COURT FILE NUMBER	1703-12327
COURT	COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL CENTRE	EDMONTON
	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 ARRANGEMENT OF CANADA NORTH GROUP INC., CANADA NORTH CAMPS INC., CAMPCORP STRUCTURES LTD., D.J. CATERING LTD., 816956 ALBERTA LTD., 1371047 ALBERTA LTD. and 1919209 ALBERTA LTD.
DOCUMENT	**BENCH BRIEF OF BUSINESS DEVELOPMENT BANK OF CANADA IN SUPPORT OF APPLICATION FOR PAYMENT OF COSTS OF CRA APPEAL**
ADDRESS FOR SERVICE AND CONTACT INFORMATION OF PARTY FILING THIS DOCUMENT	Cassels Brock & Blackwell LLP Suite 3810, Bankers Hall West 888 3rd Street SW Calgary, Alberta T2P 5C5 Telephone: 403-351-2921 Facsimile: 403-648-1151 **Attention: Jeffrey Oliver/Danielle Maréchal**

Clerk's Stamp

JUDICIAL CENTRE OF EDMONTON
FILED
JUN 12 2018
FAX
Clerk of the Court

Scheduled to be Heard Before the Honourable Justice K.G. Nielsen at 10:00 a.m. on Thursday June 21, 2018

I. INTRODUCTION

1. Pursuant to a letter of offer dated June 29, 2017 (as amended, the "**Letter of Offer**"), the Business Development Bank of Canada ("**BDC**") agreed to provide Canada North Group Inc., Canada North Camps Inc., Campcorp Structures Ltd., D.J. Catering Ltd., 816956 Alberta Ltd., 1371047 Alberta Ltd. and 1919209 Alberta Ltd. (collectively, the "**Debtors**") with interim financing (the "**Interim Facility**").

2. Without the Interim Facility, the Debtors would not have been able to continue their operations during these restructuring proceedings. The Interim Facility was provided to the Debtors on very favourable terms with a view of maximizing value for all stakeholders. Compared to many interim financing facilities, the Interim Facility charged lower interest rates and fees. The Interim Facility also contained comprehensive indemnity and cost recovery provisions in the Letter of Offer that are consistent with market practice to ensure that BDC was protected from incurring charges and expenses personally should any issues arise in relation to the Interim Facility.

3. Her Majesty the Queen in Right of Canada, as represented by the Minister of National Revenue (the "**CRA**") has challenged and is continuing to challenge the priority of the Interim Facility under the interim lender's charge (the "**Interim Lender's Charge**"). The case, currently before the Alberta Court of Appeal, has national implications and is being closely watched by the insolvency community.

4. This application presents a highly unusual situation. Leave to appeal has been granted on a question of considerable importance to BDC and the insolvency profession, notwithstanding that the issues on appeal are almost certainly moot in light of the fact that both CRA and the Interim Lender have been repaid.

5. It is difficult to imagine a legal challenge that is more fundamental to an interim lender than a challenge to the priority of its loan. While challenges of this nature are unusual, they are not unheard of. This is why the Letter of Offer contains such indemnity and cost protections. The terms of the Letter of Offer, as approved by this Honourable Court, clearly entitle BDC to its costs, charges and expenses (including its legal costs) in situations such as defending the Appeal. However, now that the challenge to the priority of the Interim Lender's Charge continues, notwithstanding its repayment, there is resistance from certain stakeholders to the continued payment of the BDC Costs (as defined below).

6. BDC is entitled to the continued payment of its legal costs and disbursements in relation to the Appeal, both by the clear contractual terms of the Letter of Offer and as a matter of equity and fairness. Stakeholders have had the benefit of the Interim Financing throughout this proceeding on terms that are relatively favourable. It is inequitable to deny BDC the corresponding benefit of the Interim Lender's Charge and the indemnity provisions contained in the Letter of Offer.

7. As a result of the foregoing, BDC seeks an Order, *inter alia*:

   (a) directing that Ernst & Young Inc., in its capacity as monitor (in such capacity the "**Monitor**") of the Debtors set aside the Cost Reserve (as defined below) in favour of BDC to secure the estimated costs, charges and expenses (including BDC's legal fees and disbursements on a solicitor and own client basis) incurred by BDC in connection with defending the Appeal (as defined below) as well as any future appeal to the Supreme Court of Canada (collectively, the "**BDC Costs**");

   (b) in the alternative, declaring that the BDC Costs shall be fully paid by the Monitor from the estate of the Debtors on an ongoing basis; and

   (c) directing the Monitor to pay forthwith BDC's reasonable legal fees and disbursements associated with the within application on a solicitor and own client basis.

II. FACTS

Initial Order and Interim Financing

8. Pursuant to an order of this Honourable Court pronounced July 5, 2017 (the "**Initial Order**"), the Debtors were granted protection from their creditors pursuant to the *Companies Creditors' Arrangement Act* (Canada) ("**CCAA**"). Ernst & Young Inc. was appointed as Monitor.

> Initial Order pronounced by the Honourable Justice
> K.G. Nielsen on July 5, 2017 [**Initial Order**].

9. On June 29, 2017, prior to the Initial Order being granted, the Debtors and BDC entered into the Letter of Offer pursuant to which BDC agreed to offer to the Debtors, on a joint and several basis, aggregate interim financing in the amended amount of up to $3,500,000 (the "**Interim Loan**") on the terms and conditions set forth in the Letter of Offer. The Letter of Offer was subsequently amended by letters dated July 12, 2017, July 21, 2017, September 28, 2017 and December 7, 2017.

> Affidavit of Russell French, sworn June 12, 2018 at
> Exhibit "A" [**French Affidavit**].

10. The Letter of Offer established the following terms and conditions (among others):

(a) as a specific and continuous guarantee of the performance by the Debtors of their obligations towards BDC under the Interim Loan documents (including the payment of principal, interest, fees and any other sums), the Debtors agreed to grant, *inter alia*, a Court authorized first-ranking, valid, enforceable financing charge (the Interim Lender's Charge) with priority over all creditors of the Debtors in the amended amount of $3,500,000, charging all of the property, assets and undertakings of the Debtors granted pursuant to the Initial Order (subject only to an Administration Charge (as defined in the Initial Order)) (collectively, the "**Security**");

French Affidavit at Exhibit "A", p 3.

(b) the Debtors agreed, on a joint and several basis, to <u>indemnify and hold BDC harmless from and against any and all claims, losses, obligations, liabilities, claims, actions or causes of action, and reasonable costs and expenses incurred, suffered, sustained or required to be paid by BDC by reason of or resulting from the Interim Loan, the Letter of Offer and the transactions and documents contemplated by the Letter of Offer</u> (the "**First Indemnity Provision**"); [emphasis added]

French Affidavit at Exhibit "A", p 9.

(c) any and all costs, charges and expenses (including without limitation, lawyers' fees as between solicitor and his own client, on a full indemnity basis) incurred by BDC in connection with the restructuring proceedings, the Interim Loan, the Interim Loan documentation, the Security, the Initial Order, the Interim Lender's Charge, the proposal, the enforcement of any rights and remedies regarding the aforementioned and the restructuring of the Debtors, included, are for the account of the Debtors (the "**Other Costs Provision**"). <u>Such costs shall be paid out of the disbursements of the Interim Loan as and when they become due and shall be secured by the Security</u>; and [emphasis added]

French Affidavit at Exhibit "A", p 9.

(d) as long as the Debtors owe any amount whatsoever to BDC (under the Interim Facility or otherwise) the Debtors shall pay all costs incurred by BDC to exercise its rights under the Letter of Offer.(the "**Second Indemnity Provision**").

French Affidavit at Exhibit "A", p 16.

11. The Initial Order, *inter alia*:

    (a) authorized and empowered the Debtors to obtain and borrow under the Interim Facility in order to finance the Debtors' working capital requirements and other general corporate purposes and capital expenditures;

    (b) limited the Interim Facility to the amended amount of $3,500,000;

    (c) ordered that the Interim Facility shall be on the terms and subject to the conditions set forth in the Letter of Offer;

    (d) granted BDC the Interim Lender's Charge against the Property (as defined in the Initial Order) to secure all obligations incurred on or after the date of the Initial Order, which charge was to not exceed the aggregate amount advanced on or after the date of the Initial Order; and

    (e) ordered that the Interim Lender's Charge (among others) rank in priority to all other security interests, trusts, liens, charges and encumbrances, claims of secured creditors, statute or others in favour of any Person (other than the Administration Charge).

Initial Order at paras 31-34 and 44.

12. BDC advanced a total of $3,500,000 (excluding interest and fees) pursuant to the terms of the Letter of Offer and Initial Order.

French Affidavit at para 6.

The CRA Deemed Trust Claim

13. On July 31, 2017, CRA filed an application (the "**CRA Application**") to vary the priority of certain charges (collectively, the "**Priority Charges**"), including the Interim Lender's Charge. The Priority Charges subordinate the CRA's deemed trust claims arising under the *Canada Pension Plan* (Canada), *Employment Insurance Act* (Canada), and *Income Tax Act* (Canada) (collectively, the "**CRA Claim**").

French Affidavit at para 7.

14. The CRA Application was heard before the Honourable Madam Justice J.E. Topolniski on August 11, 2017. In Reasons for Judgment issued on September 11, 2017, Topolniski, J. dismissed the CRA Application, holding that the CRA Claim was properly subordinated by the Priority Charges, including the Interim Lender's Charge (the "**Topolniski Decision**").

Canada North Group Inc (Companies' Creditors Arrangement Act), 2017 ABQB 550 at para 5 [**QB Decision**].

