7950

Ontario Superior Court of Justice
Commercial List

G.B. Morawetz J.

Heard: April 21, 2009.
Judgment: June 18, 2009.

(89 paras.)

Bankruptcy and insolvency law -- Creditors and claims -- Claims -- Priorities -- Unsecured claims -- Motions by unionized and non-unionized former employees for orders requiring Nortel to restore payments to the employees dismissed -- Nortel was granted protection under the Company's Credi-

tors Arrangement Act and was under financial pressure -- The employee claims were unsecured claims and therefore did not have any statutory priority -- Furthermore, the claims were based mostly on services that were provided pre-filing -- There was no reason to treat the unionized or non-unionized employees any differently than other unsecured creditors -- Nortel's resources were to be used to attempt restructuring -- Companies' Creditors Arrangement Act, s. 11.

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Motions by unionized and non-unionized former employees for orders requiring Nortel to restore payments to the employees dismissed -- Nortel was granted protection under the Company's Creditors Arrangement Act and was under financial pressure -- The employee claims were unsecured claims and therefore did not have any statutory priority -- Furthermore, the claims were based mostly on services that were provided pre-filing -- There was no reason to treat the unionized or non-unionized employees any differently than other unsecured creditors -- Nortel's resources were to be used to attempt restructuring -- Companies' Creditors Arrangement Act, s. 11.

Motion by the union for an order requiring Nortel to recommence payments that was obligated to make under the collective agreement. Motion by former employees for an order requiring Nortel to pay termination pay, severance pay and other benefits. Nortel was granted protection under the Company's Creditors Arrangement Act in January 2009. At that time, Nortel ceased making payments of amounts that constituted unsecured claims, including termination and severance payments. The union took the position that Nortel was obligated to make the payments under the collective agreement. The former employees took the position that it would be inequitable to restore payments to unionized former employees and not non-unionized former employees. However, Nortel took the position that its financial pressure precluded it from paying all of the outstanding obligations.

HELD: Motions dismissed. The employee claims were unsecured claims and therefore did not have any statutory priority. Furthermore, the claims were based mostly on services that were provided pre-filing. As a result, there was no reason to treat the unionized or non-unionized employees any differently than other unsecured creditors and Nortel's resources were to be used to attempt restructuring.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 11, s. 11.3

Employment Standards Act, 2000, S.O. 2000, c. 41, s. 5

Labour Relations Act, 1995, S.O. 1995, c. 1, Schedule A,

Counsel:

Barry Wadsworth, for the CAW and George Borosh et al.

Susan Philpott and Mark Zigler, for the Nortel Networks Former Employees.

Lyndon Barnes and Adam Hirsh, for the Nortel Networks Board of Directors.

Alan Mersky and Mario Forte, for Nortel Networks et al.

Gavin H. Finlayson, for the Informal Nortel Noteholders Group.

Leanne Williams, for Flextronics Inc.

Joseph Pasquariello and Chris Armstrong, for Ernst & Young Inc., Monitor.

Janice Payne, for Recently Severed Canadian Nortel Employees ("RSCNE").

Gail Misra, for the CEP Union.

J. Davis-Sydor, for Brookfield Lepage Johnson Controls Facility Management Services.

Henry Juroviesky, for the Nortel Terminated Canadian Employees Steering Committee.

Alex MacFarlane, for the Official Unsecured Creditors Committee.

M. Starnino, for the Superintendent of Financial Services.

ENDORSEMENT

1 **G.B. MORAWETZ J.**:-- The process by which claims of employees, both unionized and non-unionized, have been addressed in restructurings initiated under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (the "CCAA") has been the subject of debate for a number of years. There is uncertainty and strong divergent views have been expressed. Notwithstanding that employee claims are ultimately addressed in many CCAA proceedings, there are few reported decisions which address a number of the issues being raised in these two motions. This lack of jurisprudence may reflect that the issues, for the most part, have been resolved through negotiation, as opposed to being determined by the court in the CCAA process - which includes motions for directions, the classification of creditors' claims, the holding and conduct of creditors' meetings and motions to sanction a plan of compromise or arrangement.

2 In this case, both unionized and non-unionized employee groups have brought motions for directions. This endorsement addresses both motions.

Union Motion

3 The first motion is brought by the National Automobile, Aerospace, Transportation and General Workers Union of Canada (CAW-Canada) and its Locals 27, 1525, 1530, 1535, 1837, 1839, 1905, and/or 1915 (the "Union") and by George Borosh on his own behalf and on behalf of all retirees of the Applicants who were formerly represented by the Union.

4 The Union requests an order directing the Applicants (also referred to as "Nortel") to recommence certain periodic and lump sum payments which the Applicants, or any of them, are obligated to make pursuant to the CAW collective agreement (the "Collective Agreement"). The Union also seeks an order requiring the Applicants to pay to those entitled persons the payments which should have been made to them under the Collective Agreement since January 14, 2009, the date of the CCAA filing and the date of the Initial Order.

5 The Union seeks continued payment of certain of these benefits including:

(a) retirement allowance payments ("RAP");
(b) voluntary retirement options ("VRO"); and

(c) termination and severance payments.

6 The amounts claimed by the Union are contractual entitlements under the Collective Agreement, which the Union submits are payable only after an individual's employment with the Applicants has ceased.

7 There are approximately 101 former Union members with claims to RAP. The current value of these RAP is approximately $2.3 million. There are approximately 180 former unionized retirees who claim similar benefits under other collective agreements.

8 There are approximately 7 persons who may assert claims to VRO as of the date of the Initial Order. These claims amount to approximately $202,000.

9 There are also approximately 600 persons who may claim termination and severance pay amounts. Five of those persons are former union members.

Former Employee Motion

10 The second motion is brought by Mr. Donald Sproule, Mr. David Archibald and Mr. Michael Campbell (collectively, the "Representatives") on behalf of former employees, including pensioners, of the Applicants or any person claiming an interest under or on behalf of such former employees or pensioners and surviving spouses in receipt of a Nortel pension, or group or class of them (collectively, the "Former Employees"). The Representatives seek an order varying the Initial Order by requiring the Applicants to pay termination pay, severance pay, vacation pay and an amount equivalent to the continuation of the benefit plans during the notice period, which are required to be paid to affected Former Employees in accordance with the *Employment Standards Act, 2000* S.O. 2000 c. 41 ("ESA") or any other relevant provincial employment legislation. The Representatives also seek an order varying the Initial Order by requiring the Applicants to recommence certain periodic and lump sum payments and to make payment of all periodic and lump sum payments which should have been paid since the Initial Order, which the Applicants are obligated to pay Former Employees in accordance with the statutory and contractual obligations entered into by Nortel and affected Former Employees, including the Transitional Retirement Allowance ("TRA") and any pension benefit payments Former Employees are entitled to receive in excess of the Nortel Networks Limited Managerial and Non-negotiated Pension Plan (the "Pension Plan"). TRA is similar to RAP, but is for non-unionized retirees. There are approximately 442 individuals who may claim the TRA. The current value of TRA obligations is approximately $18 million.

11 The TRA and the RAP are both unregistered benefits that run concurrently with other pension entitlements and operate as time-limited supplements.

12 In many respects, the motion of the Former Employees is not dissimilar to the CAW motion, such that the motion of the Former Employees can almost be described as a "Me too motion".

Background

13 On January 14, 2009, the Applicants were granted protection under the CCAA, pursuant to the Initial Order.

14 Upon commencement of the CCAA proceedings, the Applicants ceased making payments of amounts that constituted or would constitute unsecured claims against the Applicants. Included were payments for termination and severance, as well as amounts under various retirement and retirement transitioning programs.

15 The Initial Order provides:

(a) that Nortel is entitled but not required to pay, among other things, outstanding and future wages, salaries, vacation pay, employee benefits and pension plan payments;
(b) that Nortel is entitled to terminate the employment of or lay off any of its employees and deal with the consequences under a future plan of arrangement;
(c) that Nortel is entitled to vacate, abandon or quit the whole but not part of any lease agreement and repudiate agreements relating to leased properties (paragraph 11);
(d) for a stay of proceedings against Nortel;
(e) for a suspension of rights and remedies vis-à-vis Nortel;
(f) that during the stay period no person shall discontinue, repudiate, cease to perform any contract, agreement held by the company (paragraph 16);
(g) that those having agreements with Nortel for the supply of goods and/or services are restrained from, among other things, discontinuing, altering or terminating the supply of such goods or services. The proviso is that the goods or services supplied are to be paid for by Nortel in accordance with the normal payment practices.

Position of Union

16 The position of the CAW is that the Applicants' obligations to make the payments is to the CAW pursuant to the Collective Agreement. The obligation is not to the individual beneficiaries.

17 The Union also submits that the difference between the moving parties is that RAP, VRO and other payments are made pursuant to the Collective Agreement as between the Union and the Applicants and not as an outstanding debt payable to former employees.

18 The Union further submits that the Applicants are obligated to maintain the full measure of compensation under the Collective Agreement in exchange for the provision of services provided by the Union's members subsequent to the issuance of the Initial Order. As such, the failure to abide by the terms of the Collective Agreement, the Union submits, runs directly contrary to Section 11.3 of the CCAA as compensation paid to employees under a collective agreement can reasonably be interpreted as being payment for services within the meaning of this section.

19 Section 11.3 of the CCAA provides:

> No order made under section 11 shall have the effect of
>
> (a) prohibiting a person from requiring immediate payment for goods, services, use of leased or licensed property or other valuable consideration provided after the order is made; or
> (b) requiring the further advance of money or credit.

20 In order to fit within Section 11.3, services have to be provided after the date of the Initial Order.

21 The Union submits that persons owed severance pay are post-petition trade creditors in a bankruptcy, albeit in relation to specific circumstances. Thus, by analogy, persons owed severance pay are post-petition trade creditors in a CCAA proceeding. The Union relies on *Smokey River Coal Ltd. (Re)* 2001 ABCA 209 to support its proposition.

22 The Union further submits that when interpreting "compensation" for services performed under the Collective Agreement, it must include all of the monetary aspects of the Collective Agreement and not those specifically made to those actively employed on any particular given day.

23 The Union takes the position that Section 11.3 of the CCAA specifically contemplates that a supplier is entitled to payment for post-filing goods and services provided, and would undoubtedly refuse to continue supply in the event of receiving only partial payment. However, the Union contends that it does not have the ability to cease providing services due to the *Labour Relations Act, 1995*, S.O. 1995, c. 1. As such, the only alternative open to the Union is to seek an order to recommence the payments halted by the Initial Order.

24 The Union contends that Section 11.3 of the CCAA precludes the court from authorizing the Applicants to make selective determinations as to which parts of the Collective Agreement it will abide by. By failing to abide by the terms of the Collective Agreement, the Union contends that the Applicants have acted as if the contract has been amended to the extent that it is no longer bound by all of its terms and need merely address any loss through the plan of arrangement.

25 The Union submits that, with the exception of rectification to clarify the intent of the parties, the court has no jurisdiction at common law or in equity to alter the terms of the contract between parties and as the court cannot amend the terms of the Collective Agreement, the employer should not be allowed to act as though it had done so.

26 The Union submits that no other supplier of services would countenance, and the court does not have the jurisdiction to authorize, the recipient party to a contract unilaterally determining which provisions of the agreement it will or will not abide by while the contract is in operation.

27 The Union concludes that the Applicants must pay for the full measure of its bargain with the Union while the Collective Agreement remains in force and the court should direct the recommencement and repayment of those benefits that arise out of the Collective Agreement and which were suspended subsequently to the filing of the CCAA application on January 14, 2009.

Position of the Former Employees

28 Counsel to the Former Employees submits that the court has the discretion pursuant to Section 11 of the CCAA to order Nortel to recommence periodic and lump-sum payments to Former Employees in accordance with Nortel's statutory and contractual obligations. Further, the RAP payments which the Union seeks to enforce are not meaningfully different from those RAP benefits payable to other unionized retirees who belong to other unions nor from the TRA payable to non-unionized former employees. Accordingly, counsel submits that it would be inequitable to restore payments to one group of retirees and not others. Hence, the reference to the "Me too motion".

29 Counsel further submits that all employers and employees are bound by the minimum standards in the ESA and other applicable provincial employment legislation. Section 5 of the ESA expressly states that no employer can contract out or waive an employment standard in the ESA and that any such contracting out or waiver is void.

30 Counsel submits that each province has minimum standards employment legislation and regulations which govern employment relationships at the provincial level and that provincial laws such as the ESA continue to apply during CCAA proceedings.

31 Further, the Supreme Court of Canada has held that provincial laws in federally-regulated bankruptcy and insolvency proceedings continue to apply so long as the doctrine of paramountcy is not triggered: See *Crystalline Investments Ltd. v. Domgroup Ltd*., [2004] 1 S.C.R. 60.

32 In this case, counsel further submits that there is no conflict between the provisions of the ESA and the CCAA and that paramountcy is not triggered and it follows that the ESA and other applicable employment legislation continues to apply during the Applicants' CCAA proceedings. As a result counsel submits that the Applicants are required to make payment to Former Employees for monies owing pursuant to the minimum employment standards as outlined in the ESA and other applicable provincial legislation.

Position of the Applicants

33 Counsel to the Applicants sets out the central purpose of the CCAA as being: "to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors to the end that the company is able to continue in business". (*Pacific National Lease Holding Corp. (Re)*, [1992] B.C.J. No. 3070, aff'd by 1992, 15 C.B.R. (3d) 265), and that the stay is the primary procedural instrument used to achieve the purpose of the CCAA:

> ... if the attempt at a compromise or arrangement is to have any prospect of success, there must be a means of holding the creditors at bay. Hence the powers vested in the court under Section 11 (*Pacific National Lease Holding Corp. (Re), supra*).

34 The Applicants go on to submit that the powers vested in the court under Section 11 to achieve these goals of the CCAA include:

(a) the ability to stay past debts; and
(b) the ability to require the continuance of present obligations to the debtor.

35 The corresponding protection extended to persons doing business with the debtor is that such persons (including employees) are not required to extend credit to the debtor corporation in the course of the CCAA proceedings. The protection afforded by Section 11.3 extends only to services provided after the Initial Order. Post-filing payments are only made for the purpose of ensuring the continued supply of services and that obligations in connection with past services are stayed. (See *Mirant Canada Energy Marketing Ltd. (Re)*, [2004] A.J. No. 331).

36 Furthermore, counsel to the Applicants submits that contractual obligations respecting post employment are obligations in respect of past services and are accordingly stayed.

37 Counsel to the Applicants also relies on the following statement from *Mirant, supra*, at paragraph 28:

> Thus, for me to find the decision of the Court of Appeal in Smokey River Coal analogous to Schaefer's situation, I would need to find that the obligation to pay severance pay to Schaefer was a clear contractual obligation that was necessary

> for Schaefer to continue his employment and not an obligation that arose from the cessation or termination of services. In my view, to find it to be the former would be to stretch the meaning of the obligation in the Letter Agreement to pay severance pay. It is an obligation that arises on the termination of services. It does not fall within a commercially reasonable contractual obligation essential for the continued supply of services. Only is his salary which he has been paid falls within that definition.

38 Counsel to the Applicants states that post-employment benefits have been consistently stayed under the CCAA and that post-employment benefits are properly regarded as pre-filing debts, which receive the same treatment as other unsecured creditors. The Applicants rely on *Syndicat nationale de l'amiante d'Asbestos inc. v. Jeffrey Mines Inc.* [2003] Q.J. No. 264 (C.A.) ("*Jeffrey Mine*") for the proposition that "the fact that these benefits are provided for in the collective agreement changes nothing".

39 Counsel to the Applicants submits that the Union seeks an order directing the Applicants to make payment of various post-employment benefits to former Nortel employees and that the Former Employees claim entitlement to similar treatment for all post-employment benefits, under the Collective Agreement or otherwise.

40 The Applicants take the position the Union's continuing collective representation role does not clothe unpaid benefits with any higher status, relying on the following from *Jeffrey Mine* at paras. 57 - 58:

> Within the framework of the restructuring plan, arrangements can be made respecting the amounts owing in this regard.
>
> The same is true in the case of the loss of certain fringe benefits sustained by persons who have not provided services to the debtor since the initial order. These persons became creditors of the debtor for the monetary value of the benefits lost further to Jeffrey Mines Inc.'s having ceased to pay premiums. The fact that these benefits are provided for in the collective agreements changes nothing.

41 In addition, the Applicants point to the following statement of the Quebec Court of Appeal in *Syndicat des employées et employés de CFAP-TV (TQS-Quebec), section locale 3946 du Syndicat canadien de la function publique c. TQS inc*., 2008 QCCA 1429 at paras. 26-27:

> [Unofficial translation] Employees' rights are defined by the collective agreement that governs them and by certain legislative provisions. However, the resulting claims are just as much [at] risk as those of other creditors, in this case suppliers whose livelihood is also threatened by the financial precariousness of their debtor.
>
> The arguments of counsel for the Applicants are based on the erroneous premise that the employees are entitled to a privileged status. That is not what the CCAA provides nor is it what this court decided in *Syndicat national de l'amiante d'Asbestos inc. c. Mine Jeffrey inc.*

42 Collectively, RAP payment and TRA payments entail obligations of over $22 million. Counsel to the Applicants submits that there is no basis in principle to treat them differently. They are all stayed and there is no basis to treat any of these two unsecured obligations differently. The Applicants are attempting to restructure for the final benefit of all stakeholders and counsel submits that its collective resources must be used for such purposes.

Report of the Monitor

43 In its Seventh Report, the Monitor notes that at the time of the Initial Order, the Applicants employed approximately 6,000 employees and had approximately 11,700 retirees or their survivors receiving pension and/or benefits from retirement plans sponsored by the Applicants.

44 The Monitor goes on to report that the Applicants have continued to honour substantially all of the obligations to active employees. The Applicants have continued to make current service and special funding payments to their registered pension plans. All the health and welfare benefits for both active employees and retirees have been continued to be paid since the commencement of the CCAA proceedings.

45 The Monitor further reports that at the filing date, payments to former employees for termination and severance as well as the provisions of the health and dental benefits ceased. In addition, non-registered and unfunded retirement plan payments ceased.

46 More importantly, the Monitor reports that, as noted in previous Monitor's Reports, the Applicants' financial position is under pressure.

Discussion and Analysis

47 The acknowledged purpose of the CCAA is to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors to the end that the company is able to continue in business. (See *Pacific National Lease Holding Corp. (Re),* [1992] B.C.J. No. 3070, aff'd by (1992), 15 C.B.R. (3d) 265, at para. 18 citing *Chef Ready Foods Ltd*. v. *Hongkong Bank of Canada* (1990), 4 C.B.R. (3d) 311 (B.C.C.A.) at 315). The primary procedural instrument used to achieve that goal is the ability of the court to issue a broad stay of proceedings under Section 11 of the CCAA.

48 The powers vested in the court under Section 11 of the CCAA to achieve these goals include the ability to stay past debts; and the ability to require the continuance of present obligations to the debtor. (*Woodwards Limited (Re),* (1993), 17 C.B.R. (3d) 236 (S.C.).

49 The Applicants acknowledged that they were insolvent in affidavit material filed on the Initial Hearing. This position was accepted and is referenced in my endorsement of January 14, 2009. The Applicants are in the process of restructuring but no plan of compromise or arrangement has yet to be put forward.

50 The Monitor has reported that the Applicants are under financial pressure. Previous reports filed by the Monitor have provided considerable detail as to how the Applicants carry on operations and have provided specific information as to the interdependent relationship between Nortel entities in Canada, the United States, Europe, the Middle East and Asia.

51 In my view, in considering the impact of these motions, it is both necessary and appropriate to take into account the overall financial position of the Applicants. There are several reasons for doing so:

(a) The Applicants are not in a position to honour their obligations to all creditors.
(b) The Applicants are in default of contractual obligations to a number of creditors, including with respect to significant bond issues. The obligations owed to bondholders are unsecured.
(c) The Applicants are in default of certain obligations under the Collective Agreements.
(d) The Applicants are in default of certain obligations owed to the Former Employees.

52 It is also necessary to take into account that these motions have been brought prior to any determination of any creditor classifications. No claims procedure has been proposed. No meeting of creditors has been called and no plan of arrangement has been presented to the creditors for their consideration.

53 There is no doubt that the views of the Union and the Former Employees differ from that of the Applicants. The Union insists that the Applicants honour the Collective Agreement. The Former Employees want treatment that is consistent with that being provided to the Union. The record also establishes that the financial predicament faced by retirees and Former Employees is, in many cases, serious. The record references examples where individuals are largely dependent upon the employee benefits that, until recently, they were receiving.

54 However, the Applicants contend that since all of the employee obligations are unsecured it is improper to prefer retirees and the Former Employees over the other unsecured creditors of the Applicants and furthermore, the financial pressure facing the Applicants precludes them from paying all of these outstanding obligations.

55 Counsel to the Union contends that the Applicants must pay for the full measure of its bargain with the Union while the Collective Agreement remains in force and further that the court does not have the jurisdiction to authorize a party, in this case the Applicants, to unilaterally determine which provisions of the Collective Agreement they will abide by while the contract is in operation. Counsel further contends that Section 11.3 of the CCAA precludes the court from authorizing the Applicants to make selective determinations as to which parts of the Collective Agreement they will abide by and that by failing to abide by the terms of the Collective Agreement, the Applicants acted as if the Collective Agreement between themselves and the Union has been amended to the extent that the Applicants are no longer bound by all of its terms and need merely address any loss through the plan of arrangement.

56 The Union specifically contends that the court has no jurisdiction to alter the terms of the Collective Agreement.

57 In addressing these points, it is necessary to keep in mind that these CCAA proceedings are at a relatively early stage. It also must be kept in mind that the economic circumstances at Nortel are such that it cannot be considered to be carrying on "business as usual". As a result of the Applicants' insolvency, difficult choices will have to be made. These choices have to be made by all stakeholders.

58 The Applicants have breached the Collective Agreement and, as a consequence, the Union has certain claims.

59 However, the Applicants have also breached contractual agreements they have with Former Employees and other parties. These parties will also have claims as against the Applicants.

60 An overriding consideration is that the employee claims whether put forth by the Union or the Former Employees, are unsecured claims. These claims do not have any statutory priority.

61 In addition, there is nothing on the record which addresses the issue of how the claims of various parties will be treated in any plan of arrangement, nor is there any indication as to how the creditors will be classified. These issues are not before the court at this time.

62 What is before the court is whether the Applicants should be directed to recommence certain periodic and lump sum payments that they are obligated to make under the Collective Agreement as well as similar or equivalent payments to Former Employees.

63 It is necessary to consider the meaning of Section 11.3 and, in particular, whether the Section should be interpreted in the manner suggested by the Union.

64 Counsel to the Union submits that the ordinary meaning of "services" in section 11.3 includes work performed by employees subject to a collective agreement. Further, even if the ordinary meaning is plain, courts must consider the purpose and scheme of the legislation, and relevant legal norms. Counsel submits that the courts must consider the entire context. As a result, when interpreting "compensation" for services performed under a collective agreement, counsel to the Union submits it must include all of the monetary aspects of the agreement and not those made specifically to those actively employed on any particular given day.

65 No cases were cited in support of this interpretation.

66 I am unable to agree with the Union's argument. In my view, section 11.3 is an exception to the general stay provision authorized by section 11 provided for in the Initial Order. As such, it seems to me that section 11.3 should be narrowly construed. (See Ruth Sullivan, *Sullivan on the Construction of Statutes*, 5th ed. (Markham, Ont.: LexisNexis Canada Inc., 2008) at 483-485.) Section 11.3 applies to services provided after the date of the Initial Order. The ordinary meaning of "services" must be considered in the context of the phrase "services, ... provided after the order is made". On a plain reading, it contemplates, in my view, some activity on behalf of the service provider which is performed after the date of the Initial Order. The CCAA contemplates that during the reorganization process, pre-filing debts are not paid, absent exceptional circumstances and services provided after the date of the Initial Order will be paid for the purpose of ensuring the continued supply of services.

67 The flaw in the argument of the Union is that it equates the crystallization of a payment obligation under the Collective Agreement to a provision of a service within the meaning of s. 11.3. The triggering of the payment obligation may have arisen after the Initial Order but it does not follow that a service has been provided after the Initial Order. Section 11.3 contemplates, in my view, some current activity by a service provider post-filing that gives rise to a payment obligation post-filing. The distinction being that the claims of the Union for termination and severance pay are based, for the most part, on services that were provided pre-filing. Likewise, obligations for benefits arising from RAP and VRO are again based, for the most part, on services provided pre-filing. The exact time of when the payment obligation crystallized is not, in my view, the determining factor under section 11.3. Rather, the key factor is whether the employee performed services after the date of the Initial Order. If so, he or she is entitled to compensation benefits for such current service.

68 The interpretation urged by counsel to the Union with respect to this section is not warranted. In my view, section 11.3 does not require the Applicants to make payment, at this time, of the outstanding obligations under the Collective Agreement.

69 The Union also raised the issue as to whether the court has the jurisdiction to order a stay of the outstanding obligations under Section 11 of the CCAA.

70 The Union takes the position that, with the exception of rectification to clarify the intent of the parties, the court has no jurisdiction at common law or in equity to alter the terms of a contract between parties. The Union relies on *Bilodeau et al v. McLean*, [1924] 3 D.L.R. 410 (Man. C.A.); *Desener v. Myles*, [1963] S.J. No. 31 (Q.B.); *Hiesinger v. Bonice* [1984] A.J. No. 281; *Werchola v. KC5 Amusement Holdings Ltd.* 2002 SKQB 339 to support its position.

71 The Union extends this argument and submits that as the court cannot amend the terms of a collective agreement, the employer should not be allowed to act as though it had been.

72 As a general rule, counsel to the Union submits, there is in place a comprehensive regime for the regulation of labour relations with specialized labour-relations tribunals having exclusive jurisdiction to deal with legal and factual matters arising under labour legislation and no court should restrain any tribunal from proceeding to deal with such matters.

73 However, as is clear from the context, these cases referenced at [70] are dealing with the ordinary situation in which there is no issue of insolvency. In this case, we are dealing with a group of companies which are insolvent and which have been accorded the protection of the CCAA. In my view, this insolvency context is an important distinguishing factor. The insolvency context requires that the stay provisions provided in the CCAA and the Initial Order must be given meaningful interpretation.

74 There is authority for the proposition that, when exercising their authority under insolvency legislation, the courts may make, at the initial stage of a CCAA proceeding, orders regarding matters, but for the insolvent condition of the employer, would be dealt with pursuant to provincial labour legislation, and in most circumstances, by labour tribunals. In *Re: Pacific National Lease Holding Corp*. (1992) 15 C.B.R. (3d) 265 (B.C.C.A.), the issue involved the question whether a CCAA debtor company had to make statutory severance payments as was mandatory under the provincial employment standards legislation. MacFarlane J.A. stated at pp. 271-2:

> It appears to me that an order which treats creditors alike is in accord with the purpose of the CCAA. Without the provisions of that statute the petitioner companies might soon be in bankruptcy, and the priority which the employees now have would be lost. The process provided by the CCAA is an interim one. Generally, it suspends but does not determine the ultimate rights of any creditor. In the end it may result in the rights of employees being protected, but in the meantime it preserves the status quo and protects all creditors while a reorganization is being attempted.
>
> ...
>
> This case is not so much about the rights of employees as creditors, but the right of the court under the CCAA to serve not only the special interests of the direc-

> tors and officers of the company but the broader constituency referred to in *Chef Ready Foods Ltd., supra*. Such a decision may invariably conflict with provincial legislation, but the broad purpose of the CCAA must be served.

75 The *Jeffrey Mine* decision is also relevant. In my view, the *Jeffrey Mine* case does not appear to support the argument that the Collective Agreement is to be treated as being completely unaffected by CCAA proceedings. It seems to me that it is contemplated that rights under a collective agreement may be suspended during the CCAA proceedings. At paragraphs 60-62, the court said under the heading Recapitulation (in translation):

> The collective agreements continue to apply like any contract of successive performance not modified by mutual agreement after the initial order or not disclaimed (assuming that to be possible in the case of collective agreements). Neither the monitor nor the court can amend them unilaterally. That said, distinctions need to be made with regard to the prospect of the resulting debts.
>
> Thus, unionized employees kept on or recalled are entitled to be paid immediately by the monitor for any service provided after the date of the order (s. 11.3), in accordance with the terms of the original version of the applicable collective agreement by the union concerned. However, the obligations not honoured by Jeffrey Mine Inc. with regard to services provided prior to the order constitute debts of Jeffrey Mine Inc. for which the monitor cannot be held liable (s. 11.8 CCAA) and which the employees cannot demand to be paid immediately (s. 11.3 CCAA).
>
> Obligations that have not been met with regard to employees who were laid off permanently on October 7, 2002, or with regard to persons who were former employees of Jeffrey Mine Inc. on that date and that stem from the collective agreements or other commitments constitute debts of the debtor to be disposed of in the restructuring plan or, failing that, upon the bankruptcy of Jeffrey Mine Inc.

76 The issue of severance pay benefits was also referenced in *Communications, Energy, Paperworks, Local 721G v. Printwest Communications Ltd*. 2005 SKQB 331 at paras. 11 and 15. The application of the Union was rejected:

> ... The claims for severance pay arise from the collective bargaining agreement. But severance pay does not fall into the category of essential services provided during the organization period in order to enable Printwest to function.
>
> ...
>
> If the Union's request should be accepted, with the result that the claims for severance pay be dealt with outside the plan of compromise - and thereby be paid in full - such a result could not possibly be viewed as fair and reasonable with respect to other unsecured creditors, who will possibly receive only a small fraction of the amounts owing to them for goods and services provided to Printwest in good faith. Thus, the application of the Union in this respect must be rejected.

Disposition

77 At the commencement of an insolvency process, the situation is oftentimes fluid. An insolvent debtor is faced with many uncertainties. The statute is aimed at facilitating a plan of compromise or arrangement. This may require adjustments to the operations in a number of areas, one of which may be a downsizing of operations which may involve a reduction in the workforce. These adjustments may be painful but at the same time may be unavoidable. The alternative could very well be a bankruptcy which would leave former employees, both unionized and non-unionized, in the position of having unsecured claims against a bankrupt debtor. Depending on the status of secured claims, these unsecured claims may, subject to benefits arising from the recently enacted *Wage Earner Protection Program Act*, be worth next to nothing.