15. On September 29, 2017, CRA sought leave to appeal the Topolniski Decision. BDC and the Debtors (among others) opposed the leave application on the basis that, *inter alia*, the issue being appealed was potentially moot on the record, as it was anticipated that there would be sufficient assets in the estate to satisfy both the Priority Charges and the CRA Claim.

French Affidavit at para 9 and 22.

16. The leave application was heard before the Honourable Justice F. Slatter on November 1, 2017. In his reasons allowing the application for leave to appeal, Slatter, J.A. noted that this particular priority issue is typically resistant to review and went on to state that "[t]his may present the occasion where the Court should adjudicate even if the issue is potentially moot" [emphasis added]. In other words, the CRA was granted leave for the purpose of allowing it to resolve a greater policy issue than what is actually at issue in the Appeal.

Canada v Canada North Group Inc, 2017 ABCA 363 at para 5 [**CA Decision**].

17. In order to circumscribe the costs of the Appeal, Slatter, J.A. appointed a lead respondent who is entitled to file a full factum, whereas all other interested parties are restricted to filing limited factums. By agreement of the parties, BDC was appointed as lead respondent. BDC's factum is due on or about June 25, 2018.

CA Decision at para 6; French Affidavit at par 11.

18. By letter dated May 17, 2018, counsel to BDC advised counsel to the Monitor that, *inter alia*:

(a) it is BDC's position that any costs incurred by it as part of defending the Appeal are payable by the Debtors pursuant to the terms of the Letter of Offer and are secured by the Interim Lender's Charge;

(b) BDC was requesting that the Monitor set aside and pay to BDC a reserve from any distributions made in the amount of $225,000 (the "**Cost Reserve**"), which amount represents an estimate for the BDC Costs;

(c) any legal fees paid by BDC out of the Cost Reserve remain subject to a right of taxation; and

(d) as part of this request, BDC will endeavour to recover as many of its costs as possible directly from the CRA and any costs recovered by BDC directly from CRA will be paid to the Monitor for redistribution to the appropriate party.

French Affidavit at Exhibit "B".

Payout of Interim Facility and CRA Claim

19. The Interim Facility (but not the Cost Reserve) was paid out in full on or about May 29, 2018.

French Affidavit at para 19.

20. Notwithstanding that the Interim Facility has been repaid, the Debtors remain indebted to BDC in the amount of approximately $2,750,911.29, pursuant to facilities granted to the Debtors prior to the commencement of the CCAA proceedings.

French Affidavit at para 20.

21. The CRA Claim was paid out in full on or about May 30, 2018.

French Affidavit at para 21 and Exhibit "G".

III. ISSUES

22. The issues before the Court in this matter are:

(a) whether the Debtors are required to indemnify or otherwise pay BDC for the BDC Costs, notwithstanding the repayment of the Interim Facility; and

(b) whether the BDC Costs are secured by the Interim Lender's Charge, notwithstanding the repayment of the Interim Facility.

IV. SUBMISSIONS

A. Overview of Submissions

23. BDC respectfully submits that the language in the Initial Order and the Letter of Offer, and in particular the language in the First Indemnity Provision, the Second Indemnity Provision and the Other Costs Provision (collectively, the "**Relevant Provisions**"):

(a) requires the Debtors to indemnify or otherwise pay BDC for the BDC Costs (the "**Indemnity Obligation**"); and

(b) secures the payment of the Indemnity Obligation under the Interim Lender's Charge.

24. BDC further submits that the repayment of the Interim Facility on May 29, 2018 does not impact or extinguish the Indemnity Obligation or its secured position under the Interim Lender's Charge.

B. Repayment of Interim Facility Does Not Eliminate Indemnity Obligation

25. There is superficial appeal to the notion that repayment of the Interim Facility simply eliminates the obligation to pay funds owing under the Indemnity Obligation, particularly where there is no quantifiable benefit to the estate. However, as discussed further below, that would be patently incorrect.

26. The Indemnity Obligation exists and remains secured by the Interim Lender's Charge, notwithstanding the repayment of the Interim Facility. Clearly, upon repayment of the Interim Facility the scope of possible issues that could engage a reasonable claim under to the indemnity obligation will be dramatically reduced. However, the repayment of the Interim Facility does not entirely eliminate the indemnity under the Relevant Provisions. Otherwise, BDC would be prejudiced as a result of contingencies that occur post payout but that nonetheless engage its legitimate commercial interests.

27. No benefit to the estate is necessary to justify a claim under the Indemnity Obligation. In a 2014 decision of the United States Bankruptcy Court (N.D. Texas), the court approved a payment for legal fees and expenses under an indemnity given by a borrower to an interim lender, even where such amounts did not benefit the estate. In that case, an action was commenced by the trustee of the debtor against the debtor's interim lender for various alleged wrongdoings under an interim financing agreement, including the lender's refusal to fund certain requested advances. In particular, the Court stated "[a]lthough the fees and expenses incurred by Greenblatt did not themselves benefit the estate, Scattered's lending under the DIP Agreement clearly did and the post petition agreement to indemnify was incurred so that H&M could receive the funding it required."

> *Douglas J Brickley, Chapter 11 Trustee v Scattered Corporation and Leon A Greenblatt, III*, 514 BR 790 at 837 (Bkrtcy ND Tex 2014).

28. The within application is no different. The Debtors and stakeholders have had the benefit of BDC's Interim Facility, and as a result the Indemnity Obligation must be honoured.

BDC has an Economic Interest in the Appeal

29. BDC continues to have a legitimate economic interest in the Appeal by virtue of the challenge to the priority of the Interim Lender's Charge. Any challenge to the priority of the Interim Lender's Charge at any time (whether or not BDC has been paid out in full) is an issue of significant importance to BDC and engages BDC's economic interests because, *inter alia*, the outcome of the priority dispute has potential economic impacts on all interim loans secured by a priority charge, including other outstanding BDC interim financing loans. BDC is not only entitled to defend against such challenges but is also entitled to have the costs of safeguarding this priority indemnified by the Debtors under, *inter alia*, the terms of the Relevant Provisions and Initial Order.

French Affidavit at paras 22, 24 and 27.

30. Further, the Alberta Court of Appeal granted leave notwithstanding that the issue on appeal was potentially moot on the record. In doing so, the Alberta Court of Appeal appears to have acknowledged that the Appeal raises larger policy issues than are immediately at play on the Appeal.

CA Decision at para 3.

31. As BDC continues to have an economic interest in defending those issues, BDC should be entitled to continue to rely on the Relevant Provisions.

Risk to BDC Remains

32. The Indemnity Obligation does not terminate with the repayment of the Interim Facility; rather, it terminates when the risks covered by the Indemnity Obligation come to an end.

33. Indemnity clauses are intended to shift the responsibility of an adverse event from one commercial party to another. In other words, indemnity clauses modify the contractual allocation of risk. So long as the risk of a shortfall under the Interim Facility remains possible, BDC's rights under the Relevant Provisions and the Initial Order should remain available.

Gerard McMeel, *The Construction of Contracts*: *Interpretation, Implication and Rectification* (New York: Oxford University Press Inc, 2007) at 407.

34. The risk of a claw-back to BDC's payout of the Interim Facility amount remains possible, although remote. As noted previously, the Interim Lender's Charge is subordinate only to the Administration Charge in the amended amount of $950,000. If, at the end of these

proceedings, there are insufficient funds in the Debtors' estate to payout the Administration Charge, the Monitor is entitled to claw-back amounts previously paid out under subordinate charges or security.

35. Another example is illustrative of the importance of this issue. Consider a subsequent priority claim being asserted against an interim lender after its payout, seeking either the disgorgement of funds or even only a declaration of priority of the late advanced claim. In those circumstances, it should be uncontroversial that an interim lender in that situation would be entitled to defend its position and that the costs of doing so would be covered as part of their charge and indemnity. BDC's position is analogous.

<u>BDC Should Be Involved In The Defence of the Appeal</u>

36. BDC offers and prices its interim loans on the assumption that it will not be required to spend its own funds defending challenges to the priority of its loans. The Interim Facility was offered to the Debtors on terms that were commercially favourable. As a trade-off, BDC incorporated standard but comprehensive indemnity and cost recovery provisions.

French Affidavit at paras 25-26.

37. The CRA Application was filed when the first tranche Interim Facility was already advanced. However, subsequent tranches of interim financing were advanced by BDC notwithstanding that CRA Application was extant – even prior to the release of the Topolniski Decision. At the time, the repayment in full of CRA and BDC was not certain. BDC vigorously opposed the CRA Application both before the Court of Queen's Bench and on the application for leave to the Court of Appeal.

38. After lending into that risky situation and successfully arguing against the CRA Application, certain stakeholders are opposed to funding the conclusion of this dispute. As noted previously, the Court of Appeal and the parties to the Appeal are expecting a factum from BDC on June 25, 2018, in its capacity as lead respondent.

39. If the BDC Costs are not covered by the Indemnity Obligation and secured by the Interim Lender's Charge, there is no guarantee that BDC will participate in the Appeal. If BDC does not participate in the Appeal, a lenders' perspective on this issue will not be before the Court of Appeal. Although intervener status has been granted to the Canadian Association of Insolvency and Restructuring Professionals and the Insolvency Institute of Canada, interveners must demonstrate an ability to provide "special expertise or fresh

perspective" that brings some benefit to the proceedings. As such, the interveners cannot be relied upon by BDC to bring forward the perspective of an interim lender.

> French Affidavit at para 28; *Suncor Energy Inc v Mining Assn of Canada*, 2016 ABCA 265 at para 11.

40. If BDC were to withdraw from the appeal, the Monitor would likely be required to assume the role of lead respondent for the purpose of protecting the priority afforded to the Administration Charge. This would incur similar costs for the estate, and could result in the October 2, 2018 hearing date being delayed as a result of these developments. This outcome is not conducive to the resolution of these important issues before the Court of Appeal. The estate is better served by funding BDC to continue its defence, particularly when it was BDC who stood by the Debtors and funded them in the face of the CRA Application.

B. The Debtors are Required to Indemnify BDC for the BDC Costs

41. In addition to the considerations outlined above, the wording of the Relevant Provisions makes it clear that the Indemnity Obligation arises under each of the Relevant Provisions and is secured by the Interim Lender's Charge.

<u>The First Indemnity Provision</u>

42. The language used in the First Indemnity Provision is very broad and expressly states that the Debtors shall agree to indemnify and hold BDC harmless from and against "<u>any and all claims, losses, obligations, liabilities, claims, actions or causes of action, and reasonable costs and expenses incurred, suffered, sustained or required to be paid by BDC by reason of or resulting from the Interim Loan, the Letter of Offer</u> and the transactions and documents contemplated by the Letter of Offer." [emphasis added]

> French Affidavit at Exhibit "A".

43. The First Indemnity Provision can be summarized as imposing an obligation on the Debtors to 'indemnify and hold harmless' BDC from and against 'all liabilities by reason of or resulting from the Interim Loan and the Letter of Offer.

44. The meaning of the phrase 'indemnify and save harmless' has been judicially considered and has been interpreted as being broad. Furthermore, the use of the phrase 'save harmless' has been interpreted as imposing an additional obligation that goes beyond the obligation to indemnify. As noted by Brown, J. in *Stewart Title Guaranty Co. v.*

Zeppieri, the addition of the phrase to 'save harmless' imposes not only a requirement to pay damages for which a person may become liable, but it also imposes a requirement to cover the on-going costs incurred in defending the claim subject to the indemnity provision.

> *Ontario v Turn-Key Construction Inc*, 2016 ONSC 5350 at para 19; *Stewart Title Guaranty Co v Zeppieri*, [2009] O.J. No 322 (Ont SCJ) at para 20.

45. The term 'liability' is also given a broad meaning. "Liability" is defined in Black's Law Dictionary as "a broad legal term of the most comprehensive significance, including almost every character of hazard or responsibility, absolute, contingent, or likely". Furthermore, the word "liability" has been interpreted to be a very general term that "will, as a rule, include even contingencies".

> *Black's Law Dictionary*, abridged 6th ed, *sub verbo* "liability" [**Black's**]; *JD McArthur Co v Alberta & Great Waterways Railway*, 1924 CarswellAlta 11 at para 46.

46. Under the terms of the Letter of Offer, the Debtors expressly agreed (i) to grant the Interim Lender's Charge; and (ii) that the Interim Lender's Charge will have priority over all other creditors of the Debtors (with the exception of the Administration Charge). Because the Appeal is challenging the priority position of the Interim Lender's Charge, BDC is exposed to the risk that the Interim Lender's Charge may not have the priority position required by the Letter of Offer. The Appeal therefore clearly constitutes a liability by reason of or resulting from the Letter of Offer. As such, the First Indemnity Provision applies to indemnify and hold BDC harmless from the BDC Costs.

<u>The Second Indemnity Provision</u>

47. The language in the Second Indemnity Provision states that as long as any amount remains owing by the Debtors to BDC, the Debtors are required to pay all costs (including legal fees) incurred by BDC to exercise its rights under Letter of Offer.

> French Affidavit at Exhibit "A".

48. Although the Interim Facility has been paid out, the Debtors remain indebted to BDC in the amount of approximately $2,750,911.29. This clearly constitutes an amount owed by the Debtors to BDC under the Interim Facility "or otherwise", meaning that the Second Indemnity Provision also remains available to BDC.

French Affidavit at para 20.

49. In defending the Appeal, BDC is exercising its rights under the Letter of Offer, including the right to have a valid and enforceable Interim Lender's Charge whose priority is subject only to the Administration Charge. As such, BDC's involvement in the Appeal and the corresponding BDC Costs also fall within the indemnity created by the Second Indemnity Provision.

The Other Costs Provision

50. The language in Other Costs Provision is clear that any and all costs, charges and expenses (including without limitation, lawyers' fees as between solicitor and his own client, on a full indemnity basis) incurred by BDC in connection with, *inter alia*, the restructuring proceedings, the Initial Order or the Interim Lender's security (which included the Interim Lender's Charge) are for the account of the Debtors and are secured by the Interim Lender's Charge. [emphasis added]

French Affidavit at Exhibit "A".

51. The Other Costs provision can be summarized as requiring:

(a) that the Debtors pay all of BDC's costs (including legal fees) incurred by BDC 'in connection with the restructuring proceedings, the Initial Order and/or the Interim Lender's Charge'; and

(b) that the above noted costs be secured by the Interim Lender's Charge.

52. As noted by MacFarlane, J. in *Nanaimo Community Hotel Ltd v British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940)*, the words 'in connection with' include matters occurring prior to as well as subsequent to or consequent upon so long as they are related to the principal thing.

Nanaimo Community Hotel Ltd v British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940), 1944 CarswellBC 87 at para 5.

53. The Appeal is being brought within the context of the restructuring proceedings and is challenging the priority of the Interim Lender's Charge established by the Initial Order. As such, any costs incurred by BDC in defending the Appeal have clearly been incurred 'in connection with', *inter alia*, the restructuring proceedings, the Initial Order or the Interim Lender's security, meaning that:

(a) the BDC Costs are for the account of the Debtors; and

(b) the BDC Costs are secured by the Interim Lender's Charge.

54. The fact that the BDC Costs are secured by the Interim Lender's Charge is further supported by the language of the Initial Order, which states that the Interim Lender's Charge was granted to secure <u>all obligations under the Definitive Documents incurred on or after the date of the Initial Order</u>. [emphasis added] This is the only temporal limitation in relation to the obligations.

Initial Order at para 34.

55. An "obligation" is defined in Black's Law Dictionary as "[t]hat which a person is bound to do", "any duty imposed by law, contract...etc." and "a formal and binding agreement or acknowledgment of a liability to ... do a certain thing". Each of the Relevant Provisions obligates the Debtors to pay BDC's costs, charges and expenses in the circumstances set out thereunder. As such, the Relevant Provisions constitute obligations under the Definitive Documents, which are therefore secured by the Interim Lender's Charge.

Black's, *sub verbo* "obligation".

V. CONCLUSION

56. Accordingly, for all of the forgoing reasons, it is respectfully requested that this Honourable Court grant an Order, *inter alia*:

(a) directing that the Monitor set aside the Cost Reserve in favour of BDC to secure the BDC Costs;

(b) in the alternative, declaring that the BDC Costs shall be fully paid by the estate of the Debtors on an ongoing basis; and

(c) directing the Monitor to pay forthwith BDC's reasonable legal fees and disbursements associated with the within application on a solicitor and own client basis.

ALL OF WHICH IS RESPECTFULLY SUBMITTED THIS 12th day of June, 2018.

CASSELS BROCK & BLACKWELL LLP

Per: ____________________

Jeffrey Oliver/Danielle Maréchal
Counsel for Business Development Bank of Canada

TABLE OF AUTHORITIES

Jurisprudence

1. *Canada v Canada North Group Inc*, 2017 ABCA 363.

2. *Canada North Group Inc (Companies' Creditors Arrangement Act)*, 2017 ABQB 550.

3. *Douglas J Brickley, Chapter 11 Trustee v Scattered Corporation and Leon A Greenblatt, III*, 514 BR 790 (Bkrtcy ND Tex 2014).

4. *JD McArthur Co v Alberta & Great Waterways Railway*, 1924 CarswellAlta 11.

5. *Nanaimo Community Hotel Ltd v British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940)*, 1944 CarswellBC 87.

6. *Ontario v Turn-Key Construction Inc*, 2016 ONSC 5350.

7. *Stewart Title Guaranty Co v Zeppieri*, [2009] OJ No 322 (Ont SCJ).

8. *Suncor Energy Inc v Mining Assn of Canada*, 2016 ABCA 265.

Secondary Sources

1. *Black's Law Dictionary,* abridged 6th ed, *sub verbo* “liability”, “obligation”.

2. Gerard McMeel, *The Construction of Contracts: Interpretation, Implication and Rectification* (New York: Oxford University Press Inc, 2007).

1.

2017 ABCA 363
Alberta Court of Appeal

Canada v. Canada North Group Inc.

2017 CarswellAlta 2213, 2017 ABCA 363, [2017] A.W.L.D. 6130,
[2017] A.W.L.D. 6301, 284 A.C.W.S. (3d) 461, 54 C.B.R. (6th) 5

Her Majesty the Queen in Right of Canada (Applicant / Appellant) and Canada North Group Inc., Canada North Camps Inc., Campcorp Structures Ltd., DJ Catering Ltd., 816956 Alberta Ltd., 1371047 Alberta Ltd., and 1919209 Alberta Ltd. (Respondents / Respondents) and Ernst & Young Inc. (in its capacity as Monitor, and not in its personal capacity) (Respondent / Respondent) and Business Development Bank Canada (Respondent / Respondent)

Frans Slatter J.A.