78 In the days ahead, the Applicants, former employees, both unionized and non-unionized may very well have arguments to make on issues involving claims processes (including the ability of the Applicants to compromise claims), classification, meeting of creditors and plan sanction. Nothing in this endorsement is intended to restrict the rights of any party to raise these issues.

79 The reorganization process under the CCAA can be both long and painful. Ultimately, however, for a plan to be sanctioned by the court, the application must meet the following three tests:

(i) there has to be strict compliance with all statutory requirements and adherence to previous orders of the court;
(ii) nothing has been done or purported to be done that is not authorized by the CCAA;
(iii) the plan is fair and reasonable. *Re: Sammi Atlas Inc.* (1998), 3 C.B.R. (4th) 171 (Ont. Gen. Div.)

80 At this stage of the Applicants' CCAA process, I see no basis in principle to treat either unionized or non-unionized employees differently than other unsecured creditors of the Applicants. Their claims are all stayed. The Applicants are attempting to restructure for the benefit of all stakeholders and their resources should be used for such a purpose.

81 It follows that the motion of the Union is dismissed.

82 The Applicants also raised the issue that the Union consistently requested the right to bargain on behalf of retirees who were once part of the Union and that the concession had not been granted. Consequently, the retirees' substantive rights are not part of the bargain between the unionized employees and the employer. Counsel to the Applicants submitted that the union may collectively alter the existing rights of any employee but it cannot negatively do so with respect to retirees' rights.

83 The Union countered that the rights gained by a member of the bargaining unit vest upon retirement, despite the fact that a collective agreement expires, and are enforceable through the grievance procedure.

84 Both parties cited *Dayco (Canada) Ltd. v. National Automobile, Aerospace and Agricultural Implement Workers Union of Canada (CAW-Canada)* [1993] 2 S.C.R. 230 in support of their respective positions.

85 In view of the fact that this motion has been dismissed for other reasons, it is not necessary for me to determine this specific issue arising out of the *Dayco* decision.

86 The motion of the Former Employees was characterized, as noted above, as a "Me too motion". It was based on the premise that, if the Union's motion was successful, it would only be equitable if the Former Employees also received benefits. The Former Employees do not have the benefit of any enhanced argument based on the Collective Agreement. Rather, the argument of the Former Employees is based on the position that the Applicants cannot contract out of the ESA or any other provincial equivalent. In my view, this is not a case of contracting out of the ESA. Rather, it is a case of whether immediate payout resulting from a breach of the ESA is required to be made. In my view, the analysis is not dissimilar from the Collective Agreement scenario. There is an acknowledgment of the applicability of the ESA, but during the stay period, the Former Employees cannot enforce the payment obligation. In the result, it follows that the motion of the Former Employees is also dismissed.

87 However, I am also mindful that the record, as I have previously noted, makes reference to a number of individuals that are severely impacted by the cessation of payments. There are no significant secured creditors of the Applicants, outside of certain charges provided for in the CCAA proceedings, and in view of the Applicants' declared assets, it is reasonable to expect that there will be a meaningful distribution to unsecured creditors, including retirees and Former Employees. The timing of such distribution may be extremely important to a number of retirees and Former Employees who have been severely impacted by the cessation of payments. In my view, it would be both helpful and equitable if a partial distribution could be made to affected employees on a timely basis.

88 In recognition of the circumstances that face certain retirees and Former Employees, the Monitor is directed to review the current financial circumstances of the Applicants and report back as to whether it is feasible to establish a process by which certain creditors, upon demonstrating hardship, could qualify for an unspecified partial distribution in advance of a general distribution to creditors. I would ask that the Monitor consider and report back to this court on this issue within 30 days.

89 This decision may very well have an incidental effect on the Collective Agreement and the provisions of the ESA, but it is one which arises from the stay. It does not, in my view, result from a repudiation of the Collective Agreement or a contracting out of the ESA. The stay which is being recognized is, in my view, necessary in the circumstances. To hold otherwise, would have the effect of frustrating the objectives of the CCAA to the detriment of all stakeholders.

G.B. MORAWETZ J.

cp/e/qllxr/qlpxm/qlaxw/qlaxr/qlhcs/qlana

Tab 5

Case Name:

Allarco Entertainment Inc. (Re)

IN THE MATTER OF The Companies' Creditors Arrangement Act R.S.C. 1985, c. C-36, as amended AND IN THE MATTER OF Allarco Entertainment Inc. and Allarco Entertainment 2008 Inc. and Alliance Films Inc.

[2009] A.J. No. 996

2009 ABQB 503

58 C.B.R. (5th) 140

12 Alta. L.R. (5th) 341

[2010] 4 W.W.R. 299

483 A.R. 53

2009 CarswellAlta 1458

180 A.C.W.S. (3d) 569

Docket: 0903 09146

Registry: Edmonton

Alberta Court of Queen's Bench
Judicial District of Edmonton

J.B. Veit J.

Heard: September 2, 3, 8 and 9, 2009.
Judgment: September 14, 2009.

(63 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Application of Act -- Debtor company -- Compromises and arrangements -- Directions -- Eligible financial contract -- Motion by creditor for finding court lacked jurisdiction to vary contract and debtor unable to repudiate contract allowed in part -- Creditor offered debtor right to advertise and broadcast package of programming on pay-per-view channels for overall price -- Initial order varied contract to allow debtor to pay for movies per view -- Initial order forced creditor to provide post-production services without immediate payment since debtor could advertise movies without payment -- Order contrary to CCAA -- Debtor's termination of contract upheld as it negotiated in good faith -- Unreasonable to expect debtor to borrow money to pay contracts.

Bankruptcy and insolvency law -- Proceedings -- Practice and procedure -- Courts -- Jurisdiction -- CCAA matters -- Motion by creditor for finding court lacked jurisdiction to vary contract and debtor unable to repudiate contract allowed in part -- Creditor offered debtor right to advertise and broadcast package of programming on pay-per-view channels for overall price -- Initial order varied contract to allow debtor to pay for movies per view -- Initial order forced creditor to provide post-production services without immediate payment since debtor could advertise movies without payment -- Order contrary to CCAA -- Debtor's termination of contract upheld as it negotiated in good faith -- Unreasonable to expect debtor to borrow money to pay contracts.

Motion by the creditor for an ordering finding the court lacked jurisdiction to vary its contract and a finding the debtor was not able to terminate its contract. The creditor provided the debtor with the right to advertise and broadcast and package of movie programming for an overall price. The debtor operated pay-per-view stations. The debtor applied for protection from creditors and in the initial order, the court accepted its proposal and varied the contract with the creditor to allow the debtor to pay for movies per viewing. The creditor argued that the variation was outside the court's jurisdiction and created a negative incentive for the debtor to use its service. The debtor argued the variation was acceptable because there was a gap in the CCAA with respect to post-production services. The creditor refused to accept per viewing payment and the debtor repudiated from the contracts.

HELD: Motion allowed in part. This was only the initial stages of the CCAA proceedings so it was inappropriate for the court to draw up a contract for parties that had already negotiated one. The pay-per-viewing order was contrary to the CCAA, because it effectively required the creditor to provide post-production services without immediate payment. The contract between the creditor and debtor was for the service of the right to advertise and broadcast movies, not just the right to a single broadcast, so the initial order allowed the debtor to advertise without payment. The initial order was varied to remove the pay-per-viewing order. The debtor was able to terminate the contracts, however. The creditor had attempted to improve its position and become a secured creditor and refused to accept the debtor's proposal. The debtor had attempted to negotiate in good faith and it would be unreasonable to expect the debtor to borrow more money to meet its contract obligations to the creditor.

Statutes, Regulations and Rules Cited:

Bankruptcy Code, s. 503(b)

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 11, s. 11.3(a)

Divorce Act, R.S.C. 1985, c. 3 (2nd Supp.),

Counsel:

Frank R. Dearlove, for the Applicant, Alliance Films Inc.

Charles P. Russell, Q.C., for Allarco Entertainment Inc. and Allarco Entertainment 2008 Inc.

Richard T.G. Reeson, Q.C., for Alberta Treasury Branches.

Michael J. McCabe, Q.C., for Pricewaterhouse Coopers Inc.

David Ullmann, for MGM Television of Canada, a division of Metro-Goldwyn-Mayer Studios, Inc.

Marc-Andre Morin, for Twentieth Century Fox/Incendo Television Distribution Inc. and, Incendo Media Inc.

Harry Fogul, for Twentieth Century Fox/Incendo Television Distribution Inc.

Eric Vallieres, for TVA Films, a division of TVA Group Inc.

Patrick Roche, for Maple Pictures Corp.

Roger P. Simard, for National Bank of Canada.

Andre Bennett, President & CEO, Cinema Esperanza International Inc., for Cinema Esperanza International Inc.

Danny M. Nunes, for NBC Universal.

Bertrand Langlois, CA, VP Finance, Christal Films Distributions Inc., for Christal Films Distributions Inc.

Alan H. Brown, for Starz Media LLC.

Memorandum of Decision

J.B. VEIT J.:--

Summary

1 On June 16, 2009, the Allarco Entertainment companies, which operate Super Channel - a pay-per-view television channel - obtained protection from their creditors pursuant to the provisions of the *Companies' Creditors Arrangement Act*. As part of the initial, *ex parte*, order under the statute, Allarco Entertainment obtained a "pay-per-play" regime in relation to its obligations to Alliance Films Inc., a program supplier. Alliance Films now applies for a variation of the initial order: it argues that the court had no jurisdiction to grant what amounts to a major, unilateral, variation of its contracts with Allarco Entertainment. For an overall fee which was to be paid in instalments, the Alliance contracts allowed Allarco Entertainment to exhibit films and television series, including the right to exhibit through subscription video on demand, for a limited number of times over a specific time period. Alliance asserts that the contract fees are paid for the ongoing right to exhibit the films or series episodes, that there is no "pay-per-play" provision in the contracts, and that the courts should not have imposed such a variation on Alliance.

2 Alternatively, Alliance argues that if the court does have jurisdiction to approve such contract variations, the court should not have exercised its discretion in favour of this variation because a "pay-per-play" regime constitutes a negative incentive on the debtor, Allarco Entertainment, to use the service provided by Alliance.

3 Alliance Films Inc. brought this motion in July, 2009. The court adjourned the motion on the condition that Allarco Entertainment negotiate in good faith with Alliance. The resulting negotiations were unsuccessful. On August 17, 2009, Allarco Entertainment terminated its contracts with Alliance Films. In its amended motion, in addition to asking for a variation in relation to the "pay-per-play" term in the initial order, Alliance also now asks the court to invalidate Allarco Entertainment's terminations.

4 *In its initial order, even if the court did have jurisdiction to vary the Allarco Entertainment/Alliance Film contracts by establishing a different payment structure than the one set out in the contracts, it should not have done so: a post-protection service provider usually has the right to maintain its contract prices.*

5 The CCAA states that where, under licence agreements, a contractor provides new services to a debtor who has obtained creditor protection, that service provider is entitled to "immediate payment"; this is compared to the provider who provided services prior to the granting of creditor protection, whose right to enforce payment is stayed. The CCAA does not state the basis on which compensation is to be paid for post-protection services. Allarco Entertainment argues that the basis for compensation should be "what is just and reasonable"; here, the debtor claims that a "pay-per-play" payment scheme is fair because it will get rid of instalment payments to Alliance, the payment of which will hinder Allarco Entertainment's ability to re-organize. Alliance Films argues that, at this stage of the CCAA proceedings, the court does not have the right to make unilateral contract changes. At this stage of the proceedings, the broad wording of the CCAA, which is remedial legislation, does allow the courts to make some contracts between debtors and creditors: for example, with respect to utilities such as electricity, the court can allow the service provider to be paid not only the usual utility rate but also a security deposit: ***Hydro-Québec.*** Another example is the court's decision that some contract provisions relate to past services, and cannot therefore be enforced, and that other contract provisions relate to post-protection services for which the debtor incurs an obligation of immediate payment: ***Nortel***. These are examples of the limited way in which the courts have jurisdiction to vary contracts in an initial order under CCAA proceedings. It is not necessary to articulate the principle which applies to the jurisdiction of the court in relation to contracts, s. 11.3(a) of the CCAA, and initial orders, but if that were required, it may be that, in the initial order courts have only a limited jurisdiction to affect contractual rights and that contractual payment terms negotiated between debtors and creditors generally represent the payments which debtors are required to make if they use the services set out in those contracts post-protection as that scale of payment best represents both a fair and reasonable price for the services and business in the ordinary course. This principle arises from the common law's respect for contractual obligations. Generally, contracts cannot be varied by courts: contracts represent, in effect, a law which private parties have agreed applies to them. Court can interpret or rectify, but not vary, contracts. Even courts of equity generally limited themselves to deciding which contracts, or portions of contracts, would not be enforced by the justice system. Legislation could, of course, give to the courts the jurisdiction to vary or create contracts; however, given the clear state of the common law on this issue, explicit statutory provisions would be required to give courts a general jurisdiction to vary contracts. Such explicit authority is not given to courts in the CCAA at this stage of proceedings. The court's only authority in the situation here was to distinguish between those portions of the Alliance contracts which represent services that have already been performed, the enforcement of which is stayed, and those portions which deal with the provision of ongoing services, the payment for which Allarco Entertainment was required to make according to the contract if it wished to continue using Alliance's services.

6 *Allarco Entertainment is, however, entitled to terminate its contracts with Alliance Films.*

7 After the issuance of the initial order, Allarco Entertainment negotiated with Alliance in good faith. The granting of protection from creditors is designed to promote such negotiations. Alliance is not required to continue to provide services to Allarco Entertainment post-protection; on the other hand, Allarco Entertainment is entitled to terminate contracts. The court does have a general oversight jurisdiction to determine if the termination of a contract by a debtor is just and reasonable. On this motion, Allarco Entertainment has satisfied that test: among other important aspects of the statutory test, the evidence establishes that, during the negotiations, Alliance Films was attempting to obtain a security status for its contracts which did not exist in its original contracts. Granting new security to Alliance post-protection would have given Alliance an advantage over other Allarco Entertainment creditors. Allarco Entertainment was in fact prevented from acceding to these attempts by Alliance Films.

Cases and authority cited

8 By Alliance Film: ***Thomson Knitting Inc., Re*** [1925] O.J. No. 212, 1925 CarswellOnt 5 (Ont. S.C. in Bankruptcy, App. Div.) citing ***William Hamilton Mfg. Co. v. Hamilton Steel and Iron Co.*** (1911), 23 O.L.R. 270; ***Doman Industries Ltd., Re*** [2003] B.C.J. No. 562, 2003 CarswellBC 538 (B.C.S.C.); ***Skeena Cellulose Inc., Re*** [2003] B.C.J. No. 1335, 2003 CarswellBC 1399 (B.C.C.A); ***Doman Industries Ltd., Re***, [2004] B.C.J. No. 1402, 2004 CarswellBC 1545 (B.C.C.A In Chambers); ***T. Eaton Co., Re*** [1999] O.J. No. 4216, 1999 CarswellOnt 3542 (Ont. S.C.J. [Commercial List]) citing ***Keddy Motor Inns Ltd., Re*** (1992), 13 C.B.R. (3d) 245 (N.S.C.A.); ***Doman Industries Ltd., Re*** [2004] B.C.J. No. 1149, 2004 CarswellBC 1262 (B.C.S.C.); ***Companies Creditors' Arrangement Act,*** R.S.C. 1985, c. C-36, as amended, s. 11.3; ***Stelco Inc., (Re)*** [2005] O.J. No. 1575, 2005 CarswellOnt 1537 (C.A.); ***In Re Enron Corp.*** 279 B.R. 695 (N.Y. Bankr. Gonzalez 2002); ***In Re Kmart Corporation*** 293 B.R. 905; ***In Re Thatcher Glass Corporation*** 59 B.R. 797 at 6 (Banker D. Conn. 1986).

9 By the Allarco Entertainment corporations: ***Lehndorff General Partner Ltd., Re***, 9 B.L.R. (2d) 275 (Ont. Ct. J. (Gen. Div.)); ***T. Eaton Co., Re***, (1997) 46 C.B.R. (3d) 293 (Ont. Ct. J. (Gen. Div.)); ***Nortel Networks Corp., Re***, [2009] O.J. No. 2558, 2009 WL 1763447 (Ont. Sup. Ct.); ***In Re Kmart Corporation, et al., Debtors***, 293 B.R. 905 (Ill. Bankr. Sonderby 2003); ***In Re Enron Corp. et al. Debtors***, 279 B.R. 695 (N.Y. Bankr. Gonzalez 2002); ***Skeena Cellulose Inc., Re***, (2002), 43 C.B.R. (4th) 187 (B.C.S.C.); ***Blue Range Resource Corp., Re***, (2000), 192 D.L.R. (4th) 281 (Alta. C.A.); ***T. Eaton Co., Re***, (1999), 14 C.B.R. (4th) 288 (Ont. S.C.J.); ***Doman Industries Ltd., Re*** (2004), 29 B.C.L.R. (4th) 178 (S.C.); ***Blue Range Resource Corp., Re***, (1999), 245 A.R. 154 (Q.B.); ***New Skeena Forest Products Inc., Re***, 2005 BCCA 192; ***Woodward's Ltd., Re***, (1993), 100 D.L.R. (4th) 133 (B.C.S.C.); ***Campeau v. Olympia & York Developments Ltd.*** (1992), 14 C.B.R. (3d) 303 (Ont. Ct. J. Gen. Div.); ***Air Canada (Re)*** 66 O.R. (3d) 257, [2003] O.J. No. 2976 (C.A.); ***Sagecrest Dixon Inc. (Re)*** [2009] O.J. No. 1127 (Comm.List); ***Air Canada (Re)*** [2003] O.J. No. 6239 (Comm.List).

10 By the court: ***Smith Brothers Contracting Ltd. (Re)*** [1998] B.C.J. No. 728 (B.C. Sup. Ct.); ***West Bay SonShip Yachts v Esau*** 2009 BCCA 31, [2009] B.C.J. No. 120; ***Smoky River Coal (Re)*** 2001 ABCA 209, [2001] A.J. No. 1006; ***Hydro-Québec c Fonderie Poitras ltée*** 2009 QCCA 1416, [2009 J.Q. no 7438; ***Les Boutiques San Francisco Incorporées*** [2004] Q.J. No. 2886.

11 Appendix A: The payment scheme in the initial order

1. Background

12 The following information is uncontested, or if contested, the court is able to come to a conclusion on the existence of a fact without ordering a trial of that issue.

a) Factual

13 The Allarco Entertainment companies operate Super Channel, an English language general interest pay television channel, one of only 3 pay-per-view television channels in Canada. The business of the companies is licensed and regulated by the Canadian Radio-Television and Telecommunications Commission, CRTC. One of the licensing requirements is the delivery of a certain proportion of Canadian content programming, which requirement ensures greater value for programming packages which satisfy that requirement.

14 The Allarco Entertainment companies rely on broadcasting distribution undertakings, BDUs, such as Rogers, Shaw and Bell TV, to sell Super Channel as a programming option. By law, the BDUs are obligated to treat all program networks equally, and not to unfairly encourage their customers to purchase the services of one program network in preference to others. Allarco Entertainment has an ongoing complaint about one of the BDUs, alleging that that distributor has not dealt fairly with Super Channel; this complaint is now the subject of a lawsuit, which is being case managed in Ontario. In a parallel mode, Allarco Entertainment has also laid its complaints against that BDU with the CRTC; there has not yet been a resolution of those complaints by the Commission.

15 When they applied for an initial order under the CCAA, the Allarco Entertainment companies had approximately 425 outstanding program license agreements, PLAs, with various entertainment program suppliers. Although the Allarco Entertainment companies had their own form of PLA which it used whenever possible, some of the more well known program licensors required the Allarco Entertainment companies to enter into the licensors' standard form of PLA. Approximately $64,000,000.00 of programming has been delivered to the Allarco Entertainment companies, for which payment had not been made when those companies applied for protection from their creditors.

16 Allarco Entertainment's PLAs with Twentieth Century Fox are the most significant component of the Super Channel programming cost.

17 Alberta Treasury Branch is the first secured creditor of the Allarco Entertainment companies; it holds general security agreements containing a charge over Allarco Entertainment's present and after acquired personal property. The ATB facility is currently fully drawn. ATB has agreed, on certain conditions, to reestablish the MasterCard facility for Allarco Entertainment. ATB has also indicated to Allarco Entertainment that it is prepared, on certain conditions, to forbear in pursuing recovery under the guarantee of the ATB facility.

18 Alliance has 5 PLAs with Allarco Entertainment. The PLAs typically give to Allarco Entertainment the right to play the programs offered in a package on an exclusive basis. Moreover, the first time an individual program is broadcast, Allarco Entertainment can advertise the play as a premiere, which has added value over and above the rights of exclusive broadcast.

19 When Alliance first brought this motion, it was concerned mainly with two of its program licence agreements with Allarco Entertainment, the January 15, 2008 PLA - Super Channel Q1 08 package - and the February 25th 2008 PLA - Super Channel Q2 08 package. Those agreements are similarly structured. However, there are at least two important terms which are found in the latter agreement which are not found in the former.

20 The first of these terms is:

> Security Interest
>
> Licensee shall grant Licensor a security interest in respect of Licensee's payment obligations and Licensee shall execute and deliver documentation necessary to effect the foregoing.

Although Q2 2008 was agreed to and accepted by the parties on March 31st, 2008, by June 16, 2009, no security documents had been prepared by either Allarco Entertainment or Alliance Films. Alliance characterizes this contractual term as an equitable charge which has all the validity of a legal charge.

21 The second of the terms is:

> Termination Rights
>
> In the event of default by Licensee (including failure to pay amounts when due and/or if assignment for the benefit of creditors, seeks relief under any bankruptcy law or similar law for the protection of debtors, or allows a petition of bankruptcy to be filed against it, or a receiver or trustee to be appointed for substantially all of its assets that is not removed with 30 days), Licensor shall be entitled to terminate or suspend Licensee's rights with respect to programming (i) licensed hereunder; and/or (ii) licensed to Licensee by Licensor pursuant to any other agreement. In the event Licensor decides to terminate Licensee's rights to programming, all rights will automatically revert to Licensor, free and clear of any and all encumbrances and Licensor shall be entitled to immediate possession of all related materials.

In its PLAs which contained termination rights, Alliance did not terminate its contracts with Allarco Entertainment once it knew that Allarco Entertainment had obtained an initial order under the CCAA.

22 Alliance has 3 other PLAs with Allarco Entertainment. Alliance did not focus on these 3 PLAs because no payments are due at this time in relation to those agreements. Of those additional agreements: PLA 2007/2008 Allarco Package does not contain any security or termination clauses; PLA Super Channel Q4-08 package does not contain a security clause but does contain a termination clause; and, PLA Super Channel Q3-08 Package contains both a security clause and a termination clause.

23 In their applications before the Court, Allarco Entertainment has provided the court with this broad stroke explanation of what its Plan of Arrangement might entail:

- sale to a third party investor of a portion or all of the equity in the business, having in mind the value of the existing CRTC license;
- ongoing active involvement in the business by entities related to Charles R. Allard, the sole director of Allarco Entertainment Inc.;
- significant reduction in both the cost of programming and general overhead expense would allow a viable business at a much lower level of subscriber involvement;
- success in the claim against the BDU would increase the number of subscribers;
- injection of funding into the business either by way of equity or further loans.

24 The Allarco Entertainment companies proposed, and in the initial order the court approved, PricewaterhouseCoopers Inc. as the Monitor under these proceedings. The Monitor has not, of course, taken a position on this application; however, the Monitor reports that, to date, it has not uncovered any abusive conduct by the Allarco Entertainment companies.

25 Paragraph 16 of the initial order provided that payment under the PLAs between Allarco Entertainment and various program licensors was to be made in accordance with the terms set out in para. 43 of the affidavit of the President and Chief Operating Officer of the Allarco Entertainment companies. Those terms are set out in appendix A hereto.

26 Since the granting of the initial order, Allarco Entertainment has continued to advertise access to Alliance programming, including subscription on demand, SVOD, rights.

27 The initial order has been extended by court order to September 30, 2009.

28 There is a dispute between the parties about the proportion of the contract payments which Alliance Films has received, and would receive, since the protection order. That issue will be discussed further in relation to the termination by Allarco Entertainment of the Alliance contracts.

29 There is a dispute between the parties concerning the content of the negotiations which preceded the termination by Allarco Entertainment of the Alliance contracts. This dispute will be referred to in the discussion of the termination issue hereunder.

30 As of August 17, 2009, Allarco Entertainment repudiated its contracts with Alliance and noted, "Any damages suffered by Alliance as a result of such repudiation will be dealt with in the claims process in the CCAA proceedings".

31 Although the PLA providers set out in the Appearances section hereunder have been given notice of this application, only MGM has provided evidence and submissions on the motion, although many of the other parties attended the hearing by telephone. MGM is owed in excess of $1,400,000.00 in outstanding claims for licensing fees not paid to it prior to the date of the initial order in these proceedings. MGM would have expected payments in excess of $2,000,000.00 between the date of the initial order and February 2010 in the ordinary course. MGM will continue to provide Allarco with new films, at a discounted price, while MGM defers certain other payments for films which have already been delivered to Allarco. MGM is of the view that the continuation of the CCAA process is in the best interest of MGM and likely in the best interest of many other programming suppliers in these proceedings.

b) Legislative

32 Section 11 of the CCAA reads:

> 11.(1) Notwithstanding anything in the Bankruptcy and Insolvency Act or the Winding-up Act, where an application is made under this Act in respect of a company, the court, on the application of any person interested in the matter, may, subject to this Act, on notice to any other person or without notice as it may see fit, make an order under this section.
>
> (2) An application made for the first time under this section in respect of a company, in this section referred to as an "initial application", shall be accompanied by a statement indicating the projected cash flow of the company and copies of all financial statements, audited or unaudited, prepared during the year prior to the application, or where no such statements were prepared in the prior year, a copy of the most recent such statement.
>
> (3) A court may, on an initial application in respect of a company, make an order on such terms as it may impose, effective for such period as the court deems necessary not exceeding thirty days,
>
> (a) staying, until otherwise ordered by the court, all proceedings taken or that might be taken in respect of the company under an Act referred to in subsection (1);
>
> (b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company; and
>
> (c) prohibiting, until otherwise ordered by the court, the commencement of or proceeding with any other action, suit or proceeding against the company.

(4) A court may, on an application in respect of a company other than an initial application, make an order on such terms as it may impose,

(a) staying, until otherwise ordered by the court, for such period as the court deems necessary, all proceedings taken or that might be taken in respect of the company under an Act referred to in subsection (1);
(b) restraining, until otherwise ordered by the court, further proceedings in any action, suit or proceeding against the company; and
(c) prohibiting, until otherwise ordered by the court, the commencement of or proceeding with any other action, suit or proceeding against the company.

...

(6) The court shall not make an order under subsection (3) or (4) unless

(a) the applicant satisfies the court that circumstances exist that make such an order appropriate; and
(b) in the case of an order under subsection (4), the applicant also satisfies the court that the applicant has acted, and is acting, in good faith and with due diligence.

33 In 1997, the following amendment was made to s. 11 of the BCCA:

11.3 No order made under section 11 shall have the effect of

(a) prohibiting a person from requiring immediate payment for goods, services, <u>use of</u> leased or <u>licensed</u> property or other valuable consideration provided after the order is made; or
(b) requiring the further advance of money or credit.

(Emphasis added)

2. At this stage of the CCAA proceedings, does the court have the jurisdiction to approve unilateral contract changes proposed by Allarco Entertainment to Alliance Film contracts?

34 The short answer to this question is, No.

35 As a prelude to the discussion of the specific issue which is before the court, the court observes that the conclusion reached by Bauman J. in ***Smith Brothers***, a leading decision on the interpretation of s. 11.3 of the CCAA, to the effect that it is the use (emphasis in the original at para. 19) of "leased property, not the making of the lease itself, after the stay order, which is within the purview of s. 11.3(a)" also apply here. The implications of that finding are twofold: the Alliance contracts are "true" licenses within the meaning of ***Smith Brothers*** - which means on the one hand that they are not security documents - and, Alliance cannot be forced to provide the portions of those contracts which relate to the provision of services post-protection without an immediate claim for those services.

36 The nature of the Alliance contracts is that they provide a service - the right to advertise and broadcast the availability of a package of programming - rather than the right to make a single broadcast. The advertising by Allarco Entertainment of the availability of the Alliance Films packages, including SVOB rights, constitutes "use" of the Alliance Films licensed property.

37 Allarco argues that s. 11.3 (a) of the CCAA which entitles a service provider to require immediate payment for services provided after the initial order does not indicate the payment basis on which those services will be provided. Allarco Entertainment suggests that this gap in the legislation is one which the court has the jurisdiction to fill and that the test for determining payment should be what is a just and equitable basis for compensation. Alliance argues that there is no gap, or that if there is a gap, the terms of the contract relating to payment should be accepted as being the proper basis for the provision of post-protection services.

38 To provide guidance in filling the gap, Allarco Entertainment proposes American jurisprudence pursuant to s. 503(b) of the *Bankruptcy Code* which allows a court to give priority treatment to "administrative expenses". However, in order to do so, the court must conclude not only that the debt arises out of a transaction with the debtor in possession, but also that the payment of the debt is beneficial to the operation of the debtor's business. Allarco notes that the concept of "beneficial" is narrowly interpreted, as is to be expected in a regime where those administrative expenses receive priority. For example, in ***Kmart Corporation***, the bankruptcy court asserted that "post-petition performance alone does not automatically translate into a benefit to the estate, even if there was inducement on the part of the debtor"; the same principle was also applied in ***Enron***.

39 I agree with Allarco Entertainment that there is a gap in the CCAA relating to the payment for post-protection services.

40 However, with respect, I disagree with Allarco Entertainment's proposed use of American jurisprudence. As the B.C. Court of Appeal emphasizes in ***West Bay SonShip***, although similar policy objectives inform Canadian and American insolvency legislation, and while certain American decisions might even be persuasive in certain Canadian insolvency situations, in each specific potential use of American jurisprudence care must be exercised to ensure that, in the particular case, both the American legislative scheme is similar to that in Canada and, in the absence of expert evidence on the state of American law, that the American reasoning in a particular case is not conflated with the state of American jurisprudence on the issue.