Heard: November 1, 2017
Judgment: November 3, 2017
Docket: Edmonton Appeal 1703-0237-AC

Counsel: G.F. Body, for Applicant
S.A. Wanke, for Respondents, Canada North Group Inc., Canada North Camps Inc., Campcorp Structures Ltd., DJ Catering Ltd., 816956 Alberta Ltd., 1371047 Alberta Ltd., and 1919209 Alberta Ltd.
D.R. Bieganek, Q.C., for Respondent, Ernst & Young Inc.
J.L. Oliver, for Respondent, Business Development Bank Canada

Subject: Civil Practice and Procedure; Corporate and Commercial; Insolvency; Tax — Miscellaneous

Related Abridgment Classifications

Civil practice and procedure
XXIII Practice on appeal
  XXIII.10 Leave to appeal
    XXIII.10.b Application
      XXIII.10.b.ii Grounds
Tax
I General principles
  I.5 Priority of tax claims in bankruptcy proceedings

Headnote

Civil practice and procedure --- Practice on appeal — Leave to appeal — Application — Grounds

Within Companies' Creditors Arrangement Act proceedings, case management judge determined that "super-priority" charges made in favour of interim financier, directors of debtor companies, and monitor and its counsel had priority over claim of Minister of National Revenue for unremitted source deductions — Minister brought application for leave to appeal — Application granted — Leave was granted on issue of whether judge erred in law in determining that "super-priority" charges made in favour of interim financier, directors of debtor companies, and monitor and its counsel had priority over claim of Minister for unremitted source deductions — Minister identified substantive issue justifying further appeal — There was no appellate authority directly on point — Even if issue was potentially moot, it should be adjudicated as super-priority funding cases were often resistant to review.

Tax --- General principles — Priority of tax claims in bankruptcy proceedings

Within Companies' Creditors Arrangement Act proceedings, case management judge determined that "super-priority" charges made in favour of interim financier, directors of debtor companies, and monitor and its counsel had priority over claim of Minister of National Revenue for unremitted source deductions — Minister brought application for leave to appeal — Application granted — Leave was granted on issue of whether judge erred in law in determining that "super-priority" charges made in favour of interim financier, directors of debtor companies, and monitor and its counsel had priority over claim of Minister for unremitted source deductions — Minister identified substantive issue justifying further appeal — There was no appellate authority directly on point — Even if issue was potentially moot, it should be adjudicated as super-priority funding cases were often resistant to review.

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Cases considered by *Frans Slatter J.A.*:

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Statutes considered:

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s. 13 — pursuant to

Rules considered:

Alberta Rules of Court, Alta. Reg. 124/2010

Generally — referred to

APPLICATION by Minister of National Revenue for leave to appeal judgment granting super-priority to certain claims within insolvency proceedings.

***Frans Slatter J.A.*:**

1 The Minister of National Revenue has applied, in accordance with s. 13 of the *Companies' Creditors Arrangement Act*, RSC 1985, c. C-36, for leave to appeal the decision reported as *Canada North Group Inc (Companies' Creditors Arrangement Act)*, 2017 ABQB 550 (Alta. Q.B.). The case management judge described the issue as follows:

> 1 This case is about whether Court ordered "super-priority" security interests granted in a *Companies' Creditor Arrangement Act* (*CCAA*) proceeding can take priority over statutory deemed trusts in favour of Her Majesty the Queen in Right of Canada, as represented by the Minister of National Revenue (CRA) for unremitted source deductions.
>
> The test for leave to appeal is well established: Is there a substantive ground justifying an appeal, considering a) whether the point on appeal is of significance to the practice; b) whether the point raised is of significance to the parties and the action; c) whether the appeal is reasonably arguable (or conversely frivolous); and d) whether the appeal will unduly hinder the progress of the insolvency proceedings. See *Wells Fargo Securities Canada Ltd. v. Sanjel Corp.*, 2017 ABCA 120 (Alta. C.A.) at para. 6, (2017), 47 C.B.R. (6th) 289 (Alta. C.A.) and *Canadian Imperial Bank of Commerce v. Endurance Energy Ltd.*, 2016 ABCA 217 (Alta. C.A.) at para. 9.

2 There is no appellate authority directly on point, although the respondents argue that the weight of authority is supportive of the case management judge's conclusions.

3 The respondents also argue that the issue is moot on this record, because there are sufficient assets in this estate to satisfy both the "super-priority" security interests and the claim of the Minister. They argue that the second component

of the test is not satisfied, because the outcome is not of significance to this action. The mootness issue was not raised before the case management judge because the valuation of the assets was not finalized at that time. On the other hand, the cases demonstrate that this issue is resistant to review, because the "super-priority" funding is often advanced before the priority claim can be adjudicated. This leads to the problem that the court cannot fairly "unscramble the egg" after the fact: *Canada North Group* at paras. 56, 68, 70; *Minister of National Revenue v. Temple City Housing Inc.*, 2008 ABCA 1 (Alta. C.A.) at para. 14, (2008), 422 A.R. 4, 43 C.B.R. (5th) 35 (Alta. C.A.). In this appeal there is no need to unscramble the egg, because there are lots of eggs. This may present the occasion where the Court should adjudicate even if the issue is potentially moot.

4 The respondents also argue that it is unfair to have the insolvent companies bear the expense of what is essentially a "test case", and that the Minister should be required to pay the costs of any appeal. The panel that hears the appeal is, however, in the best position to deal with any issues respecting the incremental costs generated by an appeal.

5 I am satisfied that the applicant has identified a substantive issue justifying a further appeal, and leave to appeal is granted on the following issue:

> Did the case management judge err in law in determining that the "super-priority" charges made in favour of the interim financier, the directors of the debtor companies, and the Monitor and its counsel have priority over the claim of the Minister of National Revenue for unremitted source deductions?

As in all appeals, the costs of the appeal will be in the hands of the panel.

6 In order to circumscribe the costs of this appeal, the debtor Canada North Group will (subject to any contrary agreement by counsel) be the lead respondent, and will be entitled to file a full factum as provided for in the *Rules of Court*. Other interested parties may file respondents' factums, but they will not be due until 10 days after Canada North's factum is filed, they are not to be repetitive of arguments made by Canada North, and unless permitted by the Case Management Officer they are to be limited to 8 pages. No party will receive costs of this application.

Application granted.

2.

2017 ABQB 550
Alberta Court of Queen's Bench

Canada North Group Inc (Companies' Creditors Arrangement Act)

2017 CarswellAlta 1631, 2017 ABQB 550, [2017] A.W.L.D. 4936, [2017] A.W.L.D. 5003, [2018] 2 W.W.R. 731, 283 A.C.W.S. (3d) 214, 52 C.B.R. (6th) 308, 60 Alta. L.R. (6th) 103

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 Canada North Group Inc, Canada North Camps Inc, Campcorp Structures Ltd, DJ Catering Ltd, 816956 Alberta Ltd, 1371047 Alberta Ltd, and 1919209 Alberta Ltd (Applicants)

J.E. Topolniski J.

Heard: August 11, 2017
Judgment: September 11, 2017
Docket: Edmonton 1703-12327

Counsel: Darren R Bieganek, Q.C., for Monitor, Ernst & Young
George F Body, for Her Majesty the Queen in Right of Canada, as represented by the Minister of National Revenue
Jeffrey Oliver, for Business Development Bank of Canada
Stephanie A Wanke, for Applicants, Canada North Group Inc, Canada North Camps Inc, Campcorp Structures Ltd, DJ Catering Ltd, 816956 Alberta Ltd, 1371047 Alberta Ltd, and 1919209 Alberta Ltd

Subject: Income Tax (Federal); Insolvency; Tax — Miscellaneous

Related Abridgment Classifications

Bankruptcy and insolvency
X Priorities of claims
X.5 Claims of Crown
X.5.a Federal
X.5.a.v Miscellaneous
Tax
I General principles
I.5 Priority of tax claims in bankruptcy proceedings

Headnote

Tax --- General principles — Priority of tax claims in bankruptcy proceedings

Debtors' restructuring plan became plea for Companies' Credit Arrangement Act (CCAA) — Debtors' motion and cross-motion to appoint receiver of three of debtor companies by debtor's primary lender, CWB, proceeded — Debtors served CRA with initial order by mailing to CRA office permissible form of service under Alberta' Rules of Court — When interim financer, BDC, advanced $900,000 of priority $1,000,000 facility, debtors sought to extend stay of proceedings — Debtors subsequently served CRA with application to increase interim financing — Stay of proceedings was extended, and interim financing was increased to $2,500,000 — CRA's counsel noted risk to BDC for additional advances subject to Crown's charges — CRA brought motion to determine whether Court ordered "super-priority" security interests granted in proceeding could take priority over statutory deemed trusts in favour of Minister of National or CRA for unremitted source deductions — Ruling was made — Court's order set our priority of charges at issue — Relevant CCAA sections allowed court, where appropriate, to grant priority only to those charges necessary for restructuring — Purpose of deemed trust in fiscal statutes was still met, as deemed trusts maintained their priority status over all other security interests, but those ordered under ss. 11.2, 11.51, and 11.52 of CCAA — Debtors effected service, albeit short notice service, on CRA, which Court deemed to be good and sufficient — Despite glaring failure of CRA's mail management system and although CRA was effectively and technically served June 28, purpose of service was not fulfilled until July 6 when CRA became aware of initial order — CRA's interest was security interest, not proprietary interest — Impact and interplay of "notwithstanding" language in Income Tax Act s. 227(4.1) did not change this conclusion — CRA's position disregarded rather obvious, that successful corporate restructurings resulted in continued jobs to fuel and fund its source deduction tax based — It was logical to infer that Parliament intended to create co-existing statutory scheme that accomplished goals of both fiscal statues and CCAA — CCAA gave Court ability to rank priority charges ahead of CRA' security interest arising out of deemed trusts.

Bankruptcy and insolvency --- Priorities of claims — Claims of Crown — Federal — Miscellaneous

Debtors' restructuring plan became plea for Companies' Credit Arrangement Act (CCAA) — Debtors' motion and cross-motion to appoint receiver of three of debtor companies by debtor's primary lender, CWB, proceeded — Debtors served CRA with initial order by mailing to CRA office permissible form of service under Alberta' Rules of Court — When interim financer, BDC, advanced $900,000 of priority $1,000,000 facility, debtors sought to extend stay of proceedings — Debtors subsequently served CRA with application to increase interim financing — Stay of proceedings was extended, and interim financing was increased to $2,500,000 — CRA's counsel noted risk to BDC for additional advances subject to Crown's charges — CRA brought motion to determine whether Court ordered "super-priority" security interests granted in proceeding could take priority over statutory deemed trusts in favour of Minister of National or CRA for unremitted source deductions — Ruling was made — Court's order set our priority of charges at issue — Relevant CCAA sections allowed court, where appropriate, to grant priority only to those charges necessary for restructuring — Purpose of deemed trust in fiscal statutes was still met, as deemed trusts maintained their priority status over all other security interests, but those ordered under ss. 11.2, 11.51, and 11.52 of CCAA — Debtors effected service, albeit short notice service, on CRA, which Court deemed to be good and sufficient — Despite glaring failure of CRA's mail management system and although CRA was effectively and technically served June 28, purpose of service was not fulfilled until July 6 when CRA became aware of initial order — CRA's interest was security interest, not proprietary interest — Impact and interplay of "notwithstanding" language in Income Tax Act s. 227(4.1) did not change this conclusion — CRA's position disregarded rather obvious, that successful corporate restructurings resulted in continued jobs to fuel and fund its source deduction tax based — It was logical to infer that Parliament intended to create co-existing statutory scheme that accomplished goals of both fiscal statues and CCAA — CCAA gave Court ability to rank priority charges ahead of CRA' security interest arising out of deemed trusts.

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RULING on Canada Revenue Agency's motion to determine whether Court ordered "super-priority" security interests granted in proceeding could take priority over statutory deemed trusts in favour of Minister of National for unremitted source deductions.

***J.E. Topolniski J.*:**

Introduction

1 This case is about whether Court ordered "super-priority" security interests granted in a *Companies' Creditor Arrangement Act* [1] (*CCAA*) proceeding can take priority over statutory deemed trusts in favour of Her Majesty the Queen in Right of Canada, as represented by the Minister of National Revenue (CRA) for unremitted source deductions.

2 Acknowledging that its success on this motion would cause a chill on commercial restructuring, CRA relies on the comeback provision in an initial *CCAA* Order made July 5, 2017 (Initial Order) to vary "super-priority" charges made in favour of an interim financier, the directors of the debtor companies, and the Monitor and its counsel (Priority Charges), which subordinate its deemed trust claims arising under the *Income Tax Act (ITA)* [2], *Canada Pension Plan Act* [3] *(CPP Act)*, and *Employment Insurance Act* [4] *(EI Act)* (collectively, the Fiscal Statutes) [5].

3 CRA's view is that the deemed trusts give it a proprietary, rather than a secured interest in the Debtors' assets that cannot be subordinated. Alternatively, if it is a secured creditor, its first place position under the Fiscal Statutes cannot

be undermined by the Priority Charges. Canada North Group Inc, Canada North Camps Inc, Camcorp Structures Ltd, DJ Catering Ltd, 816956 Alberta Ltd, 1371047 Alberta Ltd and 1919209 Alberta Inc (the Debtors), the Monitor, and the interim financer, Business Development Bank of Canada (BDC), strenuously oppose the motion.

4 In addition to the priority issue, there are a number of interconnected, subsidiary issues including: Whether the subject is proper for variance, the onus on a comeback motion, technical service versus actual notice, and delay prejudice.

5 For the reasons that follow, CRA's interest arising under the Fiscal Statutes is properly subordinated by the Priority Charges. Concerning the subsidiary issues, I have (obviously given the foregoing) found that the question is appropriate for a comeback hearing. I have also found that CRA bears the onus and that, even if CRA had prevailed, it would have been inappropriate to disturb the Priority Charges for the period between the Initial Order and this hearing on August 11, 2017, because of the delay prejudice.

The Factual Landscape

6 No surprise given the nature of the proceedings, matters have unfolded quickly.

7 The Debtor's restructuring plan began with s 50.4(1) *Bankruptcy and Insolvency Act* (*BIA*) [6] notice of intention to make a proposal to creditors that very quickly changed to a plea for *CCAA* relief.

8 The originating *CCAA* materials were served on CRA via courier at its Edmonton office (CRA Office) on June 28. The service package included:

a. The originating application returnable July 5, 2017 seeking a stay of proceedings and basket of other relief, including the Priority Charges;

b. A draft form of initial order that set out the sought after charges: Interim financier charge of $1,000,000, administrative charge of $1,000,000, and the director's indemnity charge of $50,000,000; and

c. An affidavit of a director of the Debtors attesting to a $1,140,000 debt to CRA for source deductions and GST (the evidence does not breakdown what is owed for source deductions, which is the only remittance in issue).

9 On July 5, the Debtors' motion and a cross-motion to appoint a receiver of three of the debtor companies by the Debtor's primary lender, Canadian Western Bank (CWB), proceeded. CRA did not appear (more will be said about this later). The Court refused CWB's receivership application and granted the Initial Order, which included typical service provisions and a comeback clause (Comeback Provision). The Priority Charges track the draft form of Order with one change - a (consensual) $500,000 reduction to the administrative charge.

10 On July 6, the Debtors served CRA with the Initial Order by mailing it to the CRA Office, a permissible form of service under Alberta's *Rules of Court*. Also on this day, the CRA employee responsible for *CCAA* filings in western Canada (CRA Representative) received the Initial Order. The curious routing was via a Department of Justice Canada (DOJ) lawyer who was given it by a party that noted CRA's manifest absence at the initial hearing.

11 On July 12, the Monitor published notice of the proceedings in one local and one national newspaper and created a proceeding-specific website.

12 By July 13, the Debtor's service package had wended its way from the CRA Office to the CRA Representative's hands.

13 Next, on July 20, when BDC had advanced $900,000 of the Priority $1,000,000 facility, the Debtors served a motion to extend the stay of proceedings (made in the Initial Order) returnable July 27 (Extension Motion). Again, service was on the CRA Offices.

14 Then, on July 21, CWB served another motion to appoint a receiver also returnable on July 27. CWB served CRA by sending the documents to a DOJ lawyer.

15 On July 25, the Debtors served CRA with an application to increase interim financing returnable July 27 on the ground that they had a new contract to supply camps for firefighters battling the wildfires then ravaging British Columbia (Enhanced Financing Motion).

16 Late on the afternoon of July 26, CRA's counsel emailed an unfiled version of this motion and a draft form of the order to be sought to the Monitor's and Debtors' counsel, who passed the information to BDC's counsel.

17 On July 27, all three motions proceeded. CRA appeared, taking no position. In the result, the stay of proceedings was extended until September 26, and the interim financing was increased to $2,500,000 (written reasons were later filed: 2017 ABQB 508 (Alta. Q.B.)). After the Court delivered its oral reasons for decision, CRA's counsel rose to advise that his client would be filing this motion, noting the risk to BDC for "additional advances subject to the Crown's charges." In response, BDC's counsel indicated that his client had earlier learned of CRA's intentions and was still prepared to advance under the facility.

The Legal Landscape

The CCAA and Judicial Decision Making

18 The *CCAA*'s purpose is to allow financially distressed businesses with more than $5,000,000 debt to keep operating and, where possible, avoid the social and economic costs of liquidation.

19 The *CCAA* process "creates conditions for preserving the *status quo* while attempts are made to find common ground amongst stakeholders for a reorganization that is fair to all." [7]

20 When enacting the *CCAA*, Parliament understood that liquidation of insolvent businesses is harmful to creditors and employees and the optimal outcome is their survival. [8] This notion would not have been lost on Parliament when the *CCAA* was substantially amended in 2009 (2009 amendments). Indeed, in a post-2009 amendment case, *Sun Indalex Finance, LLC v. United Steelworkers*, [9] Cromwell J, concurring in result and writing for McLachlin CJ and Rothstein J, spoke of the *CCAA's* purpose saying:

> [It] is important to remember that the purpose of *CCAA* proceedings is not to disadvantage creditors but rather to try to provide a constructive solution for all stakeholders when a company has become insolvent. [10]

21 The Court's function during the *CCAA* stay period is to supervise and move the process to the point where the creditors approve a compromise or it becomes evident that the attempt is doomed to fail. [11] Typically, this requires balancing multiple interests.

22 *CCAA* s 11 cloaks the Court with broad discretionary power to make any order it considers appropriate in the circumstances, subject to the restrictions set out in the *Act*. However, as the Supreme Court of Canada observed in *Century Services*, there are limits on the exercise of inherent judicial authority in a *CCAA* restructuring. [12]

23 The Supreme Court also provides this overarching direction for exercising *CCAA* judicial authority in *Century Services*:

> The general language of the *CCAA* should not be read as being restricted by the availability of more specific orders. However, the requirements of appropriateness, good faith, and due diligence are baseline considerations that a court should always bear in mind when exercising *CCAA* authority. Appropriateness under the *CCAA* is assessed by inquiring whether the order sought advances the policy objectives underlying the *CCAA*. The question

> is whether the order will usefully further efforts to achieve the remedial purpose of the *CCAA* -- avoiding the social and economic losses resulting from liquidation of an insolvent company. I would add that appropriateness extends not only to the purpose of the order, but also to the means it employs. Courts should be mindful that chances for successful reorganizations are enhanced where participants achieve common ground and all stakeholders are treated as advantageously and fairly as the circumstances permit [13].