41 For example, here the Alliance Films PLAs are, in Canadian or Albertan parlance, executory contracts. However, American authorities are not helpful on the treatment of "executory contracts" in the CCAA partly because the specialized interpretation of that term in American bankruptcy law is different from the interpretation of that term in Alberta and perhaps in Canada:

> 31 In "A Joint Report of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals - Joint Task Force on Business Insolvency Law Reform - March 15, 2002", the authors cited the following meanings for "executory contract":
>
> What is an executory contract? Neither the CCAA nor the BIA use the expression, but the United States Bankruptcy Code does in s. 365 ("Code, s. 365"). In general contract law, "executory contract" means a contract under which one or both parties still have obligations to perform. However, in U.S. bankruptcy law the expression is normally given a narrower meaning. According to the most widely accepted definition in the United States, an executory contract for the purposes of Code s. 365 is:
>
>> a contract under which both the obligations of the bankrupt ["A"] under the contract and the other party to the contract ["B"] are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.
>>
>> (Countryman, "Executory Contracts in Bankruptcy" (1974) 57 Minnesota Law Review 439 (Part 1), at 460).

42 More pertinently in this particular case, while there is in the American *Bankruptcy Code* a priority for administrative expenses which include "the actual, necessary costs and expenses of preserving the estate", there is no such limitation in s. 11.3 of the CCAA. Here, all post-protection service providers are entitled to claim immediate payment for their services. Therefore, the American jurisprudence is not, in this particular case, helpful.

43 In any event, however, no decision has been brought to my attention in which an American court has, other than in a utility situation which will be discussed later in the context of Canadian case law, itself calculated a price other than the contract price for the provision of post-protection services. Indeed, the weight of American jurisprudence on the issue appears to be that the contract price is assumed to be a reasonable price unless the debtor can show that the contract price is clearly unreasonable.

44 In the circumstances here, rather than to rely on American jurisprudence for guidance, it is more appropriate to rely on Canadian law and on first principles. As has been noted in much of the jurisprudence which interprets the CCAA, there is jurisdiction in the statute for a court to work out arrangements that will maximize benefits to all affected parties. As our Court of Appeal put it in ***Smoky River Coal, (Re)***:

> 16 CCAA orders become the roadmap for the proceedings and the litigation which may follow. Orders must therefore be drafted with clarity and precision. The purpose of the CCAA must be kept at the forefront in both drafting and interpreting a CCAA order. The CCAA is remedial legislation. As was stated in Re Lehndorff General Partner Ltd. (1992), 17 C.B.R. (3d) 24 (Ont. Gen. Div):
>
>> The CCAA is intended to facilitate compromises and arrangements between companies and their creditors as an alternative to bankruptcy and, as such, is remedial legislation entitled to a liberal interpretation. It seems to me that the purpose of the statute is to enable insolvent companies to carry on <u>business in the ordinary course</u> or otherwise deal with their assets so as to enable a plan of compromise or arrangement to be prepared, filed and considered by their creditors and the court.
>>
>> (Emphasis added)

45 The court's jurisdiction is not, however, unlimited. One limiting feature is the timing of the court's intervention. There is no doubt that, at the stage of the approval or failure of a plan, a court can impose terms on an unwilling creditor. We are not, however, at that stage.

46 At this stage, that is the stage of the initial order, whatever services are provided post-protection are offered by service providers who are entitled to be paid for those services. Generally, two payment regimes will be adopted. One is that ongoing service providers will accept, at least until the presentation of a plan, some new, negotiated, plan. Obviously if the parties to a contract agree to a variation of the terms of that contract, that variation governs. However, a service provider is not required to provide post-protection services without the right to claim immediate payment. If a service provider will not agree to modify its contractual payment terms in order to provide post-protection services, then the debtor must either terminate the contract or pay the contractual amount. In reaching this conclusion, I rely on the fact that, at the stage of the initial order, it would be inappropriate for a court to attempt to draw up a contract for the parties. What the parties have negotiated in a contract should generally be presumed to be a fair and reasonable price for the services provided. Not only are courts not business experts, but the cost of attempting to bring the court up to speed on the reasons that a creditor and a debtor each have for advancing a payment proposal would exhaust the financial capacity of an already insolvent debtor. At the stage of the presentation of a plan, the situation is, of course, different: at that stage the court has much more information on which to rely, including the business acumen of all other creditors.

47 Two exceptions to the general rule that contract terms govern have been identified in the jurisprudence. First, there are utility contracts: see ***Hydro-Québec***. Even though the original contract for service did not contain any form of security payment, a court approved a security deposit as a term of post-protection provision of services. The provision of utilities is, however, a unique form of contract. On the one hand, utility contracts are contracts of adhesion whose payment terms are typically regulated by government or government-established commissions, and, on the other, the debtor does not typically have any choice in service providers. In those circumstances, it is appropriate for a court to set the terms of payment for post-protection services since a utility provider should not be required to provide post-protection services which require the advance of further credit: see s. 11.3(b). It appears that American jurisprudence takes a similar view with respect to utilities: see ***Thatcher Glass***. The crucial nature of utility services requires the intervention of the court where the parties cannot agree on a fee for post-protection services; in other circumstances, a service provider can protect itself by refusing to provide services. These principles are usefully addressed by the Court of Appeal in ***Hydro-Québec***:

> 80 L'alinéa a) de l'article 11.3 de la LACC établit un principe clair : pendant la période de suspension, le fournisseur a droit d'être payé pour les services qu'il rend au fur et à mesure de leur utilisation.
>
> 81 Voici d'ailleurs les commentaires du professeur Richard H. McLaren au sujet de cet article:
>
>> Section 11.3 acts as an exemption to the stay provisions of s. 11 of the CCAA. It appears the section is meant to balance the rights of creditors with debtors. The section addresses the concern that judges had too much discretion in issuing stays. Under s. 11.3(a), if a person supplies goods or services or if the debtor continues to occupy or use leased or licensed property, the court will not issue a stay order with respect to the payment for such goods or services or leased or licensed property. In essence, s. 11.3(a) will not permit the court to prohibit these individuals from demanding payment from the debtor for goods, services or use of leased property, after a court order is made.16
>
> 82 Ce principe connaît cependant des limites pratiques. Il arrive parfois que la

réalité s'oppose à ce que le fournisseur soit payé immédiatement pour les services qu'il fournit à une compagnie débitrice. La fourniture d'électricité en est un exemple patent : il s'agit d'un service continu qu'il est impossible de facturer au fur et à mesure de la consommation.

83 En pareilles circonstances, il est juste et équitable pour le fournisseur de services de demander des garanties de paiement. Commentant la décision Re Smoky River Coal Ltd.17, les auteurs Houlden, Morawetz et Sarra déclarent:

> Under its inherent powers, the court can create a security for creditors who supply goods and services to the debtor after the filing of a CCAA petition and can provide for the priority and ranking of such a security interest with respect to other security holders. If the plan under the CCAA fails, the court can determine who are entitled to share in the proceeds of the security interest.18

...

87 Au sujet du droit applicable, le juge Rolland s'exprime en ces termes:

> [13] Il découle de ce qui précède qu'un fournisseur ne peut exiger d'être payé d'avance pour un service à fournir.
>
> [14] Ainsi, un créancier peut exiger d'être payé immédiatement lors de la livraison, mais pas de recevoir un paiement d'avance pour des services à fournir.
>
> [15] La situation est relativement simple lorsqu'il s'agit d'un bien individualisé, vendu et livré.
>
> [16] <u>Cela peut être plus compliqué dans les cas d'un approvisionnement continu d'un service comme l'électricité, le téléphone ou le gaz.</u>
>
> [17] Exiger de la débitrice qu'elle paie un mois d'avance comme le

> demande Gaz Métro, alors qu'elle entend fermer plus de 30 locaux au cours des prochains jours ou semaines, a pour effet de créer un fardeau trop onéreux pour la débitrice.
>
> [18] La LACC ne fait pas exception quant aux créanciers qu'il s'agisse de fournisseur d'un service continu par opposition à un fournisseur de biens.
>
> [19] Le tribunal a discrétion pour établir une procédure permettant au fournisseur de ne pas être préféré ou pénalisé par rapport aux autres créanciers.
>
> (je souligne)

48 In that particular case, the court concluded that a $42,000.00 guarantee was reasonable in the circumstances.

49 The second exception from the obligation to pay the contract price for post-protection service, an exception which constitutes a lesser intrusion on the freedom of contract than the outright establishment of new payment terms, is the selection by a court from amongst the provisions of one contract of certain services for which the debtor must pay the contract price while other provisions are identified as ones for which the debtor is not immediately required to pay: ***Nortel***. In that case, the contract - a collective agreement - included both payments to persons who were no longer providing service to the debtor and payments to persons who were providing post-protection service to the debtor. The union advanced two arguments in support of its claim that all contract payments should be made post-protection. The first was that the services that had been provided in the past were part of the consideration for services that were being provided post-protection. The second was that, because of a statutory requirement, the union did not have the freedom which most service providers have, to refuse to provide ongoing service to a debtor which has received protection from its creditors. (On this latter point, there is a certain analogy between the union - which could not, for legislative reasons, withdraw its services despite the wording of s. 11.3(a) - and Alliance, which cannot withdraw the services which it provided in three contracts because those contracts grant licences to Allarco Entertainment without termination rights arising on insolvency.) The ***Nortel*** court rejected both arguments. Although the court decided which portions of the contract had to be paid, it did not purport to vary the contractual basis for payment; it merely decided which portions of the contract were eligible for payment post-protection.

50 It appears that a similar approach was taken in ***Les Boutiques San Francisco***: the debtor could either decide to terminate the contract for display shelves, or pay the contract price for those units.

51 There may be other exceptions to the general rule but I have not been provided with any Canadian case law which has identified any such exceptions.

52 The two exceptions to the rule that post-protection services are to be paid according to the contract price reenforce the generality of the rule. Generally, contracts cannot be varied by courts: they can be interpreted or rectified but not varied. Even courts of equity limited themselves to remedies which recognized the basic authority of contracts: a court of equity might, for example, require a contracting party to render proper accounts even though that was not a term of the contract if the rendering of accounts was necessary to enforce the contract. Similarly, a court of equity might grant relief from the consequences of certain contracts - such as contracts that were unconscionable. In other cases, a court might decide that, for public policy reasons, certain contracts, such as gambling contracts, would not be enforced by the justice system.

53 Legislation could, of course, give to the courts a broad jurisdiction to create or vary contracts or to over-ride them. An example of the latter is the *Divorce Act* which provides that a court should taken into account any contract between the parties in relation, for example, to spousal support, but that the court is not limited in making a spousal support order by the terms of the contract between the parties.

54 Given the respect for contracts in the common law, explicit statutory provisions are required to give courts the jurisdiction to impose unilateral variations in contracts. Such explicit authority is not given to courts in the CCAA at the initial order stage.

55 Moreover, as was noted at the outset, it is important to correctly identify the nature of the Alliance PLAs: these are not pay-per-play contracts, but rather contracts which allow Allarco Entertainment to advertise the availability of Alliance product without in fact broadcasting Alliance product. The effect of imposing a pay-per-play payment term on Alliance at this stage would be to impose upon Alliance the obligation to provide a continuing service - allowing Allarco Entertainment to continue to advertise the availability of Alliance programming - without providing payment for that service. Indeed, as Alliance has emphasized, Allarco Entertainment's web-site continued, post-protection, to advertise Alliance programming. It is not necessary on this application to determine whether forcing Alliance to continue to provide its services to Allarco Entertainment can also be characterized as requiring Alliance to make a further advance of credit to Allarco.

56 For the reasons set out above, having now heard argument from the party affected, this court varies para. 16 of its initial, *ex parte*, order by removing the reference to para. 43(b) of the Knox affidavit and replacing it with a reference to the contractual payments due to Alliance.

3. Should the court invalidate Allarco Entertainment's termination of the Alliance Films contracts?

57 The short answer to this question is, No.

58 Alliance correctly states that the statutory right of a debtor which has obtained protection from its creditors to terminate contracts is subject to judicial oversight. Alliance argues that it is not reasonable for Allarco Entertainment to terminate its contracts because:

- Allarco was able to obtain a "pay-per-play" clause and they should therefore be required to honour the contracts;
- the exchanges between Allarco and itself establish that Allarco was intent on obtaining a "pay-per-play" provision to give itself additional, inappropriate, power in its negotiations with Alliance;
- it is not appropriate for Allarco Entertainment to defend its actions by starting from the proposition that it has only so much cash available; rather, Allarco should be required to raise additional funds;
- Allarco Entertainment did not negotiate in good faith.

59 For the purpose of this application, the court sets the following test which Allarco Entertainment must meet for termination of its contracts with Alliance Films: the termination must be fair, appropriate, reasonable, and must have been issued after good faith negotiations. I have concluded that Allarco Entertainment meets that test.

60 In coming to that conclusion, the most important of the reasons considered by the court is the evidence that Alliance attempted, during the negotiations, to become a secured creditor, an effort that would have given Alliance an unfair advantage over other Allarco Entertainment creditors. The fact that Alliance was negotiating for such security benefits is acknowledged by Alliance; it takes the position, however, that this was not a "new" feature since some of its contracts contained provision for granting security. With respect, this is not defensible. Each contract must be enforced on its own; three of the Alliance contracts did not contain a security clause. With respect to those agreements, the addition of a security clause would be "new". Moreover, even with respect to those two contracts which did contain a security clause, no security documents had been executed.

61 In addition to the grave concern about Alliance attempting to improve its position relative to other debtors, there are other factors which the court weighs in Allarco Entertainment's favour in concluding that it should not invalidate Allarco's termination of Alliance contracts:

- while it is true that, during the negotiations, Allarco Entertainment was the beneficiary of a "pay-per-play" regime and had thus obtained what it wanted relative to Alliance as a creditor, Allarco Entertainment was also aware that Alliance had attacked the legitimacy of that provision. While on this motion Allarco valiantly argued in favour of the "pay-per-play" regime relative to Alliance, it is not unreasonable to assume that Allarco also came to an informed decision that it was at least vulnerable on that issue;

- there was a reasonable business basis for Allarco Entertainment's original application for a "pay-for-play" regime relative to Alliance. It appears to me that the main business argument in Allarco's failure is that substantial ongoing payments to Alliance throughout the year as opposed to what the evidence describes as the overwhelming position in other contracts which provide for payments at the beginning and at the end of the licence period, or at the beginning, after 12 months and at the end of the licence period seriously hamper Allarco's attempts to establish a plan which would allow them to go forward rather than to fall into bankruptcy;

- there is a dispute between Allarco Entertainment and Alliance about the cost to Alliance of the "pay-per-play" provision: Allarco states that it had paid more than 5 cents on the dollar of contractual obligations. Alliance states that termination of its contracts will place it in a worse position that the PLA providers with whom Allarco has been able to reach an accommodation. While it may be true that termination will be less advantageous to Alliance than going forward on some accommodation basis, part of the point of the CCAA is to allow for the termination of some contracts so long as the test for termination is met;

- similarly, it is a reasonable business concern of Allarco's to have fresh programming to offer potential subscribers and that such programming not consist solely of leftovers from other potential licensees;

- it would not make sense to impose upon an insolvent company the obligation to borrow more money in order to meet all its debts before it terminated certain of its contracts. Such an inflexible rule would make an effective reorganization impossible. On the evidence on this motion, at this stage of the CCAA proceedings, Allarco Entertainment has made reasonable arrangements with its banker and guarantor;

- there is no evidence that Allarco negotiated in bad faith. Rather, the evidence suggests that Allarco was attempting to make reasonable accommodations with Alliance. For example, it is not reasonable that Allarco should be required to take only that programming which has been refused by all other potential licensees. Nor is it the case that Alliance is irrevocably linked to Allarco: Alliance has other markets to which it can offer its programming;

- finally, the opinion of MGM - a creditor which is roughly in the same position relative to Allarco Entertainment as is Alliance - that there have been significant changes in the business of all affected companies which legitimizes the writing down of entertainment packages for the purposes of the development of a CCAA plan supports the general approach which Allarco Entertainment has taken in the negotiations.

62 Although Alliance Film's notice of motion requests an order invalidating Allarco Entertainment's termination of the Alliance Films contract, at the hearing Alliance suggested that what it really wanted was a determination of the variation agreement first. If that issue were resolved in its favour, Alliance then hoped that further negotiations with Allarco Entertainment would be possible. Alliance suggested that even if Allarco Entertainment were to maintain its termination of the contracts, then Alliance may require some additional evidence to support its position that the termination should not be approved. With respect, I cannot adopt that approach. The determination about whether a termination at this stage meets the required test should be made as close as possible to the date of termination in order to ensure that the court has the same overall perspective as did the parties as of the date of termination.

4. Costs

63 If the parties are not agreed on costs, I may be spoken to within 30 days of the release of this decision.

J.B. VEIT J.

* * * * *

Appendix A

The following are the portions of para. 43 of Mr. Knox's first affidavit which are incorporated by reference in para. 16 of the initial court order:

(a) For those existing Program License Agreements in which the fee for delivery of a single broadcast, such as a prize fight, must be paid upon delivery of that Program, the cash flow contemplates such payment as each Program is delivered;

<u>(b) In the case of those existing Program License Agreements with fixed terms and with a limited number of Exhibition Days, and where the license window is already open, the Cash Flow Projections have been prepared based upon a formula where the overall cost of the Contract is divided by the total number of Exhibition Days permitted, with that Exhibition Day rate being applied for the number of Exhibition Days the Business actually runs that program during the</u>

Cash Flow Projection period;

(c) For existing Program Licensing Agreements which provide for monthly payments, those payments falling due during the CCAA proceedings will be paid;

(d) As a license window opens during the CCAA Proceedings on a Licensing Agreement now in existence, license fees shall be paid in accordance with that Licensing Agreement; and

(e) For Programming which is obtained by the Business during the CCAA Proceedings under Licensing Agreements not now in existence, the licensing fees shall be paid in accordance with the terms of each such Program License Agreement.

(Emphasis added)

The only program licence agreements which come within the terms set out in para. (b) above are the Alliance Films Inc. PLAs.

cp/e/qlcct/qlpwb/qlltl/qlmxl/qlaxw/qlhcs/qlcas/qlcas/qlcas/qlana

Tab 6

Indexed as:

Smith Brothers Contracting Ltd. (Re)

IN THE MATTER OF The Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36
AND IN THE MATTER OF The Company Act, R.S.B.C. 1996, c. 62
AND IN THE MATTER OF Smith Brothers Contracting Ltd., Smith's Heavy Hauling Ltd., Cottonwood River Holdings Ltd. and T.R. Grading Ltd., petitioners

[1998] B.C.J. No. 728

53 B.C.L.R. (3d) 264

13 P.P.S.A.C. (2d) 316

78 A.C.W.S. (3d) 871

Prince George Registry No. 03189

British Columbia Supreme Court
Prince George, British Columbia

Bauman J.

Heard: February 2, 1998.
Judgment: filed March 31, 1998.

(27 pp.)

Creditors and debtors -- Debtors' relief legislation -- Companies' creditors arrangement legislation -- Stay of proceedings against debtor.

Application by Ford Credit for leave to terminate one conditional sales contract and eight leases held by Smith Brothers in nine Ford trucks, and to seize the vehicles. The central issue involved the interpretation of section 11(3) of the Companies' Creditors Arrangement Act. In December 1997, a stay order was made under section 11 of the Act. There were lease/option agreements which provided that a defaulting lessee was liable for the lease payments for the unexpired term. However, sums received from the sale of the vehicle at the end of the lease term were to be subtracted from the amount owed.

HELD: Application dismissed. Section 11.3(a) extended to payment for use of property after the date of the stay order. By crediting the lessee with the excess sum, the document was implicitly ensuring that even a defaulting lessee would enjoy whatever equity he or she had built up in the vehicle. The lessee was not simply paying for use of the vehicle but was potentially acquiring equity therein. Only payments for the use of leased vehicle were excepted from a section 11 stay order under section 11.1(a). Section 11.3(a) did not cover all types of lease arrangements, and those in this case were within the class of arrangement not included.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, ss. 11, 11.3(a).

Counsel:

Jan Christianson, for the petitioners.
B.J. Brown, for Ford Credit Canada Ltd.
J.K. Dungate, for G.E. Capital Canada Equipment Financing Inc. and G.E. Capital Canada Leasing Services Inc.
M.J. Brecknell, for Toronto Dominion Bank.
D. Marcotte, for Bank of Nova Scotia.

BAUMAN J.:--

I INTRODUCTION

1 Ford Credit Canada Ltd. ("Ford Credit") brings this application in the context of proceedings commenced by the petitioners (collectively "Smith Brothers") under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 (the "CCAA").

2 Ford Credit seeks leave of the court to terminate one conditional sales contract and eight "leases" held by Smith Brothers in respect of nine Ford trucks. I put "leases" in quotation marks because the characterization of these documents is at the heart of the controversy before me.

3 The central issue involves the proper interpretation of s. 11.3(a) of the CCAA. This subsection was added to the Act as part of amendments proclaimed in force on 30 September 1997. It creates a specific exception to a s. 11 stay order. It reads:

> 11.3 No order made under s. 11 shall have the effect of
>
> (a) prohibiting a person from requiring immediate payment for goods, services, use of leased or licenced property or other valuable consideration provided after the order is made;

4 By the date of hearing, Smith Brothers had voluntarily returned four of the leased vehicles to Ford Credit.

II RELIEF SOUGHT

5 On 19 December 1997, Mr. Justice Meiklem made the initial stay order under s. 11 of the CCAA (the "Stay Order"). It was effective until 18 January 1998. It was extended to 26 January 1998 by the order of Mr. Justice R. D. Wilson on 12 January 1998. It was further extended until dismissal of the petition or further order of the court by the order of Mr. Justice Williamson made 26 January 1998.

6 Two clauses in the Stay Order are potentially relevant on the facts before me.

7 The first is at page 4, paragraph (i) of the Stay Order. In its essential terms this paragraph reads:

> (i) All persons having agreements with the petitioner (sic) whether written or oral for the supply of goods or services to the petitioner (sic) (including, without limitation, leases of goods, . . . equipment leases, . . .) are enjoined from accelerating, terminating, determining or cancelling such agreements and that such person shall continue to supply the goods or services pursuant to the provisions of such agreements so long as the petitioner pays the prices or charges under the agreements for such goods or services incurred . . . after the Filing Date concurrently with such supply . . .

8 I conclude that the payment proviso in this paragraph, to the extent that it covers leased property, is simply a reflection of the limitation on any stay order found in s. 11.3(a) of the CCAA.

9 The second relevant clause is paragraph (j) on page 5 of the Stay Order. It reads in part:

> (j) All persons having other agreements or other contracts with the Petitioner are restrained and enjoined from accelerating, terminating, determining or cancelling such agreements or acting upon any right or forfeiture (sic) (statutory, contractual or otherwise) without the consent of the petitioner, or leave of this court and that all such persons shall continue to perform and observe the terms, conditions and provisions contained in such agreements on their part to be performed or observed. . .

10 The interplay between these clauses and s. 11.3(a), on the facts at bar, raises a number of possibilities. If Ford Credit can bring its agreements under s. 11.3(a), it may demand payment for the use of the vehicles after the Filing Date without leave of the court. This is so under s. 11.3(a) and it is buttressed (perhaps unnecessarily) by the payment proviso in clause (i) of the Stay Order.

11 If, on the other hand, s. 11.3(a) is not engaged, in order to demand payment and thereafter seize the vehicles, Ford Credit would require the written consent of the petitioners or leave of the court under clause (j) of the Stay Order.

12 I say immediately that if Ford Credit is before the court under clause (j), I am not inclined to grant leave because that would tend to undermine Smith Brothers' efforts to rearrange its affairs under the CCAA before the merits of that arrangement have been considered. It would, as well, do so in a manner tending to favour Ford Credit -- only one of many creditors.

13 I turn to Ford Credit's Notice of Motion.

14 It seeks leave of the court permitting it to terminate "all contracts and vehicle leases with Smith Brothers Contracting Ltd." and to seize the vehicles. It seeks this relief "pursuant to the order of Mr. Justice Meiklem granted December 19, 1997 herein".

15 This leads to a number of observations. First, if Ford Credit can bring itself within clause (i) of the Stay Order, leave of the court to do that which it proposes is not necessary in light of the payment proviso. Further, or perhaps more properly of initial importance, s. 11.3(a) precludes anything in the Stay Order from preventing Ford Credit, if it can bring itself within the terms of the section, from demanding payment for the use of the vehicles after the Filing Date. I interject to say that I construe s. 11.3(a) to mean that if one can require immediate payment for the use of leased property after the Stay Order is made, impliedly one is then entitled, in the absence of payment, to retake the goods (if, of course, that remedy is reserved to the lessor).

16 Third, it follows that by seeking leave, Ford Credit must be doing so under clause (j) of the Stay Order. This is obviously not the basis upon which Ford Credit has put its case and accordingly I will consider its application as one seeking the direction of the court on the applicability of s. 11.3(a) (and clause (i) of the Stay Order) to the arrangements covering the vehicles. To the extent that Ford Credit is unable to bring itself within s. 11.3(a), I have considered the possibility of granting leave under clause (j) but choose not to for the reasons set out above.

III THE MERITS

17 I can deal quickly with the conditional sales agreement covering the 1993 Ford F 350 Crewcab. It is neither in form nor substance a lease of property and accordingly it comes within clause (j) of the Stay Order. Leave is not granted in respect of this vehicle.

18 The "leases" present an issue of considerable difficulty and require a consideration of the breadth of s. 11.3(a) of the CCAA, which, I am told by counsel, is a matter of first impression. My research has suggested this as well.

19 I will first deal with what is in the nature of a threshold issue, that is, whether s. 11.3(a) extends to a lease of property made before the stay order. I conclude that it does, in respect of payment for use of that property after the date of the stay order. If s. 11.3(a) was intended to apply only to leases entered into after the stay order, one would expect the section to read to the effect:

> 11.3 No order made under section 11 shall have the effect of
>
> (a) prohibiting a person from requiring immediate payment <u>for</u> goods, services, <u>leased or licensed property</u> or other valuable consideration <u>provided after the order is made</u>. (underlining added)

By instead wording the section as it has, Parliament, to my mind, is saying that it is the provision of the <u>use</u> of leased property, not the making of the lease itself, after the stay order, which is within the purview of s. 11.3(a).

20 This view is supported by what scant academic writing on the section there is at this time. In L.W. Houlden and G.B. Morawetz Bankruptcy and Insolvency Law of Canada, 3rd Ed. (Toronto: Carswell), the learned authors note in their commentary on s. 11.3:

> (13) Suppliers of Goods and Services or Rental of Property to the Debtor after the Filing of a Plan.
>
> If a person supplies goods and services or the debtor continues to occupy or use leased or licensed property, no stay order can be made in respect of such goods and services or leased or licensed property: s. 11.3.

21 It is the essential submission of Smith Brothers that a "lease" for the purposes of s. 11.3(a) should be narrowly construed. It is argued that an arrangement which may partake in part of a "lease" at law should not be so construed for the purpose of s. 11.3(a) if, upon close analysis, it is more than a true lease or rental agreement. This would be the case if, for example, it is essentially a financing arrangement facilitating the eventual acquisition of the vehicle.

22 In pursuing this submission Smith Brothers cites cases considering the lease/conditional sales contract dichotomy in the context of personal property security legislation across Canada.

23 For the purposes of this discussion I will use Professor R.C.C. Cuming's definition of a "true lease":

> . . . the term "lease" is used to refer to any transaction denominated a lease by the parties. A lease which is in substance a bailment contract is referred to as a true lease. A lease which is not a bailment, but a disguised security agreement is referred to as a security lease or security agreement. "True Leases and Security Leases Under Canadian Personal Property Security Acts" (1983) 7 Can. Bus. L.J. 251 at 256.

24 Ford Credit responds by submitting that nothing in s. 11.3(a) requires the court to invoke a PPSA analysis in construing the phrase "leased property". There is nothing ambiguous, it is urged, about that term or about the concept of a "lease" at law. In particular, Ford Credit says that there is no reason to read down "lease" for the purposes of s. 11.3(a) of the CCAA, which, it is said, is effectively the submission of the petitioners.

25 Obviously the phrase "leased property" requires some construction and any arrangement which purports to be a lease of property must be analyzed to ensure that it is one within the meaning of s. 11.3(a). To hold otherwise would permit creditors to so arrange the form of their contracts to avoid one of the major objectives of the CCAA, that is:

> . . . to facilitate the making of a compromise or arrangement between an insolvent debtor company and its creditors to the end that the company is able to continue in business [per Gibbs J.A. in Hongkong Bank of Canada v. Chef Ready Foods Ltd. (1990), 4 C.B.R. (3d) 311 (B.C.C.A.) at 315].

26 In my view, one must have regard to the substance rather than simply the form of the arrangement in considering the application of s. 11.3(a).

27 Having said what may be obvious, it is still necessary to consider whether s. 11.3(a) covers all leases or only those which might be characterized as true leases. Is a lease which is more than that -- what I will call a "Lease Plus" -- excluded from the effect of s. 11.3(a) on a proper construction thereof?

28 The most common form of Lease Plus, and the one which is at bar, is a lease with an option to purchase.

29 Smith Brothers says that it has historically acquired vehicles and equipment for its logging concern through a variety of methods. These include conditional sales agreements, term loans with chattel mortgages, and lease/option agreements. Each arrangement is essentially an alternative method of acquiring vehicles and equipment, although Smith Brothers admits that it has not always exercised its options to purchase leased property.

30 If s. 11.3(a), properly construed, elevates form over substance, then anomalies arise under the CCAA. As in the case at bar, property acquired by way of lease/option can be lost to the debtor while that acquired by term loan or conditional sales agreement would not (at least not without the leave of the court).

31 The critical issues, then, are whether s. 11.3(a) is to be construed as covering all leases, including all forms of Lease Plus, or whether it is to be confined to "true leases" and if so, what are the criteria upon which certain forms of Lease Plus are to be excluded?

32 Much PPSA litigation has of course concerned itself with whether a document in the form of a lease is nevertheless to be considered a financing agreement.

33 However, it will be observed that the need and basis for segregating various types of leases is expressly dictated by the PPSA. That is, the legislation distinguishes between a true lease and one which creates a security interest, that is one which in reality secures payment or performance of an obligation.