24 In interpreting and applying the *CCAA*, the Court is to employ a hierarchical approach, and consider and, if necessary, resolve the underlying policies at play. [14]

A Brief History of Deemed Trust Litigation

25 While there are other priority cases involving disputes between CRA and insolvent entities, this discussion necessarily begins with *Royal Bank of Canada v. Sparrow Electric Corp*. [15]

26 The contest in *Sparrow Electric* was between CRA's deemed trust claim for unremitted source deductions under the *ITA* and security interests under the *Bank Act* [16] and the Alberta *Personal Property Security Act.* [17] CRA lost the priority battle since the security interests were fixed charges attaching to the secured property when the debtor acquired it. Consequently, CRA's deemed trust had no property to attach to when it later arose. In response to *Sparrow Electric*, Parliament amended the *ITA* by expanding s 227 (4) and adding s 227(4.1) (detailed below).

27 The next noteworthy case is *First Vancouver Finance v. MNR*, [18] which concerned a priority dispute between CRA's deemed tax trusts and the interest of a third party purchaser of assets bought in an insolvency proceeding sale. The interpretation of *ITA* s 227(4.1) was at the fore.

28 The Supreme Court found in favour of the third party purchaser. Writing for the majority, Iacobucci J noted:

> a. In principle, the deemed trust is similar to a floating charge over all the debtor's assets in favour of the Crown (at para 40);
>
> b. The deemed trust operates "in a continuous manner, attaching to any property which comes into the hands of the debtor as long as the debtor continues to be in default, and extending back in time to the moment of the initial deduction" (at para 33);
>
> c. Property subject to the deemed trust can be alienated by the debtor, after which the deemed trust applies to the proceeds (at para 42); and
>
> d. The deemed trust is not a "true trust," nor is it governed by common law requirements under ordinary principles of trust law, but the effect of s227(4.1) is to revitalize the trust whose subject matter has lost all identity (citing Gonthier J in *Sparrow Electric*) (at para 27-28).

29 The Supreme Court concluded that Parliament intended s 227(4) and (4.1):

> . . . to grant priority to the deemed trust in respect of property that is also subject to a security interest regardless of when the security interest arose in relation to the time the source deductions were made or when the deemed trust takes effect. (at para 28).

30 *First Vancouver* was considered in the 2007 decision, *Temple City Housing Inc (Companies' Creditors Arrangement Act)*, [19] and again in June 2017 in *Rosedale Farms Limited, Hassett Holdings Inc., Resurgam Resources (Re)*. [20]

31 In *Temple City*, CRA opposed a Priority charge in favour of an interim financier (then termed a debtor in possession, or DIP, financier) on the basis that it had a proprietary interest in the debtor's assets under its (tax) deemed trusts. Unlike this case, it was decided before the 2009 amendments.

32 Like others before her with no statutory authority to grant the super priority charges, Romaine J assessed the merits and relied on the Court's inherent jurisdiction to grant the charge.

33 The Alberta Court of Appeal denied leave to appeal, finding the issue unimportant to the practice because amendments allowing such charges were on the horizon and future cases would engage statutory interpretation (the Court of Appeal's forecast of looming amendments was sidelined by Parliamentary inaction, and the amendments were eventually proclaimed in force on September 18, 2009). The Court also found the issue unimportant to the case itself for two distinct reasons. First, the proceeding had taken on a momentum that would make it virtually impossible to "unscramble the egg." Second, an appeal would hinder the restructuring as the DIP lender would not advance without being in a priority position.

34 Next is the seminal decision in *Century Services*, which considered the deemed trust for GST arising under the *Excise Tax Act* (ETA).[21] Despite the different deemed trust at issue, *Century Services* is important for many reasons including, general interpretation of the *CCAA*, policy considerations, the Court's function, and the parameters for exercising inherent jurisdiction.

35 *Rosedale Farms* concerned deemed tax trusts and a super-priority interim financing charge in a *BIA* proposal scenario. The reasons disagree quite strongly with the logic of *Temple City*. The Court also found that because CRA did not have the requisite notice, it could not be bound by the interim financing Order.

36 I will return to the conflicting views expressed in *Temple City* and *Rosedale Farms* in the context of the priority analysis.

The Statutory Provisions

37 The relevant statutory provisions are set out below. All emphasis is mine.

38 *CCAA* s 2(1) defines the term, "secured creditor" as including:

> **a holder of . . . a trust** in respect of, all or any property of the debtor company, whether the holder or beneficiary is resident or domiciled within or outside Canada... .

39 *ITA* s 224(1.3) defines "secured creditor" as "a person who has a security interest in the property of another person." It defines "security interest" as:

> **any interest in**, or for civil law any right in, property that secures payment or performance of an obligation and includes an interest, or for civil law a right, **created by or arising out of a** debenture, mortgage, hypothec, lien, pledge, charge, **deemed or actual trust,** assignment or encumbrance of any kind whatever, however or whenever arising, created, deemed to arise or otherwise provided for.

40 The *EI Act* and *CPP Act* cross-reference these definitions.

41 The relevant portions of *CCAA* ss 11.2, 11.51, and 11.52 read:

> 11.2 (1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, a court may make an order declaring that all or part of the company's property is subject to a security or charge — in an amount that the court considers appropriate — in favour of a person specified in the order who agrees to lend to the company an amount approved by the court as being required by the company, having regard to its cash-flow statement. The security or charge may not secure an obligation that exists before the order is made.
>
> **(2) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.**

11.51 (1) On application by a debtor company and on notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring that all or part of the property of the company is subject to a security or charge — in an amount that the court considers appropriate — in favour of any director or officer of the company to indemnify the director or officer against obligations and liabilities that they may incur as a director or officer of the company after the commencement of proceedings under this Act.

(2) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

11.52 (1) On notice to the secured creditors who are likely to be affected by the security or charge, the court may make an order declaring that all or part of the property of a debtor company is subject to a security or charge — in an amount that the court considers appropriate — in respect of the fees and expenses of

(a) the monitor, including the fees and expenses of any financial, legal or other experts engaged by the monitor in the performance of the monitor's duties;

(b) any financial, legal or other experts engaged by the company for the purpose of proceedings under this Act; and

(c) any financial, legal or other experts engaged by any other interested person if the court is satisfied that the security or charge is necessary for their effective participation in proceedings under this Act.

(2) The court may order that the security or charge rank in priority over the claim of any secured creditor of the company.

42 *CCAA* s 37, previously s 18.2, reads:

37 (1) Subject to subsection (2), despite any provision in federal or provincial legislation that has the effect of deeming property to be held in trust for Her Majesty, property of a debtor company shall not be regarded as being held in trust for Her Majesty unless it would be so regarded in the absence of that statutory provision.

(2) Subsection (1) does not apply in respect of amounts deemed to be held in trust under subsection 227(4) or (4.1) of the Income Tax Act, subsection 23(3) or (4) of the Canada Pension Plan or subsection 86(2) or (2.1) of the Employment Insurance Act (each of which is in this subsection referred to as a "federal provision") . . . .

43 *ITA* ss 227(4) and (4.1) read:

(4) Every person who deducts or withholds an amount under this Act is deemed, notwithstanding any security interest (as defined in subsection 224(1.3)) in the amount so deducted or withheld, to hold the amount separate and apart from the property of the person and from property held by any secured creditor (as defined in subsection 224(1.3)) of that person that but for the security interest would be property of the person, in trust for Her Majesty and for payment to Her Majesty in the manner and at the time provided under this Act.

(4.1) **Notwithstanding any other provision of this Act, the Bankruptcy and Insolvency Act (except sections 81.1 and 81.2 of that Act), any other enactment of Canada,** any enactment of a province or any other law, **where at any time an amount deemed by subsection 227(4) to be held by a person in trust for Her Majesty is not paid** to Her Majesty in the manner and at the time provided under this Act, **property of the person and property held by any secured creditor** (as defined in subsection 224(1.3)) of that person that but for a security interest (as defined in subsection 224(1.3)) would be property of the person, equal in value to the amount so deemed to be held in trust **is deemed**

(a) *to be held*, from the time the amount was deducted or withheld by the person, separate and apart from the property of the person, *in trust for Her Majesty whether or not the property is subject to such a security interest*, and

> (b) to form no part of the estate or property of the person from the time the amount was so deducted or withheld, whether or not the property has in fact been kept separate and apart from the estate or property of the person and whether or not the property is subject to such a security interest

> **and is property beneficially owned by Her Majesty** notwithstanding any security interest in such property and in the proceeds thereof, and the proceeds of such property shall be paid to the Receiver General in priority to all such security interests.

44 *EI Act* s 86(2.1) and *CPP Act* s 23(3) are identical to *ITA* s 227(4.1).

45 With that legal backdrop, I turn now to address whether I can and, if so should, entertain CRA's motion, or whether it is properly the subject of an appeal to the Court of Appeal.

Jurisdiction to Entertain CRA's Motion

46 The language of the Comeback Provision is typical in initial *CCAA* Orders made in this province and elsewhere. It reads:

> 58 Any interested party (including the Applicants and the Monitor) may apply to this Court to vary or amend this Order on not less than seven (7) days' notice to any other party or parties likely to be affected by the order sought or upon such other notice, if any, as this Court may order.

47 The answer to whether I have jurisdiction to entertain CRA's motion or whether it is properly a subject of appeal to the Court of Appeal rests on the answers to: for whom and when is the Comeback Provision is available.

Who can rely on the Comeback Provision?

48 The Comeback Provision is available to any interested party. It is only logical that an interested party that was not given notice of a *CCAA* initial hearing can rely on the comeback clause. [22] Similarly, and depending upon the circumstances, an interested party given notice may also access the comeback clause.

49 CRA is an interested party that received notice of the motion for the Initial Order. While the Initial Order deemed that service to be good and sufficient, CRA's actual knowledge came the day after it occurred.

When can the Comeback Provision be used?

50 Recourse through the comeback clause is available when circumstances change. As explained in *Pacific National Lease Holding Corp., Re*:

> [I]n supervising a proceeding under the C.C.A.A. **orders are made, and orders are varied as changing circumstances require**. Orders depend upon a careful and delicate balancing of a variety of interests and of problems. [23] [emphasis added]

51 Likewise, in *Re Royal Oak Mines Inc*, Blair J (as he then was) observed that the comeback clause is a means of sorting out issues as they arise during the course of the restructuring. [24]

52 Logically, non-disclosure of material information in an *ex parte* initial application also supports recourse via the comeback clause. [25]

53 An analogous form of statutory recourse is found in *BIA* s 187(5). A sparingly used tool, variance under this provision is a practical means of determining if an order should continue in the face of changed circumstances or fresh evidence. [26]

54 Equally, under r 9.15(1) of the Alberta *Rules of Court* the Court can set aside, vary, or discharge an entered judgment or order (interlocutory or final) if it was made without notice to an affected person, or to correct an accident or mistake if the person did not have adequate notice of the trial. In a similar vein, r 9.15(4) allows the Court to set aside, vary, or discharge an interlocutory order by agreement of the parties, or because of fresh evidence, or other grounds that the Court considers just.

55 Likely because many, if not most, *CCAA* authorities deal with variance of *ex parte* initial orders, little is written about recourse by appeal versus comeback. One example is the rather unusual case of *Re Algoma Steel Inc*,[27] where creditors filed a simultaneous comeback motion and appeal of the initial *ex parte* order. The appeal was heard first. The Court of Appeal found that the appeal was premature (because the order was a "lights on" order) and said that variance should have been pursued.

56 Comeback motions must be made *post haste* because of delay prejudice and the mounting prejudice caused by the momentum of proceeding itself - which Rowbothom JA described as the virtual impossibility of unscrambling the egg in *Temple City*.[28]

57 Next, I will discuss service and timing concerns.

Service

58 It is trite that the point of service is that a party must get notice of the proceeding and that a party serving documents on a proper address for service must be able to do so with confidence.[29]

59 As previously noted, CRA was served on June 28 at the CRA Office by courier delivery.

60 Rule 11.14(1)(b) provides that service is effected on statutory entities and other entities by "being sent by recorded mail, addressed to the entity, to the entity's principal place of business or activity in Alberta." Recorded mail includes mail by courier and the date of effective service is "on the date acknowledgement of receipt is signed": r 11.14(2)(b).

61 Rule 3.9 requires that an originating application and supporting affidavits be served at least 10 days before the return date. To comply, the Debtors had to serve by June 25, but because this date fell on a weekend, technically compliant service mandated delivery of the service package on June 23.

62 CRA points to the Office of the Superintendent of Bankruptcy's (OSB) website in defence of the position that service was lacking. In part, it reads:

> To make sure insolvency documents are processed quickly and effectively, you should send them to the appropriate area of the CRA.

The webpage also identifies "key processing areas for insolvency documents", which in this case is the office where the CRA Representative is located in Surrey, British Columbia.

63 The OSB website does not assist CRA. While companies seeking relief under the *CCAA* may retain insolvency professionals in advance of their filing, imposing an expectation that debtors heed the OSB's 'unofficial advice' is simply asking too much. More importantly, to require compliance is contrary to the Alberta *Rules of Court*.

64 Properly, CRA does not cast blame on the Debtors for the fact that its own challenges routing mail caused the delay in getting the service package into the right hands. What CRA does say is that despite this, it should have the opportunity to address its significant challenge to the Priority Charges because if the service package was delivered to the regional office responsible for *CCAA* matters by June 25, it was "very likely that CRA would have been represented at the July 5th application."

65 The Debtors effected service, albeit short notice service, on CRA, which the Court deemed to be good and sufficient. Short notice in insolvency proceedings is not a new concept and CRA is not new to insolvency proceedings. Indeed, it is a seasoned and sophisticated player in the *CCAA* arena with access to the might of the federal government's resources.

66 These observations aside, the *CCAA* is not all about technicalities and technical compliance. It is about ensuring maintenance of the *status quo* in the sorting-out period, balancing interests, and, in that vein, hearing from all affected voices whenever it is practicable to do so.

67 In the result, despite the glaring failure of CRA's mail management system and although CRA was effectively and technically served on June 28, the purpose of service was not fulfilled until July 6 when CRA became aware of the Initial Order. On this basis, I am satisfied that I have jurisdiction to hear the variance motion. In finding as I do, I am mindful that CRA is asking whether the Priority Charges ought to have been granted in the first instance, which could well be the subject of appeal. However, *Algoma Steel* supports the notion that variance may be the preferred route where a party did not have actual notice of an order made early in the proceeding.

Timing

68 While comeback relief may be appropriate, it "cannot prejudicially affect the position of the parties who have relied *bona fide* on the previous order in question." [30]

69 Armed with knowledge of the Initial Order the day after it was made and well-knowing that the beneficiaries of the Priority Charges would rely upon them, CRA waited twenty days to informally announce its intentions. Then, CRA chose to attend and take no position at the Extension and Enhanced Financing Motions. It also chose to defer advising the Court of this intended motion until after the Court delivered its decision on those motions.

70 CRA's dawdling put BDC, the Monitor, and perhaps the directors at risk of significant prejudice, and it is unfair for it to now ask that the priority be reversed before it gave meaningful notice to all affected parties.

71 The options for fixing the appropriate date of meaningful notice are the date of informal notice, the hearing date, and the release of these Reasons. In my view, the most appropriate date is the hearing of this motion because experience shows that not all informally announced motions actually proceed.

72 Accordingly, irrespective of whether CRA prevails at the end of the day, all of the Priority Charges should be unaffected until August 11, 2017.

73 I turn next to who bears the onus.

The Onus

74 The authorities disagree on who bears the onus where the party seeking to vary under a comeback clause was served. Indeed, Blair J (as he then was) observed that there may be no formal onus, but there "may well be a practical one if the relief sought goes against the established momentum of the proceeding." [31]

75 In *General Chemical Canada Ltd., Re*, [32] Farley J stated that "[I]n any comeback situation, the onus rests solely and squarely with the [initial] applicant to demonstrate why the original or initial order should stand."

76 In contrast, in *Re Target Canada Co*, Morowetz J directed a comeback hearing that was to be a "true" comeback hearing in which the applying party did "not have to overcome any onus of demonstrating that the order should be set aside or varied." [33] There, the initial order went beyond a usual "first day" order. While service was not addressed, it is evident that many, if not most, of the stakeholders were not represented at the hearing.

77 Considering the practicalities of *CCAA* matters, my view is that barring unforeseen circumstances, the onus on a variation application should be this:

• When the initial application is made *without notice* or with insufficient notice, the initial applicant bears the onus of satisfying the court that the terms of the initial order are appropriate.

• When the initial application is made *with notice*, the onus is on the party seeking the variation to show why it is appropriate and that the relief sought does not prejudice others who relied on the order in good faith.

78 I now turn to the substantive priority issue.

Who has priority?

79 It is beyond debate that *ITA* s227 (4) and the mirrored provisions in *EI Act* (s 86(2) and *CPP Act* (s 23(3)) create deemed trusts, and that *CCAA* s 37(2) explicitly preserves their operation. The debate is simply about whether CRA's interest arising from the deemed trusts can be subordinated by the Priority Charges.

80 Two principal questions arise:

i. What is the nature of CRA's interest?

ii. Does CRA's statutorily secured status elevate it above a Priority Charge?

What is the nature of CRA's interest?

81 CRA relies on the extension of trust provisions in the Fiscal Statutes to support the notion that it holds a proprietary rather than secured interest in the Debtors' property. Key to its position is the effect of the concluding phrase in s 227(4.1):

> Notwithstanding any other provision of this Act . . . property held by any secured creditor... is deemed...and is property beneficially owned by Her Majesty notwithstanding any security interest in such property and in the proceeds thereof, and the proceeds of such property shall be paid to the Receiver General in priority to all such security interests. [emphasis added]

82 CRA asserts that these words take it beyond a mere secured creditor because they do not just *deem* the Crown to be the owner of the interest, but rather, says that it *is* the owner.

83 This is the same position CRA advocated in *Temple City*, where Romaine J distilled these features of tax deemed trusts from *First Vancouver* :

• The "deemed trust" is not in "truth a real one as the subject matter of the trust cannot be identified from the date of creation of the trust;" and

• In principle, the deemed trust is similar to a floating charge over all the assets of the tax debtor in that the tax debtor is free to alienate its property, and when it does, the trust releases the disposed-of property and attaches to the proceeds of sale. To find otherwise would freeze the tax debtor's assets and prevent it from carrying on business, which was clearly not a result intended by Parliament.

84 Justice Romaine determined that despite the concluding words of s 227(4.1) these features were inconsistent with a property interest, noting that the definition of a "security interest" in the *ITA* included a "deemed or actual trust", which supports the interest being capable of having the same treatment as a security interest under the *CCAA*. [34]

85 Moir J in *Rosedale Farms* disagreed finding instead that:

• The analogy of the deemed trust to a floating charge in *First Vancouver* was not about creating security, but rather, sales made in the ordinary course of business. Iacobucci J's statement that the question of priority of secured creditors did not arise is noted. [35]

• The "notwithstanding" language of *ITA* s 227(4.1) expressly overrides the *BIA* and all other enactments thereby giving priority to the deemed trust. [36]

• Reliance on the *ITA* definition of "secured interest" is misguided. [37]

86 Moir J correctly notes Justice Iacobucci's observation that the creation of secured creditor priority did not arise in *First Vancouver* . However, as I read *Temple City*, the analysis did not rest on the floating charge analogy. Rather, like the *ITA* definition of "secured creditor," it was but one of several features supporting the result. That said the fact that a floating charge permits alienation of secured property resonates in all *CCAA* restructurings.