34 There is no express need to distinguish between forms of leases under s. 11.3(a) of the CCAA. Does a proper construction of the section imply that need?

35 I approach the construction of s. 11.3(a) by considering the intention of Parliament and the object and scheme of the CCAA.

36 The Court of Appeal considered the purposes of the CCAA in Chef Ready Foods Ltd., supra.

37 Mr. Justice Gibbs made reference to S. E. Edwards, "Reorganization Under the Companies' Creditors Arrangement Act" (1947), 25 Can. Bar Rev. 587 as explaining "very well the historic and continuing purposes of the Act" (at 318):

> It is important in applying the C.C.A.A. to keep in mind its purpose and several fundamental principles which may serve to accomplish that purpose. Its object, as one Ontario judge has stated in a number of cases, is to keep a company going despite insolvency. Hon. C. H. Cahan when he introduced the bill into the House of Commons indicated that it was designed to permit a corporation, through reorganization, to continue its business, and thereby to prevent its organization being disrupted and its goodwill lost. It may be that the main value of the assets of a company is derived from their being fitted together into one system and that in-

> dividually they are worth little. The trade connections associated with the system and held by the management may also be valuable. In the case of a large company it is probable that no buyer can be found who would be able and willing to buy the enterprise as a whole and pay its going concern value. The alternative to reorganization then is often a sale of the property piecemeal for an amount which would yield little satisfaction to the creditors and none at all to the shareholders.
>
> (Gibbs J.A. quoting Edwards)

38 Mr. Justice Gibbs was considering whether the CCAA could operate to stay a bank's realization under a s. 178 Bank Act security. In holding that it could, Mr. Justice Gibbs noted that Canadian courts "have shown themselves partial to a standard of liberal construction which will further the policy objectives" of the CCAA (at 320). [On the purpose and object of the CCAA see also Repap British Columbia Inc. (Re), [1998] B.C.J. No. 33, (9 January 1998), Vancouver A970588 (B.C.S.C.) and Starcom International Optics Corp. [1998] B.C.J. No. 506, (6 March 1998), Vancouver A980298 (B.C.S.C).]

39 Chef Ready Foods Ltd., supra was considered by the Ontario Court of Appeal in Nova Metal Products Inc. v. Comiskey (Trustee of) (1990), 1 O.R. (3d) 289, 1 C.B.R. (3d) 101.

40 Finlayson J.A. (Krever J.A. concurring) said this of the purpose of the CCAA (at O.R. 297):

> It is well established that the CCAA is intended to provide a structured environment for the negotiation of compromises between the debtor company and its creditors for the benefit of both. Such a resolution can have significant benefits for the company, its shareholders and employees. For this reason the debtor companies, Elan and Nova, are entitled to a broad and liberal interpretation of the jurisdiction of the court under the CCAA.

Doherty J.A. dissented, but his views on the purpose and objects of the CCAA reflect those of Gibbs J.A. in Chef Ready Foods Ltd., supra Mr. Justice Doherty writes (at O.R. 306-307):

> The legislation is remedial in the purest sense in that it provides a means whereby the devastating social and economic effects of bankruptcy or creditor initiated termination of ongoing business operations can be avoided while a court supervised attempt to reorganize the financial affairs of the debtor company is made. . . . The Act must be given a wide and liberal construction so as to enable it to effectively serve this remedial purpose, Interpretation Act R.S.C. 1985, c. I-21, s. 12; Chef Ready Foods Ltd. v. HongKong Bank of Canada, supra (sic), at p. 14 of the reasons.

41 I approach s. 11.3(a) with that spirit, that is, with the perspective that a liberal construction which furthers the policy objectives of the Act will dictate a narrow construction of the types of arrangement which are excepted from a stay order under s. 11.3(a). I underline, however, that any such construction must be intellectually defensible on the basis of the words which Parliament has used in the section -- I am not to redraft the section in the guise of construing it.

42 The decision of the Court of Appeal in Quintette Coal Ltd. v. Nippon Steel Corp. (1990), 51 B.C.L.R. (2d) 105 is also of assistance.

43 There, certain Japanese corporate debtors of Quintette Coal Ltd. ("Quintette") sought to set off monies owing to them by Quintette against payments due Quintette for deliveries of coal. Quintette was then under CCAA protection and the issue centered on the scope of s. 11 and the jurisdiction to restrain the proposed setoff.

44 Gibbs J.A. cited numerous decisions on s. 11 and concluded (at 113):

> To the extent that a general principle can be extracted from the few cases directly on point, and the others in which there is persuasive obiter, it would appear to be that the courts have concluded that under s. 11 there is a discretionary power to restrain judicial or extra judicial conduct against the debtor company the effect of which is, or would be, seriously to impair the ability of the debtor company to continue in business during the compromise or arrangement negotiating period. The power is discretionary and therefore to be exercised judicially. It would be a reasonable expectation that it would be extremely unlikely that the power would be exercised where the result would be to enforce the continued supply of goods and services to the debtor company without payment for current deliveries, whereas it would not be unlikely when the result would be to enforce payment for goods thereafter taken from or services thereafter received from the debtor company, as is the case here. In cases not involving the supply or receipt of goods or services, no doubt judicial exercise of the discretion would produce a result appropriate to the circumstances.
>
> The order made by Mr. Justice Thackray was in accord with his understanding of the "overall intention of the Act" and consistent with the reported cases. It falls well within the "general principle" distilled from those cases. At p. 199, after considering the submissions of counsel for the Japanese companies, he said:
>
>> I must look to the overall intention of the Act, and, as has been put before me by Quintette, what is required within an order to allow Quintette the time to reorganize and make a proposal. Unless there is a sound legal principle for doing so, I must not carve out one portion of the order and give an advantage to one creditor over another. I have not acceded to the arguments of counsel for J.S.I. and consequently I cannot find the legal basis for compromising the effect of the ex parte order.

45 It is interesting that Gibbs J.A. suggested that it would be unlikely that a court would exercise its s. 11 jurisdiction:

> . . . where the result would be to enforce the continued supply of goods and services to the debtor company without payment for current deliveries . . .

46 Parliament has now precluded that by adding s. 11.3(a) to the CCAA. It is instructive to note, however, that the subsection has been added against the backdrop of jurisprudence which has underlined the very broad scope of the court's jurisdiction to stay proceedings under s. 11.

47 To repeat the relevant portion of the section:

> 11.3 No order made under s. 11 shall have the effect of
>
> (a) prohibiting a person from requiring immediate payment for . . . use of leased or licenced property. . . provided after the order is made;

It is noted that the remedy which is preserved for creditors is a relatively narrow one; it is the right to require immediate payment for the use of the leased property.

48 "Payment for use" is the essential basis of a true lease covering personal property. As Professor Cuming notes (in "True Leases", supra, at 263):

> Under a true lease, the lessor surrenders his possessory right in chattels to the lessee in return for an undertaking by the lessee to perform certain acts which usually involve the payment of money to the lessor. The lessee has obligations, but the transaction cannot be characterized as a security agreement because the interest of the lessor is not related to those obligations. In other words, the lessor does not remain owner merely to ensure or to induce performance of the lessee's obligations. He remains owner because a bailment contract does not involve the transfer of ownership to the bailee.

49 In the lease/option agreements at bar, the remedy which Ford Credit invokes is found in clause 21 of the Agreements. That clause reads:

> Default: If You Fail to make any payment under this Lease when it is due, or if You fail to keep any other agreement in this Lease, Dealer may terminate this Lease and take back the Vehicle. Dealer may go on your property to retake the Vehicle. Even if Dealer retakes the Vehicle, You must still pay at once the monthly payments for the rest of the lease term and any other amounts that You owe under this Lease. Dealer will subtract from the amount owed sums received from the sale of the Vehicle in excess of what Dealer would have had invested in the Vehicle at the end of the lease term. You must also pay all expenses paid by Dealer to enforce Dealer's rights under this Lease, including reasonable solicitors' fees as permitted by law, and any damages caused to Dealer because of your default. Dealer may sell the Vehicle at public or private sale with or without notice to You.

50 Now I should say that Ford Credit does not indicate in its Notice of Motion that it expressly invokes clause 21, but I conclude that I must analyze the case on the basis that it seeks to pursue its contractual remedies. What else can it pursue but the remedies for which it has bargained?

51 Ford Credit may say that it is prepared, at this time, to forego the benefit of the acceleration provision in clause 21. But this overlooks the fact that clause 21, regardless of whether it is fully invoked, nevertheless assists us in characterizing what the document is as a matter of law. Further, the invocation of clause 21 is not the unilateral decision of Ford Credit. The lessee is entitled to insist on the sale of the vehicle and the benefit of any credit in his or her favour as set out in the clause.

52 Returning to the analysis, s. 11.3(a), by referring to "payment for use", evokes, as I have said, the notion of a true lease arrangement.

53 Clause 21 of the lease/option agreements is hardly that. Not only is the lessee dispossessed of the vehicle on default, he or she is still liable for the monthly payments for the unexpired term. The lessee in that situation is of course credited with the amount, if any, which the dealer receives on a resale of the vehicle "in excess of what Dealer would have had invested in the Vehicle at the end of the lease term".

54 Clause 21 is not limited to "payment for use". It goes far beyond that and secures the entire term of lease payments.

55 The presence of the acceleration provision is itself telling. Once again, I refer to Professor Cuming's article (supra, at 279):

> Some American courts have recognized as an indicium of a security agreement a provision in a lease under which failure by the lessee to make one or more lease payments or to otherwise to perform his obligations under the contract permits the lessor to accelerate a payment date for all unpaid lease payments. An acceleration clause is important in an instalment debt transaction between a debtor and a creditor because it enables the creditor on default by his debtor to seek the payment of the entire debt rather than having to wait until each instalment comes due. However, while the relationship between a lessor and a defaulting lessee may be one of creditor and debtor, an acceleration clause should, at least, in some cases, be viewed as foreign to the lessor -- lessee relationship. Unlike a defaulting buyer or borrower, a lessee is generally not obligated under the rules of damages to pay a specific predetermined sum to the lessor. The lessor may well be entitled to damages for breach of contract, but there is no certainty that those damages will be assessed as the equivalent of all rental payments owing under the lease with or without deduction of an amount realized from the sale of the leased chattels by the lessor. (footnotes omitted)

56 What I take from all of this is that by preserving a limited remedy for lessors, that is, "payment for use", in a field of commercial transactions which, as I have shown with these leases, encompasses a variety of arrangements with much broader remedies on default, s. 11.3(a) can be interpreted as restricting itself to the type of arrangement which is characterized by the narrower bargain. More simply: this analysis suggests that s. 11.3(a) does not cover all leases. Rather, it covers traditional true leases where the essential bargain is payment for use.

57 To put the matter in a slightly different way: Ford Credit's lease does not simply require "payment for . . . use of leased or licenced property", clause 21 secures payments when the property will clearly not be used by the lessee after a default and a retaking by the lessor.

58 Further, can one say that the leases here contemplate payments by the lessee only for the use of the vehicles? That after all is the epitome of a true lease -- that is, a contract of bailment. Once again, clause 21 assists. On a default, the lessee is liable for the lease payments for the unexpired term. However, it is contemplated that the dealer will sell the vehicle and:

> . . . will subtract from the amount owed sums received from the sale of the Vehicle in excess of what Dealer would have had invested in the Vehicle at the end of the lease term.

59 I can only conclude that by crediting the lessee in these circumstances with the excess sum defined in clause 21, the document is implicitly (and fairly) ensuring that even a defaulting lessee will enjoy whatever equity he or she has effectively built up in the vehicle.

60 From this perspective one can say that the lessee under these leases is not simply paying for use of the vehicle. He or she is potentially acquiring, as well, equity therein.

61 It is only payments for the use of leased property that are excepted from a s. 11 stay order under s. 11.3(a). Payments for use and equity are not. Similarly payments for use and equity and an option to purchase are not. This is another reason to conclude the s. 11.3(a) is not inclusive of all forms of lease.

62 Having reached this conclusion, what are the criteria for exclusion of arrangements from the scope of s. 11.3(a)? It is here that the PPSA jurisprudence offers some useful guideposts.

63 Re Bronson (1995), 34 C.B.R. (3d) 255 is a decision of Master Powers sitting as a Registrar in Bankruptcy. His decision was affirmed on appeal by Mr. Justice Lamperson, (1996), 39 C.B.R. (3d) 33 (B.C.S.C.).

64 Master Powers' decision offers a thorough review of the law on when a lease/option agreement will be construed as a security agreement for the purposes of the seize or sue provision in s. 67 of the PPSA S.B.C. 1989, c. 36.

65 Master Powers quotes this extract from R.C.C. Cuming and R.J. Wood, British Columbia Personal Property Act Handbook (Toronto: Carswell, 1990):

> If a transaction is one under which a party gives or recognizes that someone else has an interest in his or her property in order to secure payment or performance of an obligation, it is a security agreement. (p.31)
>
> If the commercial realities, i.e., the substance of the transaction, point to a secured financing arrangement rather than to a bailment in the case of a lease, or an agency relationship in the case of a consignment, then the transaction is a security agreement even though it takes the form of a lease or consignment, and even though there is no provision vesting title in the lessee or consignee. Likewise the fact that a lease provides for a purchase option exercisable by the lessee does not by itself dictate (as it did under the sale of goods on conditions act) that transaction is to be regarded as a security lease. (p. 31)
>
> The general approach is to examine carefully the relationship between the lessor and lessee in order to determine whether or not in that relationship the standard indicia of a secured credit arrangement are to be found. If the lessee is required to pay what is the equivalent of the lessor's capital investment plus a credit charge at the rate existing at the date of the agreement, there is strong evidence of a secured sale. A clause in a lease giving to the lessee the option to purchase the goods at less than their expected market value (as determined at the date of execution) indicates that the lessee has acquired an equity in the goods not unlike that which would have been acquired under an instalment purchase contract. However, the fact that at the end of a lease term roughly equivalent to the useful

> life of the goods the lessee can purchase the goods at their then market value does not prevent characterization of the transaction as a security agreement. Evidence that the lessee bears some of the obligations of ownership such as the requirement to repair and insure the goods provide some persuasive but not determinative indication of a security agreement. In one case, the court was prepared to look at the business activities of the lessor to determine whether or not it had a lessor's facilities and methods of operation and to take this into consideration in making the determination. (p.32-33)

66 The learned Master also referred to a checklist prepared by Professor Cuming in September, 1991 wherein he summarized the considerations taken into account by American courts in determining whether a document is a true lease or a security agreement.

67 These criteria are as follows:

1. Whether there was an option to purchase for a nominal sum;
2. Whether there was a provision in the lease granting the lessee an equity or property interest in the equipment;
3. Whether the nature of the lessor's business was to act as a financing agency;
4. Whether the lessee paid a sales tax incident to acquisition of the equipment;
5. Whether the lessee paid all other taxes incident to ownership of the equipment;
6. Whether the lessee was responsible for comprehensive insurance on the equipment;
7. Whether the lessee was required to pay any and all licence fees for operation of the equipment and to maintain the equipment at his expense;
8. Whether the agreement placed the entire risk of loss upon the lessee;
9. Whether the agreement included a clause permitting the lessor to accelerate the payment of rent upon default of the lessee and granted remedies similar to those of a mortgagee;
10. Whether the equipment subject to the agreement was selected by the lessee and purchased by the lessor for this specific lease;
11. Whether the lessee was required to pay a substantial security deposit in order to obtain the equipment;
12. Whether the agreement required the lessee to join the lessor or permit the lessor by himself to execute a U.C.C. financing statement (this would not apply in Canada);
13. Whether there was a default provision in the lease inordinately favourable to the lessor;
14. Whether there was a provision in the lease for liquidated damages;
15. Whether there was a provision disclaiming warranties of fitness and/or merchantability on the part of the lessor;
16. Whether the aggregate rental approximated the value of purchase price of the equipment.[para68] In

68 In my opinion s. 11.3(a) does not, at a minimum, include arrangements which are closer to financing agreements than true leases as discussed in the cases on the PPSA legislation.

69 I turn to review these lease/option agreements before me:

- they disclose a "Retail Selling Price/Lease Price of Vehicle";
- they contemplate a cash "down payment" or trade-in;
- they include an annualized lease rate, that is, I take it, something akin to a financing charge;
- they include an option to purchase exercisable by the lessee at the end of the term;
- they require that the lessee insure the vehicle;
- they exclude warranties by Ford Credit;
- they include the default clause to which I have earlier referred;
- they require the lessee to pay all sales, use and other taxes;
- they require the lessee to pay all maintenance and operating costs.

70 Counsel for Smith Brothers stresses the absence of warranties flowing from Ford Credit and submits that the essential function and responsibility of Ford Credit under the agreements is to provide financing.

71 In earlier PPSA litigation, the fact that the option price reflected the approximate residual value of the vehicle at the conclusion of the term, was thought to weigh heavily against a finding that the arrangement was in essence a financing agreement.

72 Here Ford Credit's Customer Service Representative deposes that by her estimate, Smith Brothers does not have equity in any of the leased vehicles and that each is worth significantly less than the current net payout figures.

73 The president of the petitioner deposes that in his discussions with the manager of the initial vehicle supplier, she indicated that she was confident that they could, if permitted, sell the returned vehicles for a sum in excess of the outstanding amounts under the agreements.

74 In an early leading case, Henry J. considered the question of the option price in Re Ontario Equipment (1976) Ltd. (1981), 33 O.R. (2d) 648 (Ont. H.C.J.), affirmed (1982), 35 O.R. (2d) 194 (Ont. C.A.).

75 Henry J. adopted this practical distinction between a true lease and a lease by way of security (at 651):

> The test in determining whether an agreement is a true lease or a conditional sale is whether the option to purchase at the end of the lease term is for a substantial sum or nominal amount . . . if the purchase price bears a resemblance to the fair market price of the property, then the rental payments were in fact designated to be in compensation for the use of the property and the option is recognized as a real one. On the other hand, where the price of the option to purchase is substantially less than the fair market value of the leased equipment, the lease will be construed as a mere cover for an agreement of conditional sale (per Croake D. J. in Re Crown Cartridge Corp., Debtor (1962) 220 F. Supp. 914).

76 Later commentators have noted, however, that the fact that at the end of a lease term roughly equivalent to the useful life of the goods, the lessee can purchase the goods at their market value, does not prevent characterization of the transaction as a security agreement (per Cuming and Wood, quoted in Re Bronson, supra).

77 In any event, I should stress that it is not necessary for me to reach a conclusion on whether the lease/option agreements before me on this application are security agreements for the purposes of the PPSA. It is enough that I have concluded that s. 11.3(a) does not cover all types of lease arrangement and that, in particular, those at bar are within the class of arrangement not included within the ambit of the section.

78 Smith Brothers submitted in the alternative that if s. 11.3(a) does apply, nevertheless, if these arrangements are to be properly construed as financing agreements for the purposes of the PPSA, the court enjoys the jurisdiction under s. 63 of that Act to stay the enforcement of Ford Credit's rights on default.

79 Counsel for Ford Credit vigorously opposes any such conclusion and submits that on a division of powers analysis, the CCAA has constitutionally occupied the field to the exclusion of the provincial legislation in these circumstances.

80 Because of the conclusion that I have reached, it is not necessary for me to deal with this submission.

81 In the result, the motion is dismissed. The petitioners shall have their costs against Ford Credit on Scale 3.

BAUMAN J.

cp/d/mrz/cmi/qlcct

Tab 7

Indexed as:
Communities Economic Development Fund v. Canadian Pickles Corp.

Communities Economic Development Fund, appellant;
v.
Rudy Vincent Maxwell, respondent, and
Canadian Pickles Corporation and June O'Donnell,
defendants.

[1991] 3 S.C.R. 388

[1991] S.C.J. No. 89

File No.: 21816.

Supreme Court of Canada

1991: June 3 / 1991: November 14.

Present: La Forest, L'Heureux-Dubé, Sopinka, Gonthier, Cory, Stevenson and Iacobucci JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR MANITOBA (66 paras.)

Guarantee -- Liability of guarantor of ultra vires loan -- Statutory corporation making loan contrary to statutory objects -- Whether loan ultra vires -- If so, whether guarantor liable to repay loan -- The Communities Economic Development Fund Act, R.S.M. 1987, c. C155, ss. 1, 3, 7(c), 9(7), 26(2), (5) -- The Corporations Act, R.S.M. 1987, c. C225, ss. 3(1)(b), 16(3).

Corporations -- Statutory corporation making loan contrary to statutory objects -- Applicability of doctrine of ultra vires to statutory corporation -- The Communities Economic Development Fund Act, R.S.M. 1987, c. C155, ss. 1, 3, 7(c), 9(7), 26(2), (5) -- The Corporations Act, R.S.M. 1987, c. C225, ss. 3(1)(b), 16(3).

The appellant is a lending institution created by the Manitoba Communities Economic Development Fund Act (the "Act"). Its objects, as set out in s. 3 of the Act, are to encourage the economic development of "remote and isolated communities" in Manitoba. In 1986, the appellant approved a loan to Canadian Pickles, a company operating in Stony Mountain, a small community some 20 kilometres north of Winnipeg. The loan was guaranteed by the directors of the company, including [page389] the respondent, who was also a shareholder. The full amount of the loan was advanced by the appellant to creditors of Canadian Pickles, to equipment manufacturers, and in trust to the respondent as Canadian Pickles' solicitor. The company later defaulted on the loan. The appellant then sued the company and the guarantors for repayment. The Court of Queen's Bench held that the loan was ultra vires the appellant but that the respondent was still obliged to honour his guarantee because he had encouraged the appellant to lend the money, and because he benefited from the loan as a shareholder and director of the company. Applying Breckenridge, the trial judge found the respondent liable on his guarantee on the principle of moneys "had and received". On appeal, the Court of Appeal reversed the judgment and dismissed the action. This appeal raises two issues: (1) whether appellant's loan was ultra vires; and, if so, (2) whether the respondent is liable to repay the loan as guarantor.

Held: The appeal should be dismissed.

As a statutory corporation created for a public purpose (namely, to encourage economic development in remote and isolated regions), the appellant has only those powers which are expressly or impliedly granted to it by statute. Acts of the appellant which exceed those powers will be ultra vires. Here, the loan to Canadian Pickles was contrary to the statutory objects of the appellant. Stony Mountain, where the company's operation was located, is not a remote and isolated community. Appellant's loan was thus ultra vires because s. 9(7) of the Act prohibits the making of loans in contravention of the Act.

Both the Act and The Corporations Act indicate a legislative intention to retain the doctrine of ultra vires for the appellant with respect to loans that contravene the Act. Indeed, while s. 26(2) of the Act is a clear indication of the legislative intention to give the appellant all the powers of a natural person, and to abolish the doctrine of ultra vires with respect to the appellant, s. 9(7) creates a limit on the appellant's powers. Not only is no remedy provided within the statutory scheme for a breach of s. 9(7), but the remedial provisions in Part XIX of The Corporations Act are expressly made inapplicable to the appellant by s. 3(1)(b) of The Corporations Act. Section 7(c) of the Act, which allows the appellant to exercise the powers set out in Part III of The [page390] Corporations Act, is intended only to give the appellant the incidental and ancillary powers necessary to further its statutory objects. Finally, s. 16(3) of Part III of The Corporations Act, which provides that no act of a corporation is invalid only because the act is contrary to its articles or to The Corporations Act, does not, when read together with s. 3(1)(b) of The Corporations Act and ss. 9(7) and 26(5) of the Act, abolish the doctrine of ultra vires with respect to loans that contravene the Act. In any event, if there is any conflict between s. 9(7) of the Act and s. 16(3) of The Corporations Act, it must be resolved in favour of s. 9(7), because s. 26(5) of the Act provides that where there is a conflict between the Act and The Corporations Act, the Act prevails.

The respondent is not liable to repay the ultra vires loan as guarantor. First, Breckenridge has no application in this case. The respondent received no money from the lender and, consequently, could not be liable on the basis of money "had and received". Second, on the correct interpretation of the contract of guarantee, the respondent is not liable to repay the money advanced in the event the principal debt is ultra vires. Under the contract, the guarantors are liable as principal debtors only in the circumstances enumerated. These circumstances do not include the invalidity of the principal debt.

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Distinguished: Breckenridge Speedway Ltd. v. The Queen in right of Alberta, [1970] S.C.R. 175; disapproved: Alberta (Provincial Treasurer) v. Meadow Rue Holdings Ltd. (1986), 45 Alta. L.R. (2d) 294; considered: Bonanza Creek Gold Mining Co. v. The King, [1916] 1 A.C. 566; Ashbury Railway Carriage & Iron Co. v. Riche (1875), L.R. 7 H.L. 653; Attorney-General v. Great Eastern Railway Co. (1880), 5 App. Cas. 473; Baroness Wenlock v. River Dee Co. (1885), 10 App. Cas. 355; referred to: Brougham v. Dwyer (1913), 108 L.T. 504; Sutton's Hospital Case (1613), 10 Co. Rep. 1a, 23a, 77 E.R. 937, 960; Union Bank of Canada v. A. McKillop & Sons, Ltd. (1915), 51 S.C.R. 518; Canadian Pacific Railway Co. v. City of Winnipeg, [1952] 1 S.C.R. 424; Canadian Pacific Ltd. v. Telesat Canada (1982), 133 D.L.R. (3d) 321; Redlin v. Governors of the University of Alberta (1979), 23 A.R. 42 (Dist. Ct.), aff'd (1980), 23 A.R. 31 (C.A.); Alberta Mortgage and Housing Corp. v. Ciereszko, [1986] 2 W.W.R. 57; Hazell v. Hammersmith and Fulham London Borough Council, [1991] 2 W.L.R. 372; Canadian [page391] Bank of Commerce v. Cudworth Rural Telephone Co., [1923] S.C.R. 618; Yeoman Credit, Ltd. v. Latter, [1961] 2 All E.R. 294; Heald v. O'Connor, [1971] 1 W.L.R. 497; General Produce v. United Bank, [1979] 2 Lloyd's Rep. 255; Upper Canada College v. Smith (1920), 61 S.C.R. 413; Garnham v. Tessier (1959), 27 W.W.R. 682; Penner v. Hutlet (1984), 33 Man. R. (2d) 168; Manufacturers Life Insurance Co. v. Hauser, [1945] 3 W.W.R. 740; Minchau v. Busse, [1940] 2 D.L.R. 282.

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APPEAL from a judgment of the Manitoba Court of Appeal (1989), 62 Man. R. (2d) 170, 64 D.L.R. (4th) 489, 45 B.L.R. 261, [1990] 2 W.W.R. 547, setting aside a judgment of the Court of Queen's Bench (1989), 62 Man. R. (2d) 177, [1989] 3 W.W.R. 514, granting the appellant's action on a guarantee. Appeal dismissed.

Donald G. Murray and Allan MacDonald, for the appellant. Sidney Green, Q.C., for the respondent.

Solicitors for the appellant: McJannet Rich, Winnipeg. Solicitor for the respondent: Sidney Green, Winnipeg.

The judgment of the Court was delivered by

1 **IACOBUCCI J.**:-- This appeal raises two issues: the applicability of the doctrine of ultra vires to a statutory corporation, and the liability of a guarantor to repay a loan which is ultra vires the lender.

I. Facts

2 Canadian Pickles Corporation was a Manitoba company in the business of producing and selling pickles. Canadian Pickles' operation was located in Stony Mountain, some 15 or 20 kilometres north of the City of Winnipeg. The majority shareholders of Canadian Pickles were Robert and June O'Donnell and the respondent, Rudy Vincent Maxwell, a lawyer [page393] who also acted as such for Canadian Pickles. The respondent, who owned 25 per cent of the issued shares of Canadian Pickles for which he had paid the sum of $7,000 was also a director and officer of the company.

3 The appellant, the Communities Economic Development Fund, is a lending institution created by The Communities Economic Development Fund Act, R.S.M. 1987, c. C155 (the "Act"). As set out in the statute, the objects of the appellant are to encourage the economic development of "remote and isolated communities" in the province of Manitoba. The Board of Directors of the appellant did not exercise its power under its statute to pass a by-law to establish criteria of remoteness and isolation.

4 In the fall of 1986, Canadian Pickles approached the appellant for a loan for working capital and additional equipment. The appellant approved a loan to Canadian Pickles in the amount of $150,000. The Board of Directors of the appellant had earlier made a policy decision to grant a limited number of loans to enterprises in Southern Manitoba. As a condition for granting the loan, the appellant required a guarantee from the directors of Canadian Pickles. A document entitled "Guarantee" was signed by Robert O'Donnell, June O'Donnell and the respondent.

5 The full amount of the loan was advanced by the appellant to creditors of Canadian Pickles, to equipment manufacturers, and in trust to the respondent as Canadian Pickles' solicitor. Canadian Pickles defaulted on the loan. A demand was eventually made by the appellant for the full amount of the loan plus costs and interest. When payment was not forthcoming, the appellant commenced action in the Court of Queen's Bench of Manitoba against the O'Donnells and the respondent, as guarantors of the loan. The trial judge found that the respondent was liable for the full amount of the loan. The respondent appealed to the Court of Appeal for Manitoba. His appeal was allowed and the action against him was dismissed.

[page394]

II. Statutory Provisions

6

The Communities Economic Development Fund Act, S.M. 1971, c. 84

> 2 Communities Economic Development Fund is established as a body corporate and politic and shall consist of the directors from time to time appointed under the provisions of this Act.

The Communities Economic Development Fund Act, R.S.M. 1987, c. C155

1 In this Act,

...

> "remote and isolated communities" means those communities which meet the criteria of remoteness and of isolation established under this Act, either by by-law of the board or by order of the Lieutenant Governor in Council.

> 2 The Communities Economic Development Fund is continued as a body corporate and consists of the directors appointed under this Act.

> 3 The objects of the fund are to encourage the optimum economic development of remote and isolated communities within the province and to that end

(a) to provide financial or other assistance to

(i) existing economic enterprises or to economic enterprises to be established; and
(ii) community development corporations;

(b) to emphasize and encourage the expansion and strengthening of small to medium-sized economic enterprises which are locally owned and operated; and
(c) generally to assist the minister in furthering economic development on behalf of the residents of remote and isolated communities, particularly as regards economically disadvantaged persons.

7 The fund may

...

(c) generally exercise the powers set out in Part III of The Corporations Act.

9(7) No loan shall be made under this Act or financial assistance given under this Act if the making or giving thereof contravenes any provision of this Act.

[page395]

26(2) The fund and any subsidiary of the fund has [sic] the general capacity and powers of a common law corporation; and no act of the fund or any subsidiary of the fund and no conveyance, transfer or security given to the fund is invalid.

26(5) Where there is any conflict between any provision of this Act and a provision of The Corporations Act, the provisions of this Act prevail.

The Corporations Act, R.S.M. 1987, c. C225

Part I

Interpretation and Application

1(1) In this Act,

...

"articles" means the original or restated articles of incorporation ... and includes any Act, statute or ordinance by or under which a body corporate has been incorporated ...

...

"corporation" means a body corporate heretofore or hereafter incorporated by or under an Act of the Legislature;

...

"special Act" means an Act of the Legislature other than this Act or any Act for which this Act is substituted;

3(1) Except where it is otherwise expressly provided,

...

(b) Parts II, V and VI, Division I of Part X, and Parts XIII to XIX and Parts XXI to XXVI do not apply to a corporation created for government purposes or municipal purposes or to corporations created under The Public Schools Act or The Health Services Act.

Part III

Capacity and Powers

15(1) A corporation has the capacity and, subject to this Act, the rights, powers and privileges of a natural person.

[page396]

16(3) No act of a corporation, including any transfer of property to or by a corporation, is invalid by reason only that the act or transfer is contrary to its articles or this Act.

Part XIX

Remedies, Offences and Penalties

231 In this Part,

...

"complainant" means

...

(b) a director or an officer or a former director or officer of a corporation or of any of its affiliates, or
(c) the Director, or
(d) any other person who, in the discretion of a court, is a proper person to make an application under this Part.

> 240 If a corporation or any director, officer, employee, agent, auditor, trustee, receiver, receiver-manager or liquidator of a corporation does not comply with this Act, the regulations, articles, by-laws, or a unanimous shareholder agreement, a complainant or a creditor of the corporation may, in addition to any other right he has, apply to a court for an order directing any such person to comply with, or restraining any such person from acting in breach of, any provisions thereof, and upon such application the court may so order and make any further order it thinks fit.

III. Judgments of the Courts Below

A. Manitoba Court of Queen's Bench, [1989] 3 W.W.R. 514

7 Associate Chief Justice Scott (as he then was) awarded judgment against the respondent Maxwell and dealt extensively with the issue of a possible breach by the appellant of a duty owed to the respondent. The issue of a breach of duty was not raised on this appeal. On the ultra vires issue, the Associate Chief Justice concluded that the loan was ultra vires because of the appellant's failure to follow the procedures set out in the Act (at p. 527):

[page397]

> Whatever may have been the policy reasons behind the board's decision to expand the definition of "remote and isolated", as evidenced by the extracts of minutes filed, the fund failed to follow the procedures mandated by the Act for such purpose, and it is therefore my opinion that the loan exceeds the statutory mandate of the fund.

8 Having found the loan to be ultra vires, the trial judge held that he was bound by the cases of Breckenridge Speedway Ltd. v. The Queen in right of Alberta, [1970] S.C.R. 175, and Alberta (Provincial Treasurer) v. Meadow Rue Holdings Ltd. (1986), 45 Alta. L.R. (2d) 294 (C.A.). The Associate Chief Justice found that the respondent was obliged to honour his guarantee even though the principal debt was ultra vires the lender, because the respondent had encouraged the appellant to loan the money, and because he benefitted from the loan as a shareholder and director of Canadian Pickles. Following Breckenridge, supra, the trial judge found the respondent liable on his guarantee on the principle of moneys had and received.

B. Manitoba Court of Appeal, [1990] 2 W.W.R. 547

9 The Manitoba Court of Appeal allowed the respondent's appeal, Monnin C.J.M. dissenting. The Court of Appeal was unanimous that the loan in question was ultra vires the appellant. The majority judgment emphasized that because the respondent had received no money from the Fund, he could not be liable for the repayment of the money on the principle of moneys "had and received." Accordingly, Breckenridge, supra, could not be said to apply. In his dissenting judgment, Monnin C.J.M. agreed with the trial judge's finding that the respondent had received a benefit from the loan as a director and shareholder of Canadian Pickles. Monnin C.J.M. would accordingly have found the respondent liable on his guarantee.

(1) Huband J.A. (O'Sullivan J.A. concurring)

10 Huband J.A. concluded on the basis of the decisions in Brougham v. Dwyer (1913), 108 L.T. 504 (K.B. Div.), and Breckenridge, supra, that an ultra [page398] vires loan is not an illegal contract, it is a nullity. A guarantor cannot be liable for guaranteeing a loan which is void from the outset. The loan being a nullity, the guarantee is a "meaningless document upon which no legal action can be founded" (p. 557).

11 Huband J.A. also rejected the argument that the respondent was liable on the grounds of moneys "had and received", because the respondent had received no money from the appellant (at p. 556):

> I can understand how the primary debtor, Canadian Pickles, might be said to have received money or its equivalent, or at least that it is estopped from denying its receipt. But how can that be said of the guarantor Maxwell? It is a certainty that he did not receive either money or its equivalent, and I do not see how he could possibly be estopped from so stating. I do not see how he could be held liable for repayment of moneys "had and received" when the moneys were neither had nor received by him.

12 Finally, Huband J.A. rejected the position of the Alberta Court of Appeal in Meadow Rue, supra, that the encouragement of the loan could itself create a liability. Huband J.A. rejected Meadow Rue on the grounds that encouragement of a loan cannot create a liability if the loan is itself a nullity (at p. 557):

> With great respect to the Alberta Court of Appeal, I do not see how the encouragement of the loan can create a liability when the loan itself is a nullity. I do not see how one can guarantee that which ... did not exist in point of law. The guarantee itself becomes a meaningless document upon which no legal action can be founded.

(2) Monnin C.J.M., (dissenting)

13 Monnin C.J.M. concurred with Huband J.A. in upholding the finding of the trial judge that the loan was ultra vires the appellant. However, the Chief Justice disagreed with the majority and would have upheld the result at trial, on the grounds that the principle in Breckenridge, supra, should apply to the [page399] respondent because the respondent received a benefit from the loan (at p. 551):

> In my view it cannot be said that he received no benefit from the loan. Maxwell was a shareholder, director and officer of Canadian Pickles and its legal representative. If the business had been successful, he and the other shareholders would have reaped the benefits and advantages of that loan by the accretion of the shares, the possibility of dividends and/or profits, as well as the probable additional legal work which would flow from a prosperous business enterprise.

14 Following Meadow Rue, supra, the Chief Justice accepted that a guarantor who benefits from an ultra vires loan will be liable to repay the loan. This is an example of "equity in action": the respondent is liable because it would be unconscionable for him not to be liable (at p. 552):

> I accept as sound, good common sense and good law the statement of Kerans J.A. in Meadow Rue Hldg. It would be unconscionable for Maxwell, the guarantor in this case, and under these circumstances to deny liability to the fund on the basis that he did not receive the cold cash and, further, that the fund exceeded its authority in advancing the moneys to Canadian Pickles. Maxwell is not in a position to say to the fund, "Tough luck, your document is no good, invalid and I'm under no obligation to repay one red cent."

IV. Issues

15

1. Was the loan by the appellant to Canadian Pickles ultra vires the appellant?
2. If the loan was ultra vires, is the respondent liable to replay the loan as guarantor?

V. Is the Loan Ultra Vires?

16 There can be no doubt that the appellant's loan to Canadian Pickles was contrary to the objects of the appellant as stated in s. 3 of the Act. Stony Mountain, where Canadian Pickles' operation was located, is not a remote and isolated community. In this regard, I accept the finding of Monnin C.J.M. (dissenting on other grounds): "The town of Stony Mountain is a prosperous and viable non-urban area. It is not remote nor is it an isolated community" (p. 550). [page400] Indeed, neither the trial judge nor any judge of the Court of Appeal differed on this point.

17 I would note that the appellant's board of directors is empowered by s. 1 of the Act to establish "criteria of remoteness and of isolation" by passing a by-law. I doubt that there are criteria consistent with the objects of the Act that would make Stony Mountain a remote and isolated community. Be that as it may, as already mentioned, the board of directors of the appellant chose not to attempt to bring the loan to Canadian Pickles within the objects of the Act by passing a by-law, assuming such a by-law would have been valid.

18 The making of a loan contrary to the statutory objects of the appellant is a violation of the prohibition in s. 9(7) of the Act against loans which contravene any provision of the Act. The question is, what are the consequences of this violation of s. 9(7) of the Act? Must the loan be ultra vires the appellant, or is some less drastic result possible? To answer these questions, a brief review of the law of ultra vires is warranted following which I shall discuss the relevant legal principles as they apply to the facts of the instant case.

A. The Law of Ultra Vires

19 A review of the law of ultra vires is important to establish the context in which the provisions of the Act should be interpreted. Of particular relevance is the distinction that has been made in the application of the ultra vires doctrine between common law and statutory corporations.

(1) Common Law Corporations

20 Shortly put, the doctrine of ultra vires has been applied to corporations created by statute or pursuant to statutory authority, but has not been applied to corporations created by the exercise of the royal prerogative. Corporations created by the exercise of the royal prerogative, known as "chartered", "letters [page401] patent" or "common law" corporations, are taken to have all the powers of a natural person. The actions of a common law corporation are not invalid because they are outside the stated objects of a corporation: Sutton's Hospital Case (1613), 10 Co. Rep. 1a, 23a; 77 E.R. 937, 960. Legal action may be taken against a common law corporation if it acts outside its objects, but the acts are not invalid.

21 The Judicial Committee of the Privy Council considered the powers of a letters patent corporation in Bonanza Creek Gold Mining Co. v. The King, [1916] 1 A.C. 566. The appellants were incorporated by letters patent issued by the Lieutenant-Governor of Ontario, under the authority both of The Ontario Companies Act, R.S.O. 1897, c. 191, and of all other powers and authority vested in the Lieutenant-Governor. The objects of the appellants, as stated in the letters patent, were to carry on the business of mining and exploration. The letters patent did not limit the appellants' area of operation. The appellants were carrying on mining operations in the Yukon. As a result of disagreements over certain mining leases, the appellants brought an action for damages against the respondent. The appeal came to the Judicial Committee of the Privy Council on the bare question of whether the appellants had the power to carry on operations in the Yukon.

22 The Judicial Committee held that the appellants did have the power to carry on operations in the Yukon, and allowed the appeal. Writing for the Committee, Viscount Haldane distinguished companies created by charter from those created by statute (at pp. 583-84):

> In the case of a company created by charter the doctrine of ultra vires has no real application in the absence of statutory restriction added to what is written in the charter. Such a company has the capacity of a natural person to acquire powers and rights. If by the terms of the charter it is prohibited from doing so, a violation of this prohibition is an act not beyond its capacity, and is therefore not ultra vires, although such a violation may well give ground for proceedings by way of scire facias for the forfeiture of the charter.

[page402]

23 Prior to the decision in Bonanza Creek, some Canadian courts had assumed that the doctrine of ultra vires did apply to chartered companies: see Union Bank of Canada v. A. McKillop & Sons, Ltd. (1915), 51 S.C.R. 518. After the decision, it was clear that restrictions in the charter of the company were not sufficient to make any act ultra vires, although other remedies might be available for breach of the charter: see F. W. Wegenast, The Law of Canadian Companies (1979), at pp. 141-44. However, the doctrine of ultra vires remained applicable to chartered companies after Bonanza Creek in the limited sense that an action could still be ultra vires the company if the act were prohibited by statute. This conclusion follows from the passage just quoted from Bonanza Creek, supra, at p. 583: "In the case of a company created by charter the doctrine of ultra vires has no real application in the absence of statutory restriction added to what is written in the charter" (emphasis added). For analysis, see Wegenast, supra, at pp. 141-50, and E. J. Mockler's helpful article, "The Doctrine of Ultra Vires in Letters Patent Companies", in J. S. Ziegel, ed., Studies in Canadian Company Law (1967).

(2) Corporations Created by or Under a Statute

24 The presumption at common law is that corporations created by or under a statute have only those powers which are expressly or impliedly granted to them. To the extent that a corporation acts beyond its powers, its actions are ultra vires and invalid. Assessing the limits of the powers of a corporation created by or under a statute is a question of the interpretation of the statute and corporation's constating documents which give the corporation its powers.

25 If the appropriate language is used, the powers of a corporation created by or under a statute may be as wide as those of a common law corporation. The question will turn on the language used in the statute constating documents. The point is well illustrated by the following passage from Bonanza Creek, supra, at p. 578:

[page403]

> Such a creature, where its entire existence is derived from the statute, will have the incidents which the common law would attach if, but only if, the statute has by its language gone on to attach them. In the absence of such language they are excluded, and if the corporation attempts to act as though they were not, it is doing what is ultra vires and so prohibited as lying outside its existence in contemplation of law. The question is simply one of interpretation of the words used. For the statute may be so framed that executive power to incorporate by charter, independently of the statute itself, which some authority, such as a Lieutenant-Governor, possessed before it came into operation, has been left intact. Or the statute may be in such a form that a new power to incorporate by charter has been created, directed to be exercised with a view to the attainment of, for example, merely territorial objects, but not directed in terms which confine the legal personality which the charter creates to existence for the purpose of these objects and within territorial limits. The language may be such as to show an intention to confer on the corporation the general capacity which the common law ordinarily attaches to corporations created by charter.

(a) Memorandum Corporations

26 The doctrine of ultra vires was first applied to memorandum companies incorporated under business corporation statutes in Ashbury Railway Carriage & Iron Co. v. Riche (1875), L.R. 7 H.L. 653. The appellant was incorporated under the Companies Act, 1862. The purpose of the company, set out in its memorandum, was to carry on business as mechanical engineers and general contractors. The directors of the appellant entered into a contract with the respondent Riche. As part of the contract, the appellant was to purchase a railway concession in Belgium, and to raise money for the construction of the railway. The House of Lords held that the transaction was ultra vires the appellant because it was beyond the scope of its memorandum. As a consequence, the contract was null and void, and not capable of ratification by the shareholders of the appellant. Prior to the statutory abolition in most Canadian jurisdictions of the ultra vires doctrine for companies incorporated under the business corporation statutes, [page404] Ashbury Railway and Bonanza Creek, supra, were the law in Canada.

(b) Corporations Created by Special Act

27 The applicability of the doctrine of ultra vires to corporations created by special act was at issue in Attorney-General v. Great Eastern Railway Co. (1880), 5 App. Cas. 473 (H.L.). The respondent company was incorporated by an Act of Parliament. The respondent was given a variety of powers by several statutes. The respondent purported to lease locomotives to another railway company. The appellant sought an injunction to prevent the respondent from leasing its locomotives or other rolling stock, on the grounds that the directors of the respondent had exceeded their powers. The House of Lords held that the acts in question were intra vires the company because expressly authorized by the statutory scheme. In so finding, their Lordships stated emphatically that the principle earlier enunciated in Ashbury Railway, supra, applied also to statutory corporations. In the words of Lord Watson, at p. 486:

> I cannot doubt that the principle by which this House, in the case of the Ashbury Railway Company v. Riche, tested the power of a joint stock company registered (with limited liability) under the Companies Act of 1862, applies with equal force to the case of a railway company incorporated by Act of Parliament. That principle, in its application to the present case, appears to me to be this, that when a railway company has been created for public purposes, the Legislature must be held to have prohibited every act of the company which its incorporating statutes do not warrant either expressly or by fair implication.

28 The House of Lords affirmed the applicability of Ashbury Railway to corporations created by special act in Baroness Wenlock v. River Dee Co. (1885), 10 App. Cas. 355 (H.L.). Lord Watson held that the powers of a statutory corporation are limited by the purposes of the corporation as set out in the special act (at pp. 362-63):

[page405]

> Whenever a corporation is created by Act of Parliament, with reference to the purposes of the Act, and solely with a view to carrying these purposes into execution, I am of opinion not only that the objects which the corporation may legitimately pursue must be ascertained from the Act itself, but that the powers which the corporation may lawfully use in furtherance of these objects must either be expressly conferred or derived by reasonable implication from its provisions.

29 The principle that a statutory corporation can do only what it is expressly or impliedly authorized to do by the statute creating it has been repeatedly applied by Canadian courts. The principle was approved by Locke J. in this Court, in Canadian Pacific Railway Co. v. City of Winnipeg, [1952] 1 S.C.R. 424, at p. 485. The principle was referred to as "trite law" in Canadian Pacific Ltd. v. Telesat Canada (1982), 133 D.L.R. (3d) 321 (Ont. C.A.), at p. 326. In Redlin v. Governors of the University of Alberta (1979), 23 A.R. 42 (Dist. Ct.), affirmed unanimously on appeal (1980), 23 A.R. 31, Stevenson Dist. Ct. J. (as he then was), said in reference to the same principle that, "One cannot quarrel with that general proposition" (p. 48). I would also refer to Alberta Mortgage and Housing Corp. v. Ciereszko, [1986] 2 W.W.R. 57 (Alta. Q.B.). The principle has been recently affirmed by the House of Lords in Hazell v. Hammersmith and Fulham London Borough Council, [1991] 2 W.L.R. 372 (H.L.).

(c) Abolition of the Doctrine of Ultra Vires

30 The doctrine of ultra vires has been abolished by statute for corporations incorporated under the business corporations legislation in most Canadian jurisdictions. The following jurisdictions have statutory provisions reversing the presumption that corporations have limited capacity: Canada (Canada Business Corporations Act, R.S.C., 1985, c. C-44, s. 15(1)), Alberta (Business Corporations Act, S.A. 1981, c. B-15, s. 15(1)), British Columbia (Company Act, R.S.B.C. 1979, c. 59, s. 21(1)), Manitoba (The Corporations Act, R.S.M. 1987, c. C-225, s. 15(1)), New Brunswick (Business Corporations Act, S.N.B. [page406] 1981, c. B-9.1, s. 13(1)), Newfoundland (The Corporations Act, S.N. 1986, c. 12, s. 30(1)), Ontario (Business Corporations Act, 1982, S.O. 1982, c. 4, s. 15), Saskatchewan (The Business Corporations Act, R.S.S. 1978, c. B-10, s. 15(1)), and the Yukon (Business Corporations Act, R.S.Y. 1986, c. 15, s. 18(1)). The doctrine of ultra vires may still apply in the Northwest Territories, and in Nova Scotia. Prince Edward Island is a letters patent jurisdiction.

31 In my view, the general abolition of the doctrine of ultra vires is in accordance with sound policy and common sense. The original purposes of the doctrine, which were, in the words of the 1967 Interim Report of the Select Committee on Company Law (tabled before the Ontario Legislative Assembly, at p. 25) "to protect creditors by ensuring that the company's funds to which creditors must look for payment were not dissipated in unauthorized activities and to protect investors by allowing them to know the objects for which their money was to be used", have been largely frustrated. Subsequent statutory and case law developments have made the doctrine a protection to no one and a trap for the unwary. No less an authority than L. C. B. Gower has recommended, in Gower's Principles of Modern Company Law (4th ed. 1979), at p. 179, "total abolition of the ultra vires rule in so far as it affects the capacity of companies" and indeed referred favourably to the approach taken by the Canada Business Corporations Act in this respect. See Gower, supra, at p. 180.

32 However, in spite of the general trend towards abolition of the doctrine of ultra vires, the limited aspects of the doctrine, as seen from the above review, may be present with respect to corporations created by special act for public purposes. Not only is there a long line of cases supporting the principle, but one may argue that this protects the public interest because a company created for a specific purpose by [page407] an act of a legislature ought not to have the power to do things not in furtherance of that purpose. Of course, it is open to the legislature to rebut this presumption because, for example, the legislature may provide for other remedies short of invalidity for acts contrary to the statute. But this takes us to discussing the application of the general principles of law on ultra vires to the facts of this case.

B. Application of the Law to the Facts of This Case

33 The appellant is a statutory corporation, created by The Communities Economic Development Fund Act. The appellant was created for a public purpose, namely to encourage economic development in remote and isolated regions of Manitoba. As a statutory corporation created for a public purpose, the appellant has only those powers which are expressly or impliedly granted to it by statute. Acts of the appellant which exceed those powers will be ultra vires. The issue is therefore: was the appellant expressly or impliedly granted the power to act outside its statutory objects?

34 In determining the scope of the appellant's powers, reference must be made not only to The Communities Economic Development Fund Act, but also to The Corporations Act, R.S.M. 1987, c. C225. "Corporation" is defined in s. 1(1) of The Corporations Act so as to include the appellant; "articles" is defined in the same section to include the statute by which the appellant was incorporated, that is The Communities Economic Development Fund Act. The application of The Corporations Act to the appellant is however limited by s. 3(1) of The Corporations Act, which provides that some parts, including Part XIX, of The Corporations Act (dealing with remedies, offences and penalties) do not apply to a corporation, such as the appellant, created for government purposes.

[page408]

(1) Section 26(2) of The Communities Economic Development Fund Act

35 On its face, s. 26(2) grants the appellant the capacity and powers of a common law corporation. A common law corporation is a corporation with the powers of a natural person: Canadian Pacific Railway Co. v. City of Winnipeg and Bonanza Creek, supra. The language used in s. 26(2) shows what Viscount Haldane referred to in Bonanza Creek as an "intention to confer on the corporation the general capacity which the common law ordinarily attaches to corporations created by charter" (p. 578). I find support for this position not only in the explicit grant of the "general capacity and powers of a common law corporation" to the appellant, but also in the second part of s. 26(2), which provides that no act of the appellant is invalid taken by itself. Section 26(2) is a clear indication of the legislative intention to give the appellant all the powers of a natural person, and to abolish the doctrine of ultra vires with respect to the appellant. However, s. 26(2) must be considered together with other sections of the Act, including s. 9(7).

(2) Section 9(7) of The Communities Economic Development Fund Act

36 Section 9(7) prohibits, using mandatory language, the making of loans in contravention of the Act. In my opinion, the section can only be interpreted as evidence of the intention of the legislature to limit the wide grant of powers made in s. 26(2) of the Act. I am bolstered in my conclusion by the fact that the Act provides no sanction or remedy for a loan made in contravention of the Act and in violation of s. 9(7). If section 9(7) were interpreted to mean only that the appellant should not make loans in contravention of the Act, the section would be superfluous: the conclusion that the appellant should not make loans in contravention of the Act follows from the most basic of interpretive law principles. It is a principle of statutory interpretation that every word of a statute must be given meaning: "A construction which would leave without effect any part of the language of a statute will normally be rejected" (Maxwell on the Interpretation of Statutes (12th ed. 1969), at p. 36). [page409] Accordingly, the prohibition in s. 9(7) of the Act should be interpreted so as to create a limit on the powers of the appellant.

37 With many Manitoba corporations, the remedial provisions in Part XIX of The Corporations Act and in particular the provisions in s. 240 for obtaining a restraining order, would be available for a breach of the constating statute. However, s. 3(1)(b) of The Corporations Act provides that Part XIX is inapplicable to the appellant. Hence, not only is no remedy provided within the statutory scheme for a breach of s. 9(7), but the remedy which would otherwise have been available has been expressly removed. I conclude that there is not only no evidence of a legislative intention to rebut the presumption that acts of a company which contravene the constating statute of the company are ultra vires, but on the contrary that the evidence indicates that the legislature positively intended that acts of the appellant violating the prohibition in s. 9(7) should be ultra vires.

38 I would also refer for further support for my interpretation of the effect of ss. 9(7) and 26(2) of the Act to the decision of this Court in Canadian Bank of Commerce v. Cudworth Rural Telephone Co., [1923] S.C.R. 618. The respondent in that case had originally been incorporated under The Rural Telephone Act of Saskatchewan. It was later incorporated under The Companies Act of that province. The respondent was contesting its indebtedness on a promissory note on the grounds that the note was ultra vires. The Rural Telephone Act explicitly set out the means by which the respondent could raise money. These means did not include issuing promissory notes. However, s. 14(b) of The Companies Act of Saskatchewan provided, inter alia, that:

> Every company ... shall, ... unless the contrary intention is expressed in a special Act or ordinance incorporating the company or in a memorandum of association thereof, ... so far as the capacities of such companies are concerned, have and be deemed to have had the same effect as if the company were or had been incorporated by letters patent under the great seal.

The Supreme Court of Canada held, Idington J. dissenting, that the promissory note was ultra vires the [page410] respondent, under both the Saskatchewan Rural Telephone Act and Companies Act.

39 I find the reasons of Duff J. particularly helpful. Duff J. first finds that the effect of s. 14 of the Saskatchewan Companies Act is to rebut the normal presumption that a corporation created by or under a statute has limited powers. In other words, s. 14 confers on the respondent the general capacity of a common law corporation. He goes on to consider the effect of the provisions in The Rural Telephone Act in the context of the grant of the general capacity of a common law corporation by s. 14 of the Saskatchewan Companies Act, at pp. 628-29:

> The effect, then, of section 14 upon the companies to which it applies is not to abrogate entirely the doctrine of ultra vires but to establish a rule of construction which in effect is that such companies are to be deemed to have the capacities of a common law corporation, subject to such restrictions as the legislature has evidenced an intention of imposing upon it. In declaring in section 14 that the companies referred to are to have the capacities of a common law corporation, the legislature cannot be supposed to have intended to abrogate the restrictions and prohibitions which the legislature itself has shewn an intention to impose upon such companies. A company created by charter ... is necessarily

> subject to the restrictions imposed upon it by the legislature, and where the enactment imposing such restrictions evinces an intention that a given transaction shall not be entered into, then any attempt on the part of the company to enter into such a transaction must be inoperative in law. [Emphasis added.]

40 In the case at bar, the Act by s. 26(2) gives the Fund the attributes of a company created by charter, but the Act, by s. 9(7), clearly evinces an intention that a given transaction, namely a loan contrary to the Act, shall not be entered into.

(3) Section 7(c) of The Communities Economic Development Fund Act

41 Section 7(c) of the Act allows the Fund to exercise the "powers" set out in Part III of The Corporations Act which is entitled, "Capacity and Powers". The present provisions in Part III have the effect of statutorily [page411] abolishing the ultra vires doctrine with respect to corporations covered by The Corporations Act. In interpreting s. 7(c) of the Act it is helpful to refer to the legislative history of Part III of The Corporations Act. Previous versions of Part III, enacted under The Companies Act, R.S.M. 1970, c. C160, granted a wide range of incidental and ancillary powers to incorporated companies, as did many other companies' acts of the period.

42 The Act was first enacted in 1971, as The Communities Economic Development Fund Act, S.M. 1971, c. 84. At that time, Manitoba companies were incorporated by letters patent under The Companies Act. The provision now found in s. 7(c) of the Act was then found in s. 9(c) of the 1971 Act. Section 9(c) provided that: "The fund may ... generally exercise the powers set out in subsection (1) of section 26 of The Companies Act." Section 26(1) of The Companies Act gave a company the power "as incidental and ancillary to the objects set out in its charter" to perform a wide range of acts. The necessary link between these acts and the objects of the company is emphasized by the wording of the residual clause in s. 26(1)(cc), which provided that a company might "do all such other things as are incidental or conducive to the attainment of the objects and the exercise of the powers of the company."

43 In 1976, The Companies Act was repealed, and the present Corporations Act was enacted as S.M. 1976, c. 40. Two years later, changes to the 1971 Communities Economic Development Fund Act made necessary by the introduction of the 1976 Corporations Act were introduced in The Statute Law Amendment Act (1978), S.M. 1978, c. 49. The necessary change to s. 9(c) of the 1971 Communities Economic Development Fund Act was made by s. 18(2) of The Statute Law Amendment Act (1978):

> 18(2) Clause 9(c) of the Act is amended by striking out the words and figures "subsection (1) of section 26 of The Companies Act" thereof and substituting therefor the words and figures "Part III of The Corporations Act".

[page412]

44 In my opinion, the legislative history of s. 7(c) of the Act, when interpreted in conjunction with the legislative history of Part III of The Corporations Act, indicates that s. 7(c) of the Act is intended only to give the appellant the incidental and ancillary powers necessary to further its statutory objects.

45 However, there remains the question of s. 16(3) of Part III of The Corporations Act. Like similar provisions in other corporations acts, s. 16(3) provides that no act of a corporation is invalid only because the act is contrary to its articles or to The Corporations Act. However, s. 16(3) of The Corporations Act must be read together with s. 3(1)(b) of The Corporations Act, and ss. 9(7) and 26(5) of The Communities Economic Development Fund Act. In my view, s. 16(3) of The Corporations Act is part of a legislative scheme to abolish the doctrine of ultra vires. The remedial provisions in Part XIX of The Corporations Act are an integral part of that scheme. The abolition of the doctrine of ultra vires goes together with the creation of new statutory remedies. The fact that Part XIX is expressly made inapplicable to the Fund by s. 3(1)(b) of The Corporations Act is an indication of a legislative intention to retain the doctrine of ultra vires for the Fund, with respect to loans that contravene the Act.

46 I find support for this conclusion in the legislative history of s. 7(c) of the Act, which indicates a legislative intention to give the Fund only powers necessarily incidental to its objects. Furthermore, I think that s. 9(7) of the Act clearly indicates a legislative intention to prohibit actions by the Fund beyond its powers. In addition, if there is any conflict between s. 9(7) of the Act and s. 16(3) of The Corporations Act, it must be resolved in favour of s. 9(7) of the Act, because s. 26(5) of the Act provides that where there is a conflict between the Act and The Corporations Act, the Act prevails.

(4) Conclusion

47 I would conclude that loans made by the appellant in contravention of s. 9(7) of the Act are ultra vires. The loan to Canadian Pickles is ultra vires the appellant [page413] because it was made in contravention of s. 9(7) of the Act.

VI. Is the Respondent Liable to Repay the Loan as Guarantor?

48 It is the contention of the appellant that the decision of the Alberta Court of Appeal in Meadow Rue, supra, was a correct application of Breckenridge, supra. Where the principal debt is ultra vires the lender, the appellant submitted, the guarantor should nonetheless be liable to repay the loan. In my respectful opinion, the court in Meadow Rue misapplied Breckenridge in that it did not distinguish the borrower's obligations to the lender from the guarantor's obligations to the lender. However, before turning to the circumstances of this case, it will be useful to make some general comments about the nature of a guarantee, and about the decision of this Court in Breckenridge.

A. The Nature of a Guarantee

49 A guarantee is generally a contract between a guarantor and a lender. The subject of the guarantee is a debt owed to the lender by a debtor. In the contract of guarantee, the guarantor agrees to repay the lender if the debtor defaults. The exact nature of the obligation owed by the guarantor to the lender depends on the construction of the contract of guarantee, but the liability of the guarantor is usually made coterminous with that of the principal debtor. Generally speaking, if the principal debt is void or unenforceable, the contract of guarantee will likewise be void or unenforceable. See generally, J. O'Donovan and J. C. Phillips, The Modern Contract of Guarantee (1985), at pp. 183-93.

50 Contracts of guarantee are sometimes distinguished from contracts of indemnity. In a contract of indemnity, the indemnifier assumes a primary obligation to repay the debt, and is liable regardless of the liability of the principal debtor. An indemnifier will accordingly be liable even if the principal debt is void or otherwise unenforceable. The distinction between contracts of guarantee and of indemnity ought not to be overemphasized. The resolution of a given case will turn on the correct interpretation of [page414] the contract and of the intention of the parties; attempts to label the contract as one of guarantee or of indemnity may be less than helpful. In Yeoman Credit, Ltd. v. Latter, [1961] 2 All E.R. 294 (C.A.), at p. 299, Harman L.J. had this to say about the distinction: "[i]t seems to me a most barren controversy [which] has raised many hair-splitting distinctions of exactly that kind which brings the law into hatred, ridicule and contempt by the public".

B. The Principle in Breckenridge

51 In Breckenridge, supra, the Treasurer of Alberta agreed to lend money to the plaintiffs. The plaintiffs had transferred certain interests in real property to the Treasurer as security for the loan. The plaintiffs sought rescission of the entire agreement. The Treasurer counterclaimed for the money owing, and the plaintiffs defended the counterclaim on the grounds that the loan was ultra vires the Treasurer. Writing for the majority, Martland J. found that regardless of whether or not the loan was ultra vires, the plaintiffs could have no answer to an action for money had and received. The plaintiffs had a legal obligation to repay the funds they had received.

52 On the question of the security held by the Treasurer, he held that property in the security had passed to the Treasurer. Martland J. held that property had passed not only because there were no other creditors, but also because the security had been given as part of an arrangement by which the plaintiffs sought to discharge their lawful obligation to make restitution of the money they had borrowed.

53 The question of the liability of a guarantor of an ultra vires loan did not arise in Breckenridge.

[page415]

C. Application of the Law to the Facts of This Case

54 There are two questions to be answered here. First, is the respondent liable on the basis of the principles in Breckenridge? Second, even if Breckenridge does not apply, is the respondent nonetheless liable by the terms of the contract of guarantee?

55 I cannot accept the appellant's argument that the respondent is liable on the basis of Breckenridge. Rather, I accept the reasons on this point of the majority of the Court of Appeal below. In Breckenridge, the principal debtor was obliged to repay money had and received from the lender, even though the principal debt was a nullity. In this case, the respondent received no money from the lender, and consequently the respondent cannot be liable on the basis of money had and received.

56 With respect, I must disagree with the position of the Alberta Court of Appeal in Meadow Rue, supra, at p. 295, that the rule in Breckenridge is "a simple example of equity in action" that applies to the guarantor of a loan. The essence of an action for moneys had and received is that the defendant has actually received the money sued for; where the defendant has received no money the action does not lie. See G. B. Klippert, Unjust Enrichment (1983), at pp. 5-7; Lord Goff and G. Jones, The Law of Restitution (3rd ed. 1986), at pp. 3-5. I would add that an action for moneys had and received does not lie in equity: Klippert, supra, at pp. 13-19.

57 The appellant also argued that the respondent's guarantee was a security, and that property in the security should accordingly pass to the appellant, again following Breckenridge. This argument is without merit. Even accepting the dubious proposition that a guarantee is the equivalent of real property to which the lender has acquired title, the respondent's guarantee was not given to discharge a lawful obligation owed by the respondent to the appellant. The [page416] lawful obligation was owed to the appellant by Canadian Pickles, not by the respondent.

58 The question which remains is whether, on the correct interpretation of the contract, the respondent is liable to repay the loan made by the appellant to Canadian Pickles. The relevant part of the contract is clause "(b)":

> (b) That as between the Fund and the Guarantors, the Guarantors are and shall continue to be jointly and severally liable as principal debtors under all the covenants contained in the Security, notwithstanding the bankruptcy, insolvency or going into liquidation of the Borrower, voluntarily or otherwise, and notwithstanding any transaction which may take place between the Fund and Borrower or any neglect or default of the Fund which may otherwise operate as a discharge, whether partial or absolute, of the Guarantors if they were sureties only of the Borrower and, without restricting the generality of the foregoing, notwithstanding the releasing in whole or in part of the properties and assets mortgaged or charged in the Security, and notwithstanding the granting of time or other indulgences to the Borrower;

59 As a preliminary matter, there was, in my opinion, a valid contract between the respondent and the appellant. The validity of the contract was not questioned by the respondent. On the face of the contract, there was the necessary consideration:

> ... in consideration of the advance to the Borrower by the Fund of the said sum of ONE HUNDRED FIFTY THOUSAND DOLLARS ($150,000.00), or such portion thereof as may be advanced or re-advanced, (hereinafter called the "Principal Sum") and in consideration of the sum of ONE DOLLAR ($1.00) now paid by the Fund to each of the Guarantors, the receipt and sufficiency whereof is hereby acknowledged, the Guarantors do joint and severally COVENANT, PROMISE AND AGREE ...

60 It was the appellant's argument that the contract makes the respondent a principal debtor, regardless of the status of the obligation owed by Canadian Pickles to the appellant. In making this argument, the appellant relied principally on two phrases from clause "(b)". The phrases are "the Guarantors are and shall continue to be jointly and severally liable as principal debtors", and "which may otherwise operate [page417] as a discharge, whether partial or absolute, of the Guarantors if they were sureties only of the Borrower".

61 Taking the two phrases in turn, I find that the plain meaning of the first phrase read in the context of the entire clause is that the guarantors, including the respondent, will be liable as principal debtors only in the enumerated circumstances. I cannot see that the listed circumstances include the invalidity of the principal debt. A similar clause was at issue in General Produce v. United Bank, [1979] 2 Lloyd's Rep. 255 (Q.B. (Com. Ct.)). In that case, Lloyd J. concluded that the effect of a clause providing that the guarantor's liability would continue in spite of the release of the principal's debtor's liability by operation of law was that the creditor could treat the guarantor as a principal debtor only in the specified situation. Likewise, in Heald v. O'Connor, [1971] 1 W.L.R. 497 (Q.B.D.), Fisher J. interpreted a clause making the guarantor "a primary obligor" in light of the entire agreement and concluded that it did not convert what was really a guarantee into an indemnity.

62 The second phrase which the appellant argued takes the appellant's case no further. The phrase only provides added support for the interpretation just articulated: the guarantors are liable as principal debtors only in the circumstances enumerated.

63 I would conclude that the correct interpretation of the contract is that the respondent is not liable to repay the money advanced in the event the principal debt is ultra vires. It was open to the appellant to insist upon a contract with the respondent that would have made the respondent liable in the circumstances of the case at bar. As the appellant did not do so, its claim must fail.

VII. Recent Amendments to The Communities Economic Development Fund Act

64 After the hearing of this appeal, it came to the attention of the Court that several amendments to the Act were recently passed which materially altered many of the provisions discussed above. One amendment, [page418] which appears in The Statute Law Amendment Act, 1990-91, S.M. 1990-91, c. 12, s. 3, amends the Act to add a new s. 26(6) which provides, inter alia, that no loan, guarantee or financial assistance granted by the Fund before the coming into force of the new subsection is invalid or unenforceable by reason only that the recipient economic enterprise is not located in a remote and isolated community. This amendment came into force on December 14, 1990, some six months before the appeal was argued on June 3, 1991. In addition, a series of amendments to the Act were made by The Communities Economic Development Fund Amendment Act, S.M. 1991-92, c. 38. This amending statute, inter alia, deletes the definition of "remote and isolated communities" in the Act, amends s. 9(7) referred to above, and significantly amends the newly added s. 26(6) and expressly makes this amendment retroactive to December 14, 1990. This latter group of amendments was introduced on May 27, 1991 and given Royal Assent on July 26, 1991.

65 On October 18, 1991, the Court, through the Registrar, formally asked for the views of the parties as to the effect of the legislative amendments on the issues in the appeal and why the amendments were not put before the Court during argument. In their respective replies, counsel for the parties agree, in essence, that the amendments do not affect the issues before the Court because the amendments do not specifically address pending litigation. Counsel pointed to s. 9 of The Interpretation Act, R.S.M. 1987, c. I80; see also Upper Canada College v. Smith (1920), 61 S.C.R. 413, Garnham v. Tessier (1959), 27 W.W.R. 682 (Man. C.A.), and Penner v. Hutlet (1984), 33 Man. R. (2d) 168 (Q.B.); see also Manufacturers Life Insurance Co. v. Hauser, [1945] 3 W.W.R. 740 (Alta. S.C.), and Minchau v. Busse, [1940] 2 D.L.R. 282 (S.C.C.). I agree with the submissions of counsel in this respect. Counsel also candidly admitted they were unaware of the legislative changes when the appeal was argued. Accordingly, as the recently made [page419] amendments do not affect the outcome of this appeal, they need not under the circumstances be considered further.

VIII. Disposition

66 For these reasons, I would dismiss the appeal with costs.

qp/i/qlcvd

Tab 8

Case Name:

Pegah Construction Ltd. v. Panterra Mansions Joint Venture Corp.

Between
Pegah Construction Ltd., Plaintiff, and
Panterra Mansions Joint Venture Corp., 1221456 Ontario Limited, 1746288 Ontario Inc., Lombard General Insurance Company of Canada, Romspen Investment Corporation and Howard Kutner, Defendants

[2013] O.J. No. 2543

2013 ONSC 3226

21 C.L.R. (4th) 1

2013 CarswellOnt 7268

Court File No. 07-CV-339990

Ontario Superior Court of Justice

Master C. Albert

Heard: May 14, 16, 17, 21 and 22, 2013.
Judgment: May 31, 2013.

(72 paras.)

Construction law -- Contracts -- Interpretation -- Contra proferentem -- Trial of issue whether relationship between plaintiff and defendant was owner and general contractor or owner and project manager, for the purposes of prioritizing lien claimants and mortgagees to failed construction project -- Contract created hybrid structure but conduct of parties conduct was as owner and general contractor -- Liability to trades on-site sufficient to determine structure of contractual relationship -- Parties were sophisticated so contra proferentem was not invoked.

Trial of the issue whether the relationship between plaintiff and defendant was one of owner and general contractor or one of owner and project manager, for the purposes of prioritizing lien claimants and mortgagees to a failed construction project. The defendant contracted with the plaintiff to renovate an existing building on Jarvis Street in Toronto and to build a high-rise addition at that site. The mortgagees for the project eventually put the development project into receivership. The plaintiff and other contractors registered construction lien claims against the property. At issue was whether the plaintiff was acting as agent for the defendant as project manager or contracted with other contractors directly as general contractor. Clause GC 3.1 was critical to the contract between the plaintiff and defendant as this clause established the relationship between the plaintiff and defendant.

HELD: The contract set out a relationship of owner and general contractor. The contract, particularly clause GC 3.1 created a hybrid structure between the plaintiff and defendant. The language of the contract defined a construction manager as an agent and set out an agency relationship, but there was no evidence of the plaintiff arranging a single contract as the defendant's agent. The parties conducted themselves as owner and general contractor despite the language of the contract. The liability for payment to the trades on-site was sufficient to determine the structure of the contractual relationship; this liability lay with the plaintiff as general contractor. The owners of each company in the dispute were both sophisticated parties in the construction industry, so it was not necessary to invoke contra proferentem.

Statutes, Regulations and Rules Cited:

Construction Lien Act, R.S.O. 1990, c. C.30,

Counsel:

K. Bannon (Pegah), for the plaintiff.

D. Preger, for the defendant, SF Partners as receiver for Panterra Mansions.

D.M. Steidman, for the defendants, Romspen and 1746288 Ontario Inc.

MASTER C. ALBERT:--

I. INTRODUCTION

1 This dispute arises from the now insolvent development project called Jarvis Mansions. Panterra Mansions Joint Venture Corp. ("Panterra") is the owner and developer of 539 Jarvis Street, Toronto. Panterra contracted with Pegah Construction Ltd. ("Pegah") to renovate the existing building and build a high rise addition to create a total of 34 condominium units. Firm Capital provided the initial funding and subsequently assigned its mortgage to 1746288 Ontario Inc. ("174"), with Romspen Investment Corporation ("Romspen") providing additional funding late in the day when the project encountered financial difficulties. Ultimately the mortgagees placed Panterra into receivership and appointed SF Partners Inc. as receiver (the "receiver").

2 Several contractors, including Pegah, registered construction liens against the property and the matter came before me by way of reference under the *Construction Lien Act*.

3 The rights and priorities of lien claimants and mortgage lenders must be determined for the receiver to distribute funds to lien claimants and mortgagees. These rights and priorities depend on the structure of the relationship between Panterra and Pegah.

4 Pegah maintains that its role was that of general contractor and that the receiver's holdback obligation must be calculated as ten percent of the total value of materials and services supplied under its contract with Panterra. Pegah argues substance over form and asks the court to find that Pegah was a general contractor notwithstanding that it was labelled as a construction manager in the contract.

5 The receiver's position is that Panterra contracted with Pegah to provide construction management services as Panterra's agent and not as general contractor. The receiver maintains that its holdback obligation must be calculated on a contract by contract basis with the trade contractors. Romspen and 174 as mortgagees side with the receiver. The receiver argues that form governs and that Pegah is a construction manager as defined in the written contract.

6 Pursuant to my directions of June 1, 2012 in this reference I ordered a trial of the issue of whether the relationship of Pegah and Panterra is one of owner and general contractor or one of owner and project manager.

II. PRELIMINARY ISSUE: ADMISSIBILITY OF EXTRINSIC EVIDENCE

7 Trial of the issue began on May 14, 2013. The receiver, Romspen and 174 raised as a preliminary issue the extent to which the court could hear and consider evidence extrinsic to the written contract[1].

8 After hearing argument, and applying the decision of the Manitoba Queen's Bench in *Matthews Investments Ltd. v. Assiniboine Medical Holdings Ltd.*[2], I determined that in the face of an objection to the admissibility of extrinsic evidence based on the parol evidence rule, the court must determine as a preliminary issue whether extrinsic evidence is admissible in the circumstances of the case before the court.

9 In ascertaining the meaning of a contract the court will search for an interpretation which, from the whole of the contract, is consistent with the true intent of the parties at the time they entered into the contract. Literal meaning should not be applied where to do so would bring about an unrealistic result or a result which would not be contemplated in the atmosphere in which the contracted was created[3]. The issue is the extent to which the court may consider evidence beyond the actual contract document as an aid to interpretation.

10 In a clear statement of the parol evidence rule Justice Iacobucci, in *Eli Lilly, supra,* considered *Consolidated Bathurst, supra,* and concluded that contractual intent of the parties is to be determined from the words used in the contract itself, perhaps considered in light of the surrounding circumstances at the time of entering into the contract but without considering either party's subjective intention[4]. He wrote:

> "It is unnecessary to consider any extrinsic evidence at all when the document is clear and unambiguous on its face."

11 The issue is whether the contract between Panterra and Pegah was clear and unambiguous on its face. The receiver, Romspen and 174 argue that it was. Pegah argues that it was not.

12 Ambiguous means "unclear because not distinguishing between alternatives; having more than one meaning".

13 The issue to be tried in this case is whether the contract between Panterra and Pegah creates the structure of owner and agent, with Pegah as construction manager acting as Panterra's agent, or whether the contract creates the structure of owner and general contractor, with Pegah as general contractor.

14 I find that the contract, given its plain and ordinary meaning, could be capable of three possible interpretations:

> a. The contract is for construction management services and Pegah is Panterra's agent for all purposes;
> b. The contract is for general contracting services with Pegah in the role of Panterra's general contractor for all purposes; or
> c. The contract is a hybrid one, where Pegah is authorized to act as construction manager and agent of Panterra in relation to some trades and as general contractor in relation to other trades.

15 Ambiguity in the wording of the contract is found in section GC 3.1 dealing with contracts with Trade Contractors. Under the section in the contract titled "Definitions", item 6 defines "Trade Contractor" as "a person, firm or corporation having a direct contract with the Owner to perform the work." In section GC 3.1 of the contract, under the heading "Trade Contractors" the contract provides:

> "3.1 The Construction Manager will, in accordance with the direction of the Owner, arrange for contracts to be entered into between the various Trade

> Contractors and the Owner/ or between the Trade Contractor and the Construction Manager with the approval of the Owner."

16 There is an inherent conflict in this clause on its face. Pursuant to Article A-3 the construction manager, defined in the contract as Pegah, is appointed by Pegah as its agent to act in its name for the purpose of managing the construction. The second part of GC 3.1 is ambiguous and capable of more than one meaning. If it is read together with article A-3 one would have to substitute "Panterra by its agent Pegah" for "Construction Manager" and it would be repetitive of the first part of section GC 3.1, which has already dealt with the situation of contracts between Pegah and Trade Contractors. I find that GC 3.1 is ambiguous because it is capable of more than one meaning when considered in the context of the contract as a whole.

17 Clause GC 3.1 is a critical clause in this contract because it is at the crux of whether Trade Contractors contract directly with Panterra through Pegah as Panterra's agent, or whether they contract directly with Pegah as general contractor, not as Panterra's agent. One possible interpretation is that Panterra and Pegah intended that some of the contracts with trades be direct contracts with the Panterra and some of the contracts with the trades be arranged directly with Pegah.

18 I am mindful of the caution in *Matthews Investments Ltd. v. Assiniboine Medical Holdings Ltd.* [5] that the court should not strain to create an ambiguity that does not exist. I do not believe that I have strained in this case. In the construction industry there are two basic forms of contract and many hybrids. The two basic forms are (i) construction or project management where the construction manager acts solely as agent of the owner, and (ii) general contracting services where the contractor arranges for and enters into direct contracts with all of the trades. Clause GC 3.1 creates an ambiguity that suggests a hybrid structure without clarifying the rights and obligations of the construction manager in respect of contracts made with trades directly and not as agent of the owner.

19 In my view extrinsic evidence is required to resolve this ambiguity in the language of the contract. How the parties conducted themselves, including the form of contract entered into with trades, is relevant to determining the nature of the contract as between Panterra and Pegah and whether it was for construction management services, for general contracting services or a hybrid of the two.

20 Extrinsic evidence is admissible on the trial of the issue of the structure of the relationship of Panterra and Pegah.

III.

TRIAL ISSUE: CONSTRUCTION MANAGER OR GENERAL CONTRACTOR?

21 Distribution of funds retained by the receiver depends on priorities which, in turn, depends on the structure of the relationship of Panterra and Pegah. If Panterra's position that Pegah acted as construction manager and agent is correct then its holdback obligation is significantly lower, leaving more funds available for distribution by the receiver to mortgagees Romspen and 174 ("Romspen/174").

22 The following diagrams illustrate the difference in the two structures in relation to the contractors who perform the physical construction, referred to in these reasons as "trades".

Figure 1: General contract structure

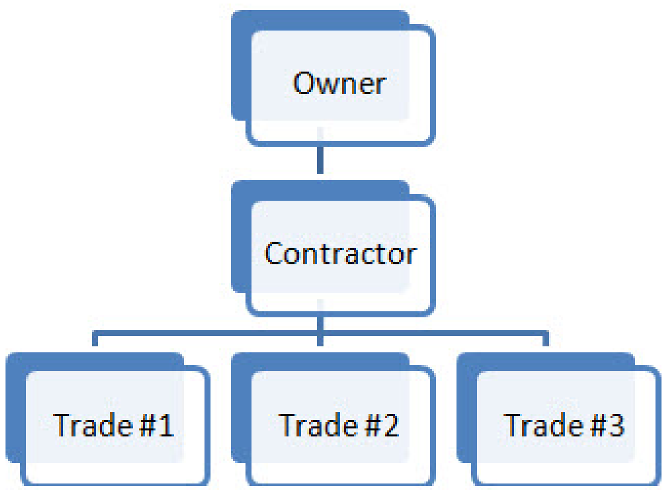
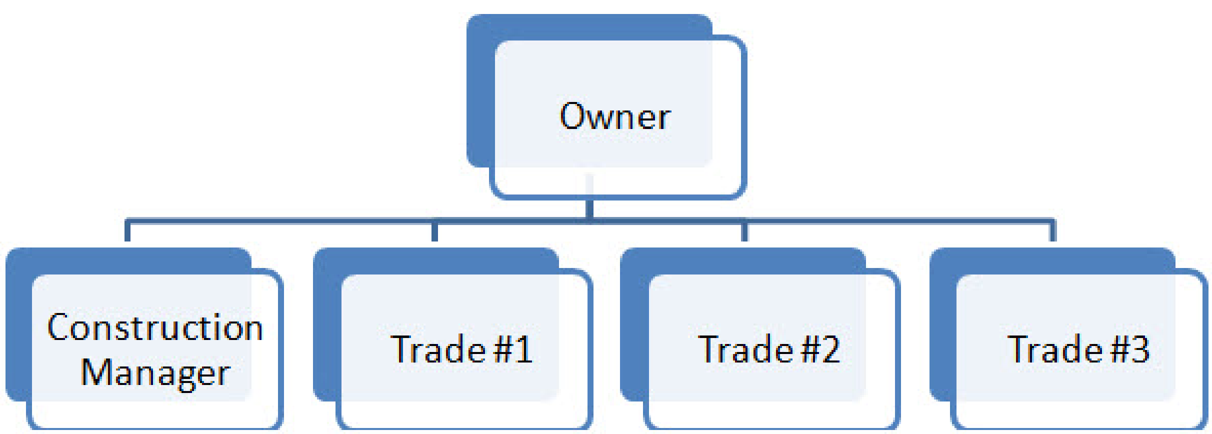


Figure 2: Construction management structure



23 Panterra and Pegah executed a written contract on May 4, 2005. The original contract budget was $6,389,000.00 (the "budget") plus a construction manager's fee of $300,000.00 (the "fee") plus GST. Six weeks later, on June 17, 2005, the parties executed two more documents: (i) an amendment to the contract reducing the budget by $245,000.000 and (ii) an irrevocable direction to the lawyer who would be holding proceeds of the sale of condominium units to pay Pegah $245,000.00 after discharging the Firm Capital mortgage. Reading these documents together, the contract price did not change. Rather, they agreed to defer payment of $245,000.00 of the contract price.

24 The triable issue of the structure of the relationship of Panterra and Pegah arises because the parties executed a CCA 5 1988 form of contract (the "CCA 5"), designed for use by an owner and construction manager where the construction manager acts as agent of the owner, but modified by the parties to incorporate features that are inconsistent with an agency structure. The contract labels and refers to Panterra as the owner and Pegah as the construction manager.

25 The parties added and amended three critical clauses:

a. GC 3.1: The parties amended the CCA 5 clause whereby the construction manager arranges for contracts with trade contractors as agent of the owner, and added an alternative option authorizing the construction manager to contract with trades directly and not as agent of the owner.
b. A-16: The parties amended the CCA 5 by adding a new clause whereby the construction manager takes on the risk of cost overruns, calculated as 50 percent up to $150,000.00 over budget and 100 percent of cost overruns above that threshold. In substance this clause increased the budget by $150,000.00 but required Pegah to pay for half of the increase and all costs above the increased budget. Article A-16 also provided that the parties would share cost savings if the project was completed under budget.
c. A-5 and GC-10: The parties amended the CCA 5 clause that provides for the construction manager's fee to be paid monthly and replaced it with a schedule for percentage payments of the fee based on construction milestones.

26 The issue is whether the contract, as modified, transformed the structure from one of owner and construction manager to one of owner and general contractor. It is a matter of substance over form.

27 Project funding was stretched to the limit with no room for cost overruns. That is clear from the contract amendment reducing the construction budget by $245,000.00 to facilitate a mortgage advance. The significance of the transaction is that both Panterra and Pegah knew or ought to have known that there would be no funding available if project costs exceeded the budget. It also suggests that cost savings were unlikely.

28 It is not in dispute that the parties intended to incorporate incentives into the contract to encourage cost savings and discourage cost overruns. Pegah explains that the reason the CCA 5 form of contract was used was to allow for transparency in costs and flexibility: Panterra wanted the ability to examine and control costs, particularly in light of the funding concerns.

29 Clause A-16 was added to serve two purposes: (i) as an incentive to Pegah to minimize costs by sharing financially in any cost savings; and (ii) as a disincentive for cost overruns because Pegah was ultimately liable for cost overruns, after sharing the first $150,000.00. In an agency structure all cost savings would flow to the owner, and all cost overruns would be the sole responsibility of the owner. In a general contracting structure cost savings would flow to the general contractor and all cost overruns would be the sole responsibility of the general contractor. In the contract between Panterra and Pegah cost savings were to be shared and cost overruns beyond the increased threshold were the sole responsibility of Pegah.

30 Panterra argues that as a sophisticated businessman in the construction industry Mr. Mohtashami, president of Pegah, understood the ordinary meaning of the labels used in the contract and the amendments to the CCA 5 did not change the nature of the contract. Panterra points out that the amendment to article GC 3.1 that contemplates Pegah entering into direct contracts with trades requires the approval of the owner, but admits that Panterra is deemed to have approved of all trade contracts that were within budget.

31 In my opinion, if the court finds that the amendment to article GC 3.1 creates a structure akin to owner and general contractor then the requirement to secure the approval of the owner does not change that structure to one of agency. There are many reasons why an owner may contract for approval rights over trades working on its project. One reason might be to ensure that trades with whom the owner has had a prior negative experience are not hired. Failure to secure Panterra's written approval for each trade contract would not change the structure from one of direct contracts with trades to one of agency with the contract rights and obligations vis-a-vis the trades attaching to Panterra in place of Pegah. In any event, I find that the contract did not require that Panterra's approval be written. Mr. Rosen, as project architect, consultant and principal of the owner, was on site regularly and knew or ought to have known what trades were working on the project. There is no evidence of any occasion where Mr. Rosen challenged or refuted Pegah's hiring of a trade directly without obtaining Panterra's written approval.

32 Pegah argues that labels used in the contract do not determine meaning. Context does. In *Communities Economic Development Fund v. Canadian Pickles Corp.*[6] the issue before the court was whether a party to a document titled a "guarantee" was liable to the lender as a guarantor where the underlying debt to the borrower was invalid. The court considered whether the agreement signed by the guarantor was a guarantee or an indemnity and concluded that the label of "guarantee" used by the parties was not determinative. Rather, the correct interpretation of the contract and the intention of the parties govern.

33 The receiver relies on *Adams v. McLean & Dickey Ltd.*,[7] citing Winkler, C.J.O. in *Salah v.*

Timothy's Coffees of the World Inc.[8] for the following propositions:

a. a contract must be construed as a whole, giving meaning to all its terms;
b. the court must consider the objective evidence of the "factual matrix" or context underlying the negotiation of the contract, but must not consider the subjective intention of the parties;
c. the court should avoid an interpretation that renders one or more of its terms ineffective or leads to a commercial absurdity; and d. extrinsic evidence may be relied up to clear up an ambiguity.

34 Counsel for Romspen/174 argues that the intention of the parties must be ascertained objectively from the evidence without regard to the subjective intention of the parties. On that basis Romspen/174 asks the court to disregard evidence of Mr. Mohtashami's belief as to his company's relationship with Panterra. I agree and have disregarded subjective evidence of intention of all witnesses. My findings as to the parties' intentions are based on the written contract and their conduct as they performed the contract.

35 Applying these principles to the present case, Pegah argues that the use of the label "construction manager" in the written contract is not determinative of the structure of the relationship of Panterra and Pegah. Rather, the court must interpret the written contract by considering the contract in its entirety and objective evidence of intention.

36 Both the receiver and Romspen/174 argue that industry standard is not germane to determining the meaning of a negotiated contractual provision and the court should not perform linguistic acrobatics: *Veracap Corporate Finance Limited v. Carefoot*[9]. In that case the contract provided for an overly generous fee provision that was challenged as not making business commonsense. The court concluded that it would not interfere with autonomous bargains that do not "conform to some external notion of economic fairness". The court noted that business commonsense may be considered where a "detailed semantic and syntactical analysis of the words in a commercial contract...yield to a conclusion that flouts business common sense", citing *The Antaois Compania Neviera S.A. v. Salen Rederierna A.B.*[10]

37 Applying *Antaois Compania, supra*, to the present case the issue is whether a detailed semantic and syntactical analysis of the contract yields to a conclusion that flouts industry standards. The receiver and Romspen/174 argue it does not lead to such a conclusion and on that basis industry standards should not be considered.

38 I find that the words used in the contract between Panterra and Pegah, given their ordinary meaning, contain an inherent ambiguity in terms of the structure of the relationship created by the contract.

39 The parties used the label "construction manager" in the contract and defined that party as an agent. Given their ordinary and meanings "construction manager" and "agent" would have certain characteristics. Ascertaining whether the label is used by the parties in its ordinary meaning, or whether the rights and obligations imposed by the rest of the contract create a different structure, is the key issue. The label used by the parties is not determinative: *Communities Economic Development Fund v. Canadian Pickles Corp., supra.*

40 Context is important. Justice Blair, writing for the Court of Appeal, made the following observation in *Ventas Inc. v. Sunrise Senior Living Real Estate Investment Trust*[11]:

> "Contracts are not made in a vacuum, and there is no dispute that the surrounding circumstances in which a contract is negotiated are relevant considerations in interpreting contracts. As this court noted in *Kentucky Fried Chicken, supra*,[12] "[w]hile the task of interpretation must begin with the words of the document and their ordinary meaning, the general context that gave birth to the document, or its "factual matrix" will also provide the court with useful assistance."

41 The parties negotiated and deliberately added a clause to shift the risk of runaway project costs from Panterra to Pegah with a guaranteed a maximum price (the budget plus $150,000.00 over budget to be shared). Panterra had no risk of cost overruns above the increased threshold. Pegah took on 100 percent of that risk.

42 The parties negotiated and deliberately inserted a clause into the contract whereby Pegah could contract with trades directly and not as Panterra's agent.

43 In fact, Pegah contracted directly with all but one trade. The only trade that contracted directly with Panterra was KML Building Solutions. That contract was executed on August 5, 2005, three months after the Pegah contract, for the price of $590,000.00 for additional steel structural support after the original budget had been fixed. This work was not part of Pegah's budget. There is no evidence of any trade contract for work performed in respect of items in the Pegah budget where the trade executed a contract directly with Panterra or with Pegah as agent for Panterra.

44 I find that the contract creates a hybrid structure. It defines a construction manager as an agent and creates an agency relationship, but there is no evidence of a single instance where Pegah arranged for a trade contract as Panterra's agent. The contract also contemplates that Pegah, still labelled the construction manager, may act independently and not as Panterra's agent to enter into direct contracts with trades. That is, in fact, how the parties conducted themselves in performing the contract.

45 Pegah relies on *Centrum Renovations & Repair Inc. v. Ditta*[13] for factors considered by the court when asked to determine whether the structure was one of general contracting or construction management. The receiver and Romspen/174 distinguish *Centrum* because in that case there was no written contract and the court considered the conduct of the parties to determine the nature of their relationship.

46 In my view the factors considered by the court in *Centrum* are relevant for the purpose of considering whether Panterra and Pegah incorporated these factors into their written contract.

47 The criteria indicative of a general contract structure considered by the court in *Centrum*[14], expressed in terms of the case before me, are:

a. Whether the contract contemplates that Pegah negotiate and contract directly with trades in the manner of a general contractor;
b. Whether trades submit quotes to Pegah, not to Panterra, in the vast majority of cases;
c. Whether trades seek payment from Pegah directly; and d. Whether Pegah pays trades directly for work performed on the project.

48 In *Centrum* the court was of the view that the last two factors alone, if met, are sufficient to find that the structure is one of general contractor and owner.

49 Aside from the factors in *Centrum* for distinguishing between a construction management and a general contracting structure, a helpful discussion of differences between the two structures is found in an article published by David Bristow, Q. C., titled "An Overview of Three Commonly Used Construction Contracts - Stipulated Price Contract, Construction Management and Design Build"[15]. Mr. Bristow explains factors to consider when selecting one of three standard form contracts published by the Canadian Construction Documents Committee ("CCDC"). Only two of the three forms of contract are relevant to the present case: the CCDC 2 and the CCA 5.

50 Regarding the CCA 5 construction management contract, Mr. Bristow describes the following distinguishing features:

> "The management contractor does not actually perform the construction; rather, it is the construction manager's role to administer the trade contracts. The construction manager ... provides the administrative work necessary to perform the contract. The owner is responsible for contracting with each of the trade contractors in regards to the actual construction work ... The construction manager's role includes assisting the owner in solidifying the various trade contractors (that is, the subcontracts). The owner is in fact the contractor, while the construction manager is typically an agent of the owner and does not have any direct liability with respect to the trade contractors and materials."

51 Mr. Bristow explains exposure to risk in a construction management contract as follows:

> "... It is the owner, not the construction manager, who must ultimately carry the risk of the construction project, despite the fact the construction manager is often responsible for scheduling and controlling the project's cost...the contractual liability for each sub-contractor remains with the owner. Under the construction

> management structure, the construction manager's exposure to liability is considerably less than that of ... a contractor under the CCDC 2-1994 Stipulated Price Contract."

52 Referring to the CCA 5 form of contract Mr. Bristow further explains:

> "It is not meant to encompass those situations where the construction manager acts as an independent contractor and contracts with trade contractors on his own account. Further, it is also not meant to address those cases where the construction manager guarantees the owner a maximum price or fixed completion date."

53 A review of the unamended form of the CCA 5 discloses that it has no provision for a construction manager to take on the risk of cost overruns. In fact, such a provision would contradict the agency relationship created by article A-3(b). Nor does it provide for a construction budget.

54 The following chart summarizes the factors described in the previous paragraphs that distinguish a construction management structure from a general contracting structure:

General Contractor ("GC")	**Construction Manager ("CM")**	**Panterra and Pegah**
GC hires and contracts directly with trades.	Owner hires trades with CM acting as owner's agent.	Contract permits Pegah to contract with trades directly and also to arrange contracts between Panterra and trades. *Pegah actually contracts with all trades directly except one. Pegah does not act as agent on any trade contracts.*
GC is liable to pay trades. Owner's liability to trades is limited to statutory holdback.	CM is not liable to pay trades. Owner is contractually liable to pay trades.	Article 3.1 of contract: Pegah is liable to pay trades where direct contract. Trades look to Pegah, not Panterra, for payment.
Fixed budget. Extras must be approved by owner. GC is liable for costs overruns. Owner's risk is limited to contract price plus approved extras.	Owner, not CM, is liable for costs over budget.	Pegah is 100% liable for cost overruns beyond $150,000 over budget and 50% of cost overruns up to $150,000 over budget. Panterra has no risk beyond $150,000 over budget.
Fixed price. GC enjoys 100 & of benefit of cost savings.	Owner enjoys 100 % of benefit of cost savings.	Article A-16: Panterra and Pegah share equally in cost savings below budget.
CCDC-2 form of contract	CCA 5 1988 form of contract	Parties used the CCA 5 form of contract as a base and modified it to incorporate elements of the CCDC 2 structure.

55 The contract in the present case contemplates and permits Pegah to enter into contracts directly with trades. Pursuant to article 3.1 Pegah's role was to negotiate the contracts with the trades, receive quotes, select the trades, and then arrange for contracts to be entered into in one of two ways: (i) between the trade and the owner, or (ii) between the trade and Pegah.

56 If the parties conduct themselves in accordance with the first part of article 3.1 then they are in a construction management structure with Pegah acting as Panterra's agent in respect of contracts entered into between Panterrah and the trades. If the parties conduct themselves in accordance with the second part of article 3.1 (which the parties had expressly negotiated and added to the preprinted form of contract) then they are in a general contracting structure with Pegah entering into contracts directly with trades.

57 The distinction is significant in terms of risk: where Pegah acts as agent for Panterra the owner takes on all of the risk under the contracts with trades, including liability for the full contract price; where Pegah enters into contracts directly with trades, Pegah takes on all of the risk including the risk for payment of trade accounts, and the owner's risk is limited to the ten percent holdback obligation under the *Construction Lien Act*.

58 Article 3.1 is ambiguous because it contemplates two structures simultaneously. The evidence shows that all trade contracts for items included in the contract budget were entered into directly between Pegah and the trades. Not a single contract with a trade was entered into with Pegah as agent for the owner. The one contract where Panterra entered into a direct trade contract was for an item that was added later, outside the budget.

59 Pegah provided a price guarantee assuming all of the risk of cost overruns beyond the agreed upon budget (as increased by the shared $150,000.00). This contractual obligation, together with the contractual authority to enter into direct contracts with trades, are contractual provisions that are consistent with a general contract structure and inconsistent with a construction management structure.

60 The receiver argues that there is no reason why a construction manager cannot take on risk and retain the role of construction manager. No cases or authorities were provided wherein a project manager took on the risk of the project budget and payment of trade contracts and was found by the court to have remained the owner's agent. No cases were provided where a construction manager who took on the risk of cost overruns and payment to trades was not treated as a general contractor for purposes of holdback, priority, obligation to pay trades and liability to an owner for cost overruns.

61 I agree with the court in *Centrum, supra,* that the liability for payment to the trades is sufficient to determine the structure of the relationship between Panterra and Pegah.

62 I find that the contract between Panterra and Pegah contemplates a general contracting structure. While it is not necessary to go beyond the contract to make this finding, the parties' conduct in performing the contract is consistent with a general contracting structure.

Contra Proferentem

63 I asked the parties to address the principle of *contra proferentem* and whether it might assist the court to interpret the written contract executed by Panterra and Pegah.

64 The *contra proferentem* principle of interpretation of contracts, simply stated, is that where there is ambiguity in the wording of a written contract it should be interpreted against the interests of the party who set the terms of the contract, usually the drafter of the contract. Ambiguity is a condition precedent to its application. A contract is ambiguous if a contractual provision is reasonably capable of more than one interpretation.[16] As already noted, I found that GC 3.1 of the contract is ambiguous.

65 The principle is generally reserved for situations where one person dictates the terms of the contract to the other, leaving the non-drafting party with no meaningful opportunity to negotiate and modify the contract wording[17]. One example is a car rental contract where the consumer is presented with the rental car company's standard form of contract and has no meaningful opportunity to amend its onerous terms. In *Ironside v. Smith, supra,* the court concluded that where the parties to a written contract have real, meaningful negotiations, it is inappropriate to invoke the *contra proferentem* principle of interpretation in the face of ambiguity in the contract.

66 In *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*[18], the court considered the principle of *contra proferentem* and determined that it applies, if at all, "when all other rules of construction fail". In other words, it is a rule of last resort.

67 Reconciling the decisions of the Alberta Court of Appeal in *Ironside v. Smith, supra,* and the Supreme Court of Canada in *CNR v. Royal, supra,* the applicable law is that the principle of *contra proferentem* applies only if other rules of construction are inadequate. The court must consider whether one party dictated the terms of the contract to the other, or whether two sophisticated parties negotiated its terms.

68 The evidence in the present case is clear: Ali Mohtashami on behalf of Pegah and Sheldon Rosen on behalf of Panterra, the individuals who negotiated and executed the written contract in this case, are both sophisticated and experienced individuals who have worked in the construction and development industry for many years. Mr. Rosen is a professional architect. Mr. Mohtashami is a trained engineer with a Masters degree in Business Administration.

69 I conclude from these authorities and the facts of the case before me that it is not necessary to resort to the principle of *contra proferentem*.

IV. CONCLUSION

70 Mr. Rosen and Mr. Mohtashami are both sophisticated businessmen. Both of them have many years of experience in the industry. They negotiated a deal that was a hybrid between a general contract structure and a project management structure. In committing their agreement to writing they modified the CCA 5 form of contract. Their modifications introduced elements of risk and responsibility that are consistent with a general contract structure and inconsistent with a construction management structure.

71 I find that the structure of the contract is in substance one of owner and general contractor. The critical features of a general contract of risk for cost overruns and liability to trades for payment are present, and the critical features of a construction management structure have been diluted so extensively as to render the label "construction manager" incapable of bearing its ordinary meaning.

72 For these reasons, on the trial issue before the court, I find that Panterra and Pegah contracted as owner and general contractor.

MASTER C. ALBERT

cp/e/qlcct/qlrdp/qlced/qlmll/qljac

1 including the contract addendum amending the price and direction to pay Pegah $245,000 out of the proceeds of sale of condominium units.

2 *Matthews Investments Ltd. v. Assiniboine Medical Holdings Ltd.*, [2007] M.J. No. 353, 2007 CarswellMan 387 at paragraphs 23 to 25.

3 *Consolidated Bathurst Export Ltd. v. Mutual Bioler & Machinery Insurance Co.* (1979), [1980] 1 S.C.R. 888, 112 D.L.R. (3d) 49 per Estey, J., cited in *Eli Lilly & Co. v. Novopharm Ltd*. [1998] 2 S.C.R. 129 (S.C.C.) at para. 52.

4 *Eli Lilly, supra,* at paragraph 54.

5 *Matthews Investments Ltd. v. Assiniboine Medical Holdings Ltd.* 2007 CarswellMan 387 (Manitoba Q.B.) at para. 18.

6 *Communities Economic Development Fund v. Canadian Pickles Corp.* [1991] 3 S.C.R. 388 at para. 53 (S.C.C.)

7 *Adams v. McLean & Dickey Ltd.,* 2013 CarswellOnt 3040, 2013 ONSC 1049 (Ontario Superior Court of Justice).

8 *Salah v. Timothy's Coffees of the World Inc.,* 2010 ONCA 673 (Ont. C.A.) at paragraph 16.

9 *Veracap Corporoate Finance Limited v. Carefoot,* 2013 ONSC 381 (CanLII) at paragraph 26 (Superior Court of Ontario).

10 *The Antaois Compania Neviera S.A. v. Salen Rederierna A.B*, [1985] 1 A.C. 191 at page 201.

11 *Ventas Inc. v. Sunrise Senior Living Real Estate Investment Trust*, 2007 CarswellOnt 1705, 222 O.A.C. 102, 29 B.L.R. (4th) 312, 56 R.P.R. (4th) 163, 85 O.R. (3d) 254 at para. 45.

12 *Kentucky Fried Chicken Canada v. Scott's Food Services Inc.*,(1998), 1998 CarswellOnt 4170, 41 B.L.R. (2d) 42, 114 O.A.C. 357 (Ont. C.A.)

13 *Centrum Renovations & Repair Inc. v. Ditta*, 2006 CarswellOnt 7390, 65 C.L.R. (3d) 270 (Ontario Superior Court of Justice).

14 *Supra* at paragraph 6.

15 (2000), 49 C.L.R. (2d) 265.

16 *Hillis Oil & Sales Ltd. v. Wynn's Canada Ltd.* 1986 CanLII 44 (SCC), [1986] 1 S.C.R. 57 at 67, cited in *Ironside v. Smith*, 1998 ABCA 366 (CanLII) at para. 64.

17 *Ironside v. Smith, supra*, at para 66-67.

18 *Canadian National Railway Co. v. Royal and Sun Alliance Insurance Co. of Canada*, 2008 SCC 66, [2008] 3 S.C.R. 453 at para 33, citing *Stevenson v. Reliance Petroleum Ltd.*, 1956 CanLII 27 (SCC), [1956] S.C.R. 936 at p. 953.

Tab 9

Indexed as:

Blue Range Resource Corp. (Re)

IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985 c. C-36, as amended
AND IN THE MATTER OF Blue Range Resource Corporation
Between
Enron Capital & Trade Resources Canada Corp., appellant (applicant), and
Blue Range Resource Corporation, Humble Petroleum Marketing Ltd., PriceWaterhouseCoopers Inc., in its capacity as monitor, Royal Bank of Canada, National Bank of Canada and First National Bank of Chicago, respondents (respondents), and
TransCanada Energy Ltd. and International Swaps and Derivatives Association, Inc., intervenors
(Appeal # 99-18410)
And between
Duke Energy Marketing Limited Partnership, appellant, and
Blue Range Resource Corporation and Humble Petroleum Marketing Ltd., respondents
(Appeal #99-18411)
And between
Engage Energy Canada, L.P., appellant (applicant), and
Blue Range Resource Corporation and Humble Petroleum Marketing Ltd., PriceWaterhouseCoopers Inc., in its capacity as monitor, Royal Bank of Canada, National Bank of Canada and First National Bank of Chicago, respondents
(Appeal #99-18418)

[2000] A.J. No. 1032

2000 ABCA 239

192 D.L.R. (4th) 281

[2001] 2 W.W.R. 454

87 Alta. L.R. (3d) 329

266 A.R. 98

20 C.B.R. (4th) 187

99 A.C.W.S. (3d) 592

Dockets: 99-18410, 99-18411 and 99-18418

Alberta Court of Appeal
Calgary, Alberta

Hunt, Berger and Fruman JJ.A.

Heard: February 29 and March 1, 2000.
Judgment: filed August 31, 2000.

(58 paras.)

Appeal from the order of LoVecchio J. Dated June 30, 1999 and filed July 8, 1999.

Counsel:

A.R. Anderson and S.J. Burrell, for Enron Capital & Trade Resources Canada Corp.
H.A. Gorman, for Duke Energy Marketing Limited Partnership.
L.B. Robinson, for Engage Energy Canada, L.P.
No counsel present for Blue Range Resource Corporation and Humble Petroleum Marketing Ltd.
No counsel present for National Bank of Canada, Royal Bank of Canada and First National Bank of Chicago.
A.J. Jordan, Q.C. and J.M. Eamon, for PriceWaterhouseCoopers Inc.
S.E. Dunphy, for International Swaps and Derivatives Association, Inc.
J.G. Hanley, for TransCanada Energy Ltd.

[Quicklaw note: An Erratum was filed by the Court November 30, 2000. The corrections have been made to the text and the Erratum is appended to this document.]

REASONS FOR JUDGMENT RESERVED

Reasons for judgment were delivered by Fruman J.A., concurred in by Hunt and Berger JJ.A. Supplementary reasons were delivered by Berger J.A. (para. 57).

1 FRUMAN J.A.:-- With mounting debt and brewing litigation, a company may be headed down the steep slope towards insolvency. The Companies' Creditors Arrangement Act permits the court to slow the company's descent by staying all actions and proceedings pending against it, and prohibiting creditors from terminating contracts. This permits the company to continue to operate while it attempts to restructure its financial affairs. But not all contracts are protected from termination. Despite an insolvency, creditors are entitled to terminate "eligible financial contracts" and set-off obligations. The legal issue in this appeal is whether long term natural gas supply contracts, entered into by a now insolvent gas producer, are eligible financial contracts. The answer to this question requires a foray into the perplexing financial world of derivatives.

FACTS

2 Blue Range Resources Corporation and its wholly-owned subsidiary, Humble Petroleum Marketing Ltd.[1] produce natural gas. As part of their business they have, over time, entered into long term contracts to sell natural gas to the appellants, Enron North America Corp. and its wholly-owned subsidiary Enron Canada, Duke Energy Limited Partnership, and Engage Energy Canada, L.P.[2] The appellants are risk management and gas marketing companies and are not end-users of the natural gas they purchase.

3 In early 1999, Blue Range and Humble found themselves on the brink of insolvency. They hastily made an ex parte application under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, commonly known as the CCAA, asking the court to stay all proceedings pending against them.

4 As is now the custom, the ex parte application asked for sweeping relief. The order granted was not disappointing. It stayed not only actions, but contractual obligations, restraining creditors from "accelerating, terminating, suspending, modifying or cancelling any such agreement ... exercising any rights of distress, recission or set-off or consolidation of accounts in relation to any indebtedness or obligation": Order of LoVecchio J. granted March 2, 1999, para. 3(b) (AB I at 7). The order provided an exception for "eligible financial contracts", as defined in s. 11.1(1) of the CCAA. Because those contracts were not stayed, a creditor was not prohibited from "terminating, amending or claiming an accelerated payment ... and setting off the obligations between Blue Range and such other party in accordance with [the contract's] provisions": Order, para. 3(c) (AB I at 8).

5 On March 19, 1999, the appellants applied to have their long term gas supply agreements declared eligible financial contracts. If their application succeeded, the contracts would be exempt from the CCAA stay order, permitting the appellants to terminate them and exercise any set-off rights provided in the agreements. LoVecchio J. decided that the agreements were not eligible financial contracts and dismissed the applications. I conclude that the agreements are eligible financial contracts.

THE COMPANIES' CREDITORS ARRANGEMENT ACT

6 The CCAA, which has become increasingly popular in recent years, provides a structured environment in which large insolvent companies continue to carry on business and retain control over their assets while their creditors, shareholders and the court consider a plan or compromise. See Quintette Coal Ltd. v. Nippon Steel Corp. (1990), 2 C.B.R. (3d) 303 (B.C.C.A.); Re Lehndorff General Partners Ltd. (1993), 17 C.B.R. (3d) 24 (Ont. Gen.Div.); and Re Smoky River Coal Ltd. (1999), 175 D.L.R. (4th) 703 (Alta. C.A.); leave to reargue refused (1999), 175 D.L.R. (4th) 727. The process of compromise is overseen by a judge who has discretion to do what is necessary, within the confines of the legislation, to maintain the status quo while the negotiations, creditor approvals and reorganization take place. This "will enable the company to remain in operation for what is, hopefully, the future benefit of both the company and its creditors": Re Northland Properties Ltd. (1988), 73 C.B.R. (N.S.) 146 at 154 (B.C.S.C.) citing Meridian Developments Inc. v. Toronto Dominion Bank (1984), 32 Alta L.R. (2d) 150 at 155 (Q.B.).[3]

7 To invoke the CCAA, a "debtor company", which has claims against it exceeding five million dollars, may apply to the court on an ex parte basis seeking the suspension of actions and contractual rights of creditors. The court may then order a comprehensive stay of proceedings under s. 11. Section 11(3) permits a court, on an initial application, to stay proceedings taken, restrain further proceedings, and prohibit the commencement of any actions against the debtor company for a period of 30 days. Typically, the initial order is later extended for a period deemed necessary by the court (s. 11(4)). The court's discretionary powers under s. 11 have been interpreted to restrain any conduct "the effect of which is, or would be, seriously to impair the ability of the debtor company to continue in business during the compromise or arrangement negotiating period": Campeau v. Olympia & York Developments Ltd. (1992), 14 C.B.R. (3d) 303 at 309 (Ont. Gen. Div.) citing Quintette Coal Ltd. v. Nippon Steel Corp., supra, at 312. Accordingly, a court-ordered stay will usually prohibit creditors from terminating contracts with the debtor company.

8 Until 1997, the court had a broad discretion under the CCAA to order stays which interfered with a creditor's exercise of its contractual rights. That year the eligible financial contract provisions, which had been added in 1992 to s. 65.1(8) of the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 (S.C. 1992, c. 27, s. 30), were imported into s. 11.1 of the CCAA (S.C. 1997, c. 12, s. 124) in order to harmonize the two insolvency statutes.[4] In its report to Parliament in 1991, the Standing Committee on Consumer and Corporate Affairs referred to termination and netting out provisions that had been exempted under United States bankruptcy law, and noted that "competitive considerations might require similar provisions here". The Committee went on to recommend the eligible financial contract exemption "that would allow certain financial swap and hedging agreements to be terminated where a notice of intention or a proposal has been filed" (Canada, Standing Committee on Consumer and Corporate Affairs and Government Operations "First Report on Bill C-22", October 7, 1991, at 15:13-15:14).

9 As a result of the addition of the eligible financial contract provisions, "no order may be made under [the CCAA] staying or restraining the exercise of any right to terminate, amend or claim any accelerated payment under an eligible financial contract" (s. 11.1(2)). This entitles a non-defaulting party to terminate an eligible financial contract and exercise rights of netting out or set-off, despite the CCAA proceedings. While the amendment permits a creditor to enforce the terms of the contract previously negotiated with the debtor company, it does not confer any extra powers; specifically s. 11.1(3) says "the setting off of obligations between the company and the other parties to the eligible financial contract, in accordance with its provisions, is permitted". The non-defaulting creditor who, on a net basis, is owed money, is deemed to be a creditor of the debtor company (s. 11.1(3)), and would participate in the CCAA proceedings on the same footing as other creditors. Presumably it would vote on the restructuring and ultimately receive whatever pro-rated payment other creditors receive.

10 Section 11.1(1) provides a comprehensive and intimidating list of the types of transactions that are eligible financial contracts:

> 11.1(1) In this section,
>
> "eligible financial contract" means
>
> (a) a currency or interest rate swap agreement,
> (b) a basis swap agreement,
> (c) a spot, future, forward or other foreign exchange agreement,
> (d) a cap, collar or floor transaction,
> (e) a commodity swap,
> (f) a forward rate agreement,
> (g) a repurchase or reverse repurchase agreement,
> (h) <u>a spot, future, forward or other commodity contract</u>,
> (i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities,
> (j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i),
> (k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j),
> (l) any master agreement in respect of a master agreement referred to in paragraph (k),
> (m) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (l), or
> (n) any agreement of a kind prescribed;

[Emphasis added.]

11 Here the key issue is whether the longer term gas supply contracts are forward commodity contracts under s. 11.1(1)(h).

THE AGREEMENTS

12 The agreements being considered in this appeal provide for long term natural gas sales by Blue Range or Humble to the appellants. They consist of:

a) Master Firm Gas Purchase/Sale Agreement dated June 13, 1994, as amended, between Enron and Humble (AB IV 406);
b) Master Firm Gas Purchase/Sale Agreement dated May 19, 1998, as amended, between Enron and Blue Range (AB VII at 921);
c) Gas Purchase Agreement dated June 25, 1996, between Duke and Humble (AB VI at 731-771);
d) Guarantee by Blue Range of Humble's obligations to Duke dated June 25, 1996 (AB VI at 772);
e) Gas Purchase Contracts dated July 1, 1991 and a Gas Purchase Letter Agreement dated December 1, 1992, between Humble and Engage (AB IV at 300 and 359);
f) Gas Transaction Agreement dated May 20, 1994, between Engage and Humble (AB IV at 390);
g) Guaranty Agreement by Blue Range of Humble's obligations to Engage dated July 1, 1994 (AB V at 581).

13 The contracts between Blue Range, Humble and Enron are master agreements which contemplate that the parties will enter into gas purchase and sale agreements from time to time (AB IV at 406; AB VII at 921). These subsequent agreements, which are in the form of confirmation letters, set out the terms and conditions of specific natural gas purchase and sale transactions (AB VI at 831; AB VII at 983 and 997). The master agreements contain termination provisions which are triggered by various events of default including "the failure by a party to make when due, any payment required under this Agreement ... an assignment for the benefit of creditors, a petition or proceeding under Bankruptcy law including the CCAA" (Clause 10.3, AB VII at 921). Both the Duke and Engage agreements are natural gas purchase and sale contracts with Humble, whose obligations are guaranteed by Blue Range. While the termination provisions in the Duke and Engage contracts do not mirror the Enron provisions, they too provide for termination in certain circumstances. All the agreements contain netting out or set-off provisions.

14 The agreements therefore fit within one of three categories: they are either individual gas purchase and sale contracts, master agreements which provide for gas purchase and sale contracts, or guarantees of gas purchase and sale contracts. The appellants contend that the individual gas purchase and sale contracts are forward commodity contracts, qualifying as eligible financial contracts under s. 11.1(1)(h) of the CCAA. It is conceded that if that is the case, each master agreement would be "a master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j)", qualifying under s. 11.1(1)(k). Similarly each guarantee would be "a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (l)", qualifying under s. 11.1(1)(m). The key issue in this appeal, then, is whether the long term gas purchase and sale contracts are forward commodity contracts. If so, all the agreements are exempt from the CCAA stay provisions and may be terminated by the appellants.

THE CHAMBERS JUDGE'S DECISION

15 The chambers judge decided that the agreements were not forward commodity contracts within the meaning of s. 11.1(1)(h). Noting that the term "forward commodity contract" is not defined in the CCAA, he considered many different definitions provided by the parties and concluded "[b]ased on these sources one could define these items as almost anything or conclude that almost any contract fits" (AB I at 256). He expressed concern that a broad definition would defeat the object of the stay imposed in CCAA proceedings (AB I at 266).

16 The chambers judge observed that s. 11.1 is entitled "eligible financial contracts", not "eligible contracts" and considered the word "financial" in the title to be "very significant" and to be the "guiding principle" in giving a "purposeful meaning to the section in light of the statute as a whole" (AB I at 259-60). He decided that a distinction should be drawn between contracts whose purpose is to lead to the actual delivery of a commodity, which he called physical contracts, and contracts whose purpose is only financial and is not intended to lead to actual delivery of a commodity, which he called financial contracts. In his view, only the latter could be considered eligible financial contracts and "[t]he question whether contracts are one or the other is to be resolved by the intention of the parties" (AB I 260). Because the preamble to the Enron Master Firm Agreement referred to delivery and receipt of natural gas, he concluded that "the parties were intending this to be a contract which was 'physical' in nature as opposed to 'financial'" (AB I 266) and the agreement was not an eligible financial contract. He reached the same conclusion with respect to the Duke and Engage agreements (AB I 267).

FORWARD COMMODITY CONTRACTS

Hedges and Netting Out

17 Although "forward commodity contracts" are not defined in the CCAA, according to text writers they are merely "contract[s] to buy or sell an asset at a certain price on a future date": M. J. Bienenstock and P.M. Basta, "The Treatment of Derivatives under the Bankruptcy Code" in Real Estate Workouts and Bankruptcies 1994, (Practising Law Institute, 1994) 231 at 239. The long term natural gas supply contracts in this appeal fit within this general description. Put simply, they are negotiated contracts between private parties to buy and sell a specified quantity of gas at a certain or determinable price on a certain future date. According to the contracts, on the delivery dates Blue Range or Humble will deliver the gas to the purchaser at a specified delivery point, in exchange for the purchase price. The contracts therefore contemplate eventual physical settlement by the delivery of natural gas.

18 The agreements also serve an important financial purpose which is unrelated to physical or financial settlement; they are risk management tools, commonly known as "hedges". Blue Range or

Humble agree to sell the gas at a predetermined price on a future date and assume the "short position". The buyer agrees to purchase the gas and assumes the "long position". The seller is looking for price certainty and limited downside exposure: Blue Range or Humble, who are guaranteed a particular purchase price, predict that the market price for gas will decline, and on the delivery date they will sell the gas at a price which is above market value.[5] The buyer assumes the risk of price fluctuations and predicts precisely the opposite: Enron, Duke and Engage gamble that the market price for gas will rise, and on the delivery date they will purchase the gas at a price that is below market value. See Bienenstock and Basta, supra, at 241-42.

19 Generally, no premium is paid when a long term gas purchase and sale contract is entered into, and on that day the contract has a zero value. But the price of gas fluctuates constantly, which in turn affects the value of the contract. Because gas is a commodity that trades on the New York Mercantile Exchange, its price and the value of an agreement providing for a future sale of gas are readily ascertainable at any given time. From the perspective of the purchaser, the contract will be "in the money" when the market value of gas exceeds the purchase price specified in the contract. It will be "out of the money" when the market value is less than the purchase price. The contract is therefore "marked to market" and may take on a positive or negative value, depending on the price of gas.

20 In order to further hedge their risk, many gas producers enter into a series of agreements with the same gas marketing and risk management companies, providing for the sale of gas at different prices, on different dates and at different points of delivery. Each of these contracts has its own calculable value. At any point in time, some of these will be "in the money", others "out of the money". Termination and netting out or set-off provisions permit the purchaser to terminate all the agreements upon a triggering event. The purchaser may then "calculate the value of all the transactions as of the termination date and ... net the positive and negative values to determine a lump sum termination amount payable by one party to the other": M.E. Grottenhaler and P.J. Henderson, The Law of Financial Derivatives in Canada (Toronto: Carswell, 1999) at 5.1.

The Derivatives Market

21 Contracts to sell things at some future date are not a new creation. Historians suggest forward commodity contracts have been around for some 800 years, since they first appeared at medieval trade fairs in the 12th century. See Richard J. Tweles and Frank J. Jones, The Futures Game: Who Wins? Who Loses? Why? (New York: McGraw Hill, 1987). One might wonder then why such basic contracts have taken on new prominence. The answer lies not in the nature of forward commodity contracts, but in the nature of the assets that are the subject of such contracts. It is necessary to consider these assets in the context of this case by reviewing the types of transactions commonly used in the natural gas industry, the manner in which they are actually traded and settled, and the consequences if a non-defaulting party cannot terminate contracts and net out obligations in the event of an insolvency. This analysis assists in understanding the purpose of the eligible financial contract provisions, and interpreting the words used in s. 11.1(1)(h).

22 Natural gas contracts trade through an exchange or board of trade in what is known as an exchange transaction, or between two negotiating parties in an off-exchange or over-the-counter transaction. There are, in turn, two main types of over-the-counter gas transactions: those which are physically settled by the delivery of gas, and those which are financially settled by cash payment.[6]

23 These instruments are all part of the global derivatives market. "Derivative products are investment tools whose value depends on, or is derived from, the performance of some underlying asset such as stocks, bonds, commodities, currencies or indices": G. Luinenburg and F. Soda, "The Enforceability of Over-the-Counter Derivative Contracts Under Canadian Insolvency Regimes" (1996) 12 B.&F.L.R. 41 at 43 [footnote omitted]. Forward commodity contracts and other derivatives have a financial value that can readily be calculated; they are commercial hedging contracts that can be used to manage various types of risk, including changes in commodity prices, exchange rates, interest rates and market risks.

24 Risk management companies, like the appellants, offer a wide range of cash-settled and physically-settled commodity products to customers, who may be producers, end-users or other financial intermediaries in the natural gas market. Natural gas market participants who do not ultimately consume the gas place little emphasis on the distinction between physically- and financially-settled transactions. Just as investors who dabble in the futures market do not anticipate waking up one morning to find a freight-car load of pork bellies on their front lawn, investors who deal in forward gas contracts do not intend to take physical possession of the gas.

25 Many of the trades among producers, gas marketers, risk managers and end-users involve buying and selling the right to take physical delivery of natural gas on a future date. Given the liquidity of the natural gas market, purchasers can readily offload their obligation to take delivery of gas under a physical contract by entering into a contract to make delivery of the same quantity of gas at the same point of delivery. These offsetting arrangements can be made with the original seller or a new party. The market operates like an exchange, as parties agree to make or take delivery, but settle their obligations by entering into offsetting contracts: Affidavit of David W. Richardson, sworn November 10, 1999 (Supp. AB II 18).

26 Although some end-user will eventually claim the gas, trades along the way are not settled by physical delivery. Instead, they are normally settled by "title transfers", using such systems as the NOVA Inventory Transfer System, which plays a role similar to a securities depository and transfer agent in the securities industry: Richardson Affidavit, supra, at 16. Participants transfer a nominated volume of gas from their Nova account to another participant's account. The transfer is done by book entry, without actual possession or physical delivery of gas. Like the active trading that takes place in other financial markets, the volume of gas traded on a daily basis far exceeds the amount of natural gas that actually flows through the system.

27 The appellants argue that an effective and fully functional termination, netting and set-off scheme that applies to all derivative instruments, including forward commodity contracts, is critical to the vitality of the derivatives market. A similar observation was made by Farley J. in Confederation Treasury Services Ltd. (Trustee of) v. Hees International Bancorp Inc. (1997), 45 C.B.R. (3d) 204 (Ont. Gen.Div.). He recognized that derivative contracts are a legitimate method of managing risk and as a matter of public policy should not be dealt with in a manner that affects their efficiency either in non-insolvency or insolvency situations. "If the right to terminate contemplated in the agreement ... is not enforceable, the whole structure of risk management for the swaps and other transactions is weakened or may fall apart": at 231 [citation omitted]. The effect of non-enforceability on the derivatives market is worth exploring.

28 The CCAA stay provisions create disparities among market participants. While the non-defaulting party is subject to the stay order and may not terminate its contracts, the debtor company suffers from no similar disability. Subject to the court's supervision, it may terminate and breach contracts with impunity, forcing the non-defaulting party to claim damages as an unsecured creditor in the CCAA proceedings. The ability to selectively repudiate contracts is disdainfully known as "cherry picking". The debtor company could, for example, retain "out of the money" transactions, speculating that they might improve in value, but knowing full well that it would not be able to pay if the market moved in the other direction. At the same time it might terminate "in the money" transactions, triggering a cash payment by the non-defaulting party. See Luinenburg and Soda, supra, at 65; Brenda Gonzalez-Hermosillo, "The Microstructure of Financial Derivatives Markets: Exchange-Traded versus Over-the-Counter", Technical Report No. 68 (Bank of Canada, 1994) at 64, online at http://www.bank-banque-canada.ca/english/res/tr68-e.htm.

29 Without enforceable termination and netting out provisions, the insolvent company maintains complete control and may repudiate a contract at any time without notice. Because the non-defaulting party cannot count on performance, it cannot effectively re-hedge its risk by entering into an offsetting contract incorporating similar terms. Given the volatility of the market, the non-defaulting party is exposed to excessive and unmanageable risk.[7]

30 Quite apart from the unfairness of cherry picking, other undesirable consequences follow. In order to determine credit availability, risk management companies account for "out of the money" transactions by deducting the value of "in the money" transactions. This practice is only appropriate if termination and netting out provisions are enforceable, and unaffected by an insolvency.[8] If forward gas contracts are not exempt from the CCAA stay provisions and no offsetting deductions are permitted, available credit quickly will be gobbled up. As a result, risk management companies will limit the capital they can allocate to this market, or ask cash-strapped gas producers to put up additional security to cover any short-falls. The unfortunate effect will be reduced availability of physical forward gas sales contracts to small producers, who are most in need of hedges to manage price risks. It will also encourage business to migrate to the United States, where physically-settled transactions are protected under United States bankruptcy law,[9] putting Canadian risk management companies at a competitive disadvantage. These results weaken the risk management structure within the derivatives market, and are contrary to the object of the eligible financial contract amendment.

Interpretation of the CCAA

31 An analysis of the language of s. 11.1(1) indicates that the eligible financial contract definition addresses derivative instruments and confirms that Parliament must have intended to protect the derivatives market from the uncertainties of insolvency.

32 The global derivatives market has shown phenomenal growth over the last decade. Derivative instruments, whose variety and number are limited only by ingenuity, are identified by a bewildering array of newly coined terms.[10] However, derivative instruments really consist of a couple of basic financial building blocks assembled to produce an almost infinite series of exotic-sounding products. See Clifford W. Smith, Charles W. Smithson and D. Sykes Wilford, Managing Financial Risk (New York: Harper & Row, 1990); see also Charles W. Smithson, "A LEGO Approach to Financial Engineering: An Introduction to Forwards, Futures, Swaps and Options", Midland Corporate Finance Journal, 4, no. 4 (Winter 1982) at 16-28. There are four basic building blocks: forwards and futures,[11] which in the case of commodities are physically settled, and swaps[12] and options,[13] which are financially settled. These interlocking pieces are refined, developed and combined to produce sophisticated products. A forward contract can be regarded as the most fundamental piece because other building blocks, the swap contract and the futures contract, for example, are no more than variations on forward contracts. See Richard Briffett, "An Introduction to Derivative Instruments and How They are Used", 1995, online at http://www.law.emory.edu/ lawrld/deriv2.html.

33 Parliament appears to have taken the building block approach to derivative instruments in stride in its formulation of s. 11.1(1). Each of the basic interlocking pieces seems to be included in the "eligible financial contract" definition: future and forward commodity contracts at s. 11.1(1)(h); commodity swaps at s. 11.1(1)(e); and options at s. 11.1(1)(j). A series of other well-recognized derivative instruments are included in the definition. But the derivatives market is always changing and the list of eligible financial contracts is not static. This is acknowledged in s. 11.1(1)(k) which includes combinations of other instruments, as well as derivatives or agreements similar to contracts referred to in other subsections. It seems, therefore, that derivative instruments of all varieties are embraced by the eligible financial contract definition.

34 Physically-settled forward commodity contracts are an important part of the derivatives market, both in their own right and as components of other instruments. Can it be said that on a proper reading they are excluded from the definition of eligible financial contracts? An interpretation of s. 11.1(h), viewed in the context of the other definitions in s. 11.1(1), indicates that is not the case.

35 The legislature is presumed to avoid "superfluous or meaningless words ... it does not pointlessly repeat itself or speak in vain"; "every word of a statute must be given meaning": R. Sullivan, Driedger on the Construction of Statutes 3rd ed. (Toronto: Butterworths, 1994) at 159-60; Communities Economic Development Fund v. Canadian Pickles Corp., [1992] 1 W.W.R. 193 at

209 (S.C.C.).

36 The definition of eligible financial contracts includes spot contracts[14] at (h), spot foreign exchange contracts at (c), and repurchase or reverse repurchase contracts[15] at (g). These contracts can only be settled by physical delivery, never by financial payment. If eligible financial contracts require cash settlement, these terms are robbed of any meaning. Therefore an across-the-board interpretation of eligible financial contracts that excludes physically-settled transactions cannot stand.

37 Nor is there ambiguity in the expressions "eligible financial contract" or "forward commodity contract" to justify defining either term by reference to physical or financial settlement. It is only when a statute is fairly capable of two constructions that words of qualification can be used to resolve the established ambiguity or imprecision: Howley v. Canada (Deputy Attorney General) (1976), 69 D.L.R. (3d) 689 at 695 (S.C.C.). It is not necessary to require financial settlement in order to impart meaning on section 11.1(1)(h); these contracts are risk management tools and serve a financial purpose unrelated to settlement. The presumption of straightforward expression also obliterates the physical and financial settlement distinction. The term "forward commodity contract" is included in the section without any words of qualification. One could postulate that had Parliament intended to restrict s. 11.1(1)(h) to financially-settled commodity contracts, it could, for example, have defined those contracts as "a spot, future, forward or other commodity contract which is settled by cash payment and not by delivery of product".

38 Parliament addresses cash-settled commodity-based contracts in other subsections of s. 11.1(1). These include cap, collar or floor transactions[16] at (d), commodity swaps[17] at (e) and "any derivative ... in respect of ... an agreement or contract referred to in paragraph (a) to (i)" at (j). The last section is of particular importance, because its broad wording encompasses financially-settled derivatives of any other species of contract contemplated in s. 11.1(1), including derivatives of both physically- and financially-settled contracts. Because these sections deal specifically with cash-settled commodity contracts, "forward commodity contracts" in s. 11.1(1)(h) undoubtedly refer to something else -- that something else must be physically-settled commodity contracts.

Restricting the Meaning of "Commodity"

39 But once the term "forward commodity contract" is interpreted to include physically-settled transactions, it could potentially include every contract to buy or sell on a future date any "thing produced for use or sale ... article of commerce ... [or] object of trade": Oxford English Dictionary, 2nd ed., s.v. "commodity". Even commercial contracts would not be protected from termination, making it impossible to maintain the status quo while a debtor company reorganized its affairs. Such a broad interpretation would defeat the CCAA's predominant purpose: preserving the insolvent company as a viable operation while reorganizing its affairs to benefit both the company and its creditors: Meridian Developments Inc. v. Toronto Dominion Bank, supra, at 155; Quintette Coal Ltd. v. Nippon Steel Corp., supra, at 309. Section 11.1(1) is an exception to a statutory protection which must "be interpreted in light of [the] underlying rationale and not be used to undermine the broad purpose of the legislation ...": Driedger, 3rd ed., at 369-70. See National Trustco v. Mead (1990), 71 D.L.R. 4th 488 at 497-99 (S.C.C.). This dictates a narrower construction of provisions which are excepted from a stay order: Re Smith Brothers Contracting Ltd. (1998) 53 B.C.L.R. (3d) 264 at 272 (S.C.).

40 The chambers judge chose to sort the contracts by physical or financial settlement in order to limit the impact of s. 11.1(1)(h). That approach is inconsistent with the words used in the section and Parliament's purpose in enacting the eligible financial contract provisions. If all physically-settled instruments are protected from termination by the non-defaulting party, an important chunk of the derivatives market is vulnerable in an insolvency, weakening the Canadian risk management structure.

41 The chambers judge based his interpretation on the word "financial" in the term "eligible financial contract". Although a more restrictive interpretation of "forward commodity contract" may be warranted, any boundaries on its meaning must come from the words of the section rather than the label Parliament attached to the species of contracts. "Commodity" is the critical word, and it is not defined in the CCAA. The word "commodity" must be examined in the context of the legislation to see whether Parliament intended a broad dictionary meaning -- to include a forward contract to buy or sell practically anything of value -- or something less expansive.

42 Other statutes provide definitions which are considerably narrower than the dictionary definition. For example, the Securities Act, R.S.A. 1980, c. S-6.1 defines "commodity" at s. 1(b.01) to include:

> (i) any good, article, service, right or interest of which any unit is, from its nature or by mercantile custom, treated as the equivalent of any other unit;
> (ii) the currency of any jurisdiction;
> (iii) any gem, gemstone or other precious stone;

The Commodity Futures Act, R.S.O. 1990, c. C.20 defines "commodity" in s. 1:

> "commodity" means ... any agricultural product, forest product, product of the sea, mineral, metal, hydrocarbon fuel, currency or precious stone or other gem ..."

43 A common feature in these definitions is that the articles are fungible in nature - each unit is interchangeable for another. They have no specific or defining characteristics and may easily be replaced. Grottenhaler and Henderson, supra, at 5-8 describe the similarities among the list of items contained in the definition of eligible financial contracts in s. 11.1(1):

> Most of these transactions involve payments flowing between the parties depending on the fluctuation in the price or rate. Importantly, they also, for the

> most part, involve commodities or rights for which there is an active market. They are fungible in the sense that it is not difficult in most cases to find a replacement transaction and to do so in a relatively short time period.

44 Unlike leases and ordinary executory contracts whose markets change at a leisurely pace, derivative products are subject to a volatile underlying market: Luinenberg and Soda, supra, at 86. "[T]he spot market price for the underlying asset of a successful derivative security must be volatile and unpredictable with a sufficient (trading) volume to ensure convergence to a competitive equilibrium price": Sean M. O'Connor, "The Development of Financial Derivatives Markets: The Canadian Experience", Technical Report No. 62, (Bank of Canada, 1993) at 21.

45 Like the other items in s. 11.1(1), forward commodity contracts are financial hedges and risk management tools. Interpreting them in the context of the rest of the section requires that they share certain traits. The contracts listed in s. 11.1(1) deal with units that are the equivalent of any other unit. Therefore commodities must be interchangeable, and readily identifiable as fungible commodities capable of being traded on a futures exchange or as the underlying asset of an over-the-counter derivative transaction. Commodities must trade in a volatile market, with a sufficient trading volume to ensure a competitive trading price, in order that forward commodity contracts may be "marked to market" and their value determined. This removes from the ambit of s. 11.1(1)(h) contracts for commercial merchandise and manufactured goods which neither trade on a volatile market nor are completely interchangeable for each other.

Application

46 It is clear that natural gas meets this narrower definition of commodity. Unlike consumer goods which vary widely in size, style and quality, one mcf of gas is identical to another mcf of gas. Natural gas trades on a highly liquid and volatile market, and while its price fluctuates from moment to moment, that price is readily ascertainable. Forward gas contracts therefore have a calculable cash equivalent.

47 Since physically-settled forward commodity contracts are included in the definition of eligible financial contracts, and gas is a commodity, the next issue is whether the agreements in question are forward commodity contracts. As the term is not defined in the CCAA, industry and expert definitions provide valuable guidance.

48 Haedicke and Aronowitz, supra, footnote 12, at 88:74-75 define a "forward contract" for the energy industry as:

> A customized contract to buy or sell a commodity for delivery at a certain future time for a certain price. It is customized by individual negotiations between two parties, rather than standardised and traded on a board of trade. The parties to the forward contract usually know each other, and in most cases the contract is settled by actual delivery of the commodity.

49 James Joyce, a specialist in energy risk assessment who provided an expert report in this case, identified the key elements of a forward commodity contract in the natural gas industry to include:

a) a buyer of natural gas;
b) a seller of natural gas;
c) a defined contract term longer than the next day;
d) a defined volume of natural gas;
e) a defined delivery and receipt point (including any transportation requirements, as applicable); and
f) a defined price or pricing mechanism. (AB VII at 1049.)

50 Not every contract involving the purchase and sale of natural gas is a forward commodity contract. For example, Joyce's definition would not capture standard gas utility contracts, which do not usually commit a consumer to purchase a specified volume of gas for a specified price. Instead they are demand driven, with consumers purchasing the amount of gas needed from time to time at prices which fluctuate depending on rates set by a regulatory authority.

51 The Haedicke and Aronowitz and Joyce definitions reasonably set out the requirements for a forward commodity contract in the natural gas industry. The gas purchase and sale contracts under consideration in this appeal, which are negotiated bilateral contracts as required in the Haedicke and Aronowitz definition, also contain all the elements referred to in the Joyce definition. Therefore the agreements are forward commodity contracts.

52 The final measure is to test the fairness of this result. A manufacturer of consumer goods selling specified products to particular customers may encounter serious financial obstacles if, in CCAA proceedings, customers are permitted to terminate contracts for the purchase of goods. The manufacturer may never find substitute purchasers with the same requirements, impairing its cash flow and ability to stay in business during the restructuring period. This defeats the purpose of the CCAA. But the same cannot be said of a gas producer whose long term gas supply contracts are terminated. Blue Range and Humble may readily sell their gas in the spot market, assuring them a source of income. In addition, they may negotiate new long term gas supply contracts, perhaps on more favourable terms.

53 The appellants are also fairly treated. Through the use of the termination and netting out provisions they may crystallize their losses, deal with their exposure through further hedging transactions and avoid piling on losses that are likely to arise in the volatile gas market. This permits them to continue to offer these risk management tools to small gas producers who are in need of them, and preserves the integrity of these financial instruments in the derivatives market.

SUMMARY

54 Eligible financial contracts in s. 11.1(1) include both physically-settled and financially- settled transactions. Restricting forward commodity contracts in s. 11.1(1)(h) to cash-settled contracts is contrary to the plain meaning of the section and inconsistent with Parliament's objective of protecting the risk management structure within the derivatives market. Nor is such a restriction necessary to achieve the purpose of the CCAA. While forward commodity contracts may be physically settled by the delivery of product, they must be restricted to contracts for fungible commodities which trade in a liquid and volatile market.

55 Natural gas is such a commodity. Each of the agreements under consideration in this appeal is an eligible financial contract because it is either a forward commodity contract (s. 11.1(1(h)), a master agreement in respect of a forward commodity contract (s. 11.1(1)(k)), or a guarantee of the liabilities under a forward commodity contract (s. 11.1(1)(m)).

56 The appeal is allowed.

FRUMAN J.A.
HUNT J.A.:-- I concur.
BERGER J.A.:-- I concur.

The following is the judgment of:

57 BERGER J.A. (supplementary reasons):-- Counsel will note that this judgment is styled "Reasons for Judgment Reserved". The label "Reserved" no longer has the significance it once had. The Court's policy set out in Hutterian Brethren Church of Starland v. Starland No. 47 (Municipal District), (1993) 9 Alta.L.R. (3d) 1, at 15 and R. v. Bonneteau (1995), 24 Alta.L.R. (3d) 153, at 158 was abolished on September 1, 1999.

58 The effect of the new policy, which still permits circulation of draft reasons to members of the Court off the panel (for comment only), was stated as follows by Hetherington, J.A. in R. v. Fash (cited as R. v. D.M.F.) [1999] A.J. No. 1086:

> "In the past this court has said that, so far as statements of law or principle are concerned, a reserved judgment which is not a dissenting judgment sets out views accepted by a majority of the members of the court. (See Hutterian Brethren Church of Starland v. Starland No. 47 (Municipal District) (1993), 9 Alta. L.R. (3d) 1, at 15, and R. v. Bonneteau (1994), 24 Alta. L.R. (3d) 153, at 158.) However, this is no longer the case. The practices of the court have changed. Now so far as statements of law or principle are concerned, a reserved judgment which is not a dissenting judgment sets out the views of a majority of the panel which heard the appeal. It can not be inferred that a majority of the members of the court share those views."

BERGER J.A.

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ERRATUM

Filed: November 30, 2000

Please replace page 2 of the above noted judgment with the attached corrected page.

The changes made are as follows:

1. Para [6], line 13, which reads "L.R. (2d) 150 at 154 (Q.B.).3" has been changed to read:

"L.R. (2d) 150 at 155 (Q.B.).3"

2. Footnote 3 at the bottom of page 2 has been deleted.

FRUMAN J.A.

cp/i/qljpn/qlsxs

1 Blue Range and Humble are represented in this appeal by PriceWaterhouseCoopers Inc., in its capacity as monitor under the CCAA.

2 Both Enron companies are the North American merchant trading arms of Enron Corp., a Houston-based integrated natural gas and electricity company. These companies offer risk management services primarily related to the energy sector. Duke is a limited partnership carrying on business as a natural gas marketer in Alberta. Engage is the merchant trading arm of Westcoast Energy Inc. and The Coastal Corporation, and offers risk management services to entities operating in the energy sector. The appellants are joined in this appeal by two intervenors: TransCanada Energy Ltd. is Canada's largest domestic marketer of natural gas and other commodities; International Swaps and Derivatives Association, Inc. is the global trade association representing the world's major institutions in the privately negotiated derivatives industry.

3 Footnote deleted.

4 Similar "eligible financial contract" definitions were added in 1992 to s. 39.15(7) of the Canada Deposit Insurance Corporation Act, R.S.C. 1985, c. C-36 (S.C. 1992, c.26, s. 11); and in 1996 to s. 22.1(2) of the Winding-Up and Restructuring Act, R.S.C. 1985, c. W-11 (S.C. 1996, c. 6, s. 142).

5 As one might have guessed, Blue Range's and Humble's predictions were wrong. They overestimated the volume of gas they would produce and underestimated the market price for gas. The companies therefore did not receive market price for the gas they produced and also had to purchase gas in the spot market to honour their contractual commitments. These were significant contributing causes of the insolvency: Affidavit of Jeffrey Tonkin sworn March 2, 1999 (AB II at 4).

6 Enron calls financially settled transactions "derivative contracts" or "gas-based derivative contracts": Affidavit of P. R. Milnthorp dated March 19, 1999 (AB II at 16-17). This terminology is confusing. Forward commodity contracts are themselves considered to be derivatives. See, for example, Luinenburg and Soda, supra, at 43: "Well-known derivative products include ... forwards" [original emphasis]; Bienenstock and Basta, supra, at 239; "Examples of derivatives are forward contracts"; J.C. Hull, Options, Futures and Other Derivatives 3rd ed. (Upper Saddle River: Prentice Hall, 1997) at 1-2: "A forward contract is a particularly simple derivative .... A key variable determining the value of a forward contract at any given time is the market price of the asset" [original emphasis]; G. L. E. May, "Overview of Financial, Tax and Accounting Principles for Derivative Financial Instruments", Canadian Tax Foundation, 1995 Conference Report 29:1 at 29:3: "Generally, derivative financial instruments are contingent claims that give owners the obligation or right to buy or sell a quantity at a predetermined price in the future...."

7 Extreme volatility leads to roller coaster profits and losses, making the derivatives market a high stakes game that is not for the passive, the inexperienced or the faint of heart. These features of the market are well-recognized:

> Q: What's the difference between being rich and being poor? A: About 15 seconds, some days.

"What's the Difference on Wall Street", January 28, 1999, "Derivatives Humor for 1999 - January to August", Copyright 1996-1999 by The William Margrabe Group, Inc., online at http://www.margrabe.com/Humor/Humor99.html.

8 In fact this type of accounting will actually be prohibited for some market participants, like banks, that are required by regulation to maintain adequate capital. See for example Guideline A of "Guideline with respect to Capital Adequacy Requirements for Banks", issued by the office of the Superintendent of Financial Institutions. Without an unqualified legal opinion to the effect that termination and close-out netting provisions are effective on insolvency, participants who account for transactions in this fashion will be offside their capital requirements. See Grottenhaler and Henderson, supra, at 5.1-5.2.1.

9 United States bankruptcy law also exempts forward commodity contracts from the stay provisions; however, the exemption is based not only on the nature of the contract, but also

on the nature of the market participant. Under the U.S. Bankruptcy Code, special protection is available to "forward contract merchants" (defined at 11 U.S.C. s. 101(26)), stockbrokers and financial institutions to terminate, net and set-off "forward contracts" (defined at 11 U.S.C. s. 101(25)) when the other party to the contract files a petition in bankruptcy. The provisions were designed to protect transactions involving forward contract merchants, rather than ordinary supply contracts between producers and end-users. So long as one of the parties is a forward contract merchant, the contract is exempted, whether it was entered into with a producer, end-user or third party: Sullivan & Cromwell opinion, March 31, 1999 (AB VII at 1060-61). Sullivan & Cromwell also expressed the opinions that Enron would be a "forward commodity merchant" and that the agreements to which it is a party in this appeal would be "forward contracts", within the meaning of the U.S. Bankruptcy Code: id. (AB VII at 1063).

10 The derivatives market has an argot of its own (not to be confused with an ARGO, which hedges the swap leg with puts). The lingo includes:

- for those with an alliterative bent: strips, straps, STRYPES, straddles, strangles and structures;

- for animal lovers: turtle trades, CUBS, ELKS, STEERS, COBRAs, hamster options, kangaroo bonds and naked dog baskets;

- for individualists: SLOBs, sticky floaters, ZENS, SPINs and hermaphrodite options;

- and for the remorseful investor: gilt strips. See The William Margrabe Group, Inc.'s Derivatives Dictionary, Copyright 1996-2000 by The William Margrabe Group, Inc., online at http://www.margrabe.com/Dictionary.html.

11 Both future and forward commodity contracts are physically-settled. The essential difference between them is their manner of trading. A futures contract trades on an exchange or board of trade. The exchange's clearing house assumes the obligation of both the buyer and seller of the contract and guarantees the transaction, but requires market users to post collateral or "margin", and maintain minimum capital requirements. See Gonzalez-Hermosillo, supra, at 28-30. Forward contracts are off-exchange or over-the-counter transactions involving custom contracts negotiated between two parties. Market participants are end-users and dealers who deal directly with each other. Forward contracts are subject to more risks than exchange-traded contracts, including the risk that the contracting party will default on the original contract: id. at 59.

12 A swap is no more than a series of forward contracts. A gas commodity swap contract is an agreement between two parties to buy or sell a stream of cash flows over a predetermined length of time. One party agrees to pay based on a fixed price, while the other agrees to pay based on a floating or market price. Because payments are measured by the difference in prices on the same notional volume of gas, the contracts are always financially-settled: Mark

E. Haedicke and Alan B. Aronowitz, "Gas Commodity Markets" in Energy Law and Transactions Vol. IV (New York: Matthew Bender & Co. Inc., 1999) at 88:19.

13 An option holder pays a premium to acquire the right, but not the obligation, to purchase a specified volume of gas at a specified price, called the strike price, during a specified period of time. The value of the option will depend upon the price of the gas, which will fluctuate from day to day. An option to purchase gas at $2.50 per Mmbtu may have a negligible value if gas trades at $1.50 but will be worth more than $2 if gas trades at $4.50. The option holder need never exercise the option and acquire the gas, but for a more modest investment can benefit from the spread between the strike price and the market value. The holder has no exposure to risk from unfavourable price movements, other than a loss of the premium paid to acquire the option. See Laura J. Porterfield, "Derivative financial instruments: time for better disclosure", The CPA Journal Online, July 1994, copyright 1997 New York State Society of Certified Public Accounts, online at http://www.nysscpa.org/cpajournal/old/15611641.htm.

14 Spot contracts, used either in respect of commodities or foreign exchange, contemplate only physical delivery. That delivery is immediate in contrast to a future delivery. See Black's Law Dictionary, 6th ed. Time is not a variable and price fluctuations have no effect. As a result, spot contracts have no financial character and no means by which they may be settled in any way other than physical delivery of product, except perhaps by payment of a stiff penalty.

15 A "repurchase contract" or "repo" is "a contract to sell a security combined with a simultaneous agreement by the original seller to repurchase the security at a later date": Bienenstock and Basta, supra, at 257. It is a present-day sale combined with an agreement to repurchase the same security in the future. These transactions must be physically-settled by an exchange of cash for the return of the security. Financial settlement is never possible.

16 Caps, floors and collars are forms of commodity swaps. In a cap transaction, one party pays a single or periodic fixed amount and the other party pays periodic amounts based on the excess of a commodity price over a specified price; in a floor transaction, the other party pays periodic amounts based on the excess of a specified price over a commodity price. A collar transaction is a combination of a cap and a floor, where one party pays the floating rate commodity price on the cap and the other pays the floating rate commodity price on the floor. As with other swaps, payments are measured by the difference in prices, and the contracts are always financially-settled. See Schedule "A" to Stikeman, Elliott "Memorandum of Law for the International Swaps and Derivatives Association, Inc.", February 1998 (Supp. AB III at 260-61).

17 See footnote 12, supra.

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C. 1985, c. C-36, AS AMENDED

Court File No: CV-13-10274-00CL

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF 8440522 CANADA INC., DATA & AUDIO-VISUAL ENTERPRISES WIRELESS INC., AND DATA & AUDIO-VISUAL ENTERPRISES HOLDINGS INC.

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

Proceeding commenced at Toronto

BOOK OF AUTHORITIES OF THE APPLICANTS

NORTON ROSE FULBRIGHT CANADA LLP
Royal Bank Plaza, South Tower, Suite 3800
200 Bay Street, P.O. Box 84
Toronto, Ontario M5J 2Z4 CANADA

Orestes Pasparakis LSUC#: 36851T
Tel: (416) 216-4815
Email: Orestes.Pasparakis@nortonrosefulbright.com

Virginie Gauthier LSUC#: 41097D
Tel: (416) 216-4853
Email: Virginie.Gauthier@nortonrosefulbright.com

Evan Cobb LSUC#: 55787N
Tel: (416) 216-1929
Fax: (416) 216-3930
Email: Evan.Cobb@nortonrosefulbright.com

Lawyers for the Applicants