87 *Rosedale Farms* is distinguishable in that it concerned a *BIA* scenario. Nevertheless, even if it were otherwise, like Romaine J, I accept that the definitions of secured creditor and security interest in the *CCAA* and Fiscal Statutes support finding that the interests arising from the deemed trusts are security interests, not property interests. In particular, I note that s 224(1.3) defines a security interest as "any interest in property that secures payment . . . and includes a ... deemed or actual trust ... ."

88 Indeed, it would seem inconsistent to interpret the interest they create in a way contrary to their enabling statutes.

89 For these reasons, I conclude that CRA's interest is a security interest, not a proprietary interest. The impact and interplay of the "notwithstanding" language in *ITA* s 227(4.1), the discussion of which follows, does not change my conclusion.

Does CRA's statutorily secured status elevate it above the Priority Charges?

90 It may appear that *CCAA* ss 11.2, 11.51, or 11.52 conflict with the deemed trust sections in the Fiscal Statutes, and that a strict "black letter" reading of only ss 227(4) and (4.1) may support CRA's interpretation. However, one must not read these provisions in a vacuum. The Fiscal Statutes, the *BIA*, and the *CCAA* are part of complex legislative schemes that operate concurrently and must "be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament." [38] Each references the other, expressly or impliedly, and it would be an error to focus on only one section in one piece of the entire scheme.

91 *ITA* s 227(4.1) opens with these words:

> **Notwithstanding any other provision of this Act, the Bankruptcy and Insolvency Act (except sections 81.1 and 81.2 of that Act), any other enactment of Canada, any enactment of a province or any other law**, where at any time an amount deemed by subsection 227(4) to be held by a person in trust for Her Majesty is not paid to Her Majesty notwithstanding any security interest in such property . . . . [emphasis added] (Notwithstanding Provision)

92 CRA points to the *obiter dicta* of Fish J (in his separate concurring reasons) in *Century Services* (at para 104) finding that Parliament intended deemed trusts to prevail in insolvency proceedings as a complete answer. The other members of the Court did not adopt his reasoning. For that reason, I cannot find his *obiter dicta* to be "the answer."

93 While the *CCAA* preserves the operation of the Fiscal Statutes deemed trusts, it also authorizes the reorganization of priorities through Court ordered priming.

94 CRA urges that the Fiscal Statutes and the *CCAA* can be 'stitched together' to read:

> Notwithstanding [sections 11, 11.2, 11.51, and 11.52 of the *Companies' Creditors Arrangements Act*,] property of [the Applicants] equal in value to the [unremitted source deductions] . . . is beneficially owned by Her Majesty notwithstanding any security interest in such property [including security interests granted pursuant to ss. 11.2, 11.51, or 11.52 of the *CCAA*] and in the proceeds thereof, and the proceeds of such property shall be paid to the Receiver General in priority to all such security interests.

95 The problem with "stitching" in this way is that incorporating these sections into the Notwithstanding Provision implies that they are somehow in conflict with it. The Supreme Court of Canada has taken a restrictive view of what constitutes a conflict between statutory provisions of the same legislature.

96 In *Thibodeau v Air Canada*, [39] the Court addressed whether there was a conflict between the *Official Languages Act* and the *Convention for the Unification of Certain Rules for International Carriage by Air*, concluding that there is a conflict between two provisions of the same legislature "*only* when the existence of the conflict, in the restrictive sense of the word, *cannot be avoided by interpretation*" [40] [emphasis added]. Nothing in these *CCAA* sections directly conflict with s 227(4.1) and thus, one must attempt to interpret these provisions without conflict.

97 Further, in *ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board)*, [41] the Supreme Court of Canada, dealing with another complex legislative scheme, said:

> The provisions at issue are found in statutes which are themselves components of a larger statutory scheme **which cannot be ignored**:
>
>> As the product of a rational and logical legislature, the statute is considered to form a system. **Every component contributes to the meaning as a whole**, and the whole gives meaning to its parts: "each legal provision should be considered in relation to other provisions, as parts of a whole" . . . .
>>
>> (P. -A. Côté, *The Interpretation of Legislation in Canada* (3rd ed. 2000), at p 308)
>>
>> As in any statutory interpretation exercise . . . courts need to examine **the context that colours the words and the legislative scheme**. The ultimate goal is to discover the clear intent of the legislature and the true purpose of the statute **while preserving the harmony, coherence and consistency of the legislative sch**eme (***Bell ExpressVu***, at para. 27; see also *Interpretation Act*, R.S.A. 2000, c. I-8, s. 10 (in Appendix)). "[S]tatutory interpretation is the art of finding the legislative spirit embodied in enactments": ***Bristol-Myers Squibb Co***., at para. 102. [emphasis added]

98 Deschamps J observed in *Century Services*, at para. 15:

> . . . the purpose of the *CCAA* ... is to permit the debtor to continue to carry on business and, where possible, avoid the social and economic costs of liquidating its assets.

99 She also quoted with approval the reasons of Doherty JA in *Elan Corp v Comiskey* [42] (Doherty JA was dissenting):

> 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.

100 In a survey of *CCAA* cases, Dr. Janis Sarra found that 75% of the restructurings required the aid of interim lenders. [43]

101 In *Indalex*, the Supreme Court of Canada observed the phenomenon, citing Sarra, and said:

> . . . case after case has shown that "the priming of the DIP facility is a key aspect of the debtor's ability to attempt a workout" (J. P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (2007), at p. 97). The harsh reality is that lending is governed by the commercial imperatives of the lenders, not by the interests of the plan members or the policy considerations that lead provincial governments to legislate in favour of pension fund beneficiaries. [44]

102 The interim financiers' charge provides both an incentive and guarantee to the lender that funds advanced in the course of the restructuring will be recovered. Without this charge such financing would simply end, and with that, so too would end the hope of positive *CCAA* outcomes. Here, I digress to note the increasing prevalence of interim financiers having no prior relationship to the debtor. It does not take a stretch of imagination to forecast that this practice will diminish if not end altogether without the comfort of super-priority charges.

103 Similarly, the charge in favour of directors is important. The charge is intended to keep the captains aboard the sinking ship. Without the benefit of this charge, directors will be inclined to abandon the ship, and it would be remarkably difficult, if not impossible, to recruit replacements.

104 Likewise, the priority charge for administrative fees is critical to a successful restructuring. Indeed, it is the only protection the Monitor has to ensure that its bills are paid. While the debtor's counsel has the option of resigning if its accounts go unpaid, the Monitor does not have that luxury. As a Court officer, the Monitor's job is to see the proceeding through to completion or failure and would need Court approval to be relieved of that duty. Finally, insolvency practitioners well know that they typically do not have to look to the administrative charge for their initial work — where it has the most significance is at the end.

105 Further, the 2009 amendments codifying and elaborating on priority charges that had previously been granted under the Court's residual, inherent jurisdiction, shows Parliament's intention that secured creditors' interests could be eroded if the Court was satisfied of the need.

106 Had Parliament wanted to limit the Court's ability to give priority to these charges, it could have drafted s 11.52(2) (and the mirror provisions) to expressly provide:

> . . . priority over the claim of any secured creditor **except the claim of Her Majesty over deemed trusts under s. 227(4) and (4.1) of the Income Tax Act**.

107 CRA's interpretation recognizes the obvious, underlying policy reason favouring the collection of unremitted source deductions, which is described as being "at the heart" of income tax collection in Canada": *First Vancouver* at para 22. However, it fails to reconcile that objective with the Canadian insolvency restructuring regime and Parliament's continued commitment (as evidenced by the 2009 amendments) to facilitating complex corporate *CCAA* restructurings, even if erosion of security is required.

108 The *CCAA*'s aim is to facilitate business survival and avoid the multiple traumas occasioned by business failure. Interim financiers are an integral part of the restructuring process. Without them, most *CCAA* restructurings could not get off the ground. Likewise, directors and insolvency professionals are essential to the process, and they too need the comfort of primed charges to fully engage in the process. Surely, Parliament knew all of these things when it passed the 2009 amendments authorizing primed charges.

109 CRA's position, which it acknowledges will cause a chill on complex restructurings, undermines the *CCAA*'s purpose for the sake of tax collection. It disregards the rather obvious, that successful corporate restructurings result in continued jobs to fuel and fund its source deduction tax base. Notably, its interpretation fails to reconcile these purposes.

110 The Fiscal Statutes and the *CCAA* should, if possible, be interpreted harmoniously to ensure that Parliament's intention in the entire scheme is fulfilled.

111 It is logical to infer that Parliament intended to create a co-existing statutory scheme that accomplished the goals of both the Fiscal Statues and the *CCAA*. In my view, it is possible to construe these legislative provisions in a manner that preserves the harmony, coherence, and consistency of the entire legislative scheme.

112 I conclude that it is the Court's order that sets the priority of the charges at issue. The relevant *CCAA* sections allow the Court, where appropriate, to grant priority *only* to those charges necessary for restructuring. The purpose of the deemed trusts in the Fiscal Statutes is still met as deemed trusts maintain their priority status over *all other* security interests, but those ordered under ss 11.2, 11.51, and 11.52.

113 A harmonious interpretation respecting both sets of statutory goals is one that preserves the deemed priority status over all security interests, subject to a Court order under *CCAA* ss 11.2, 11.51, and 11.52 granting a "super priority' to those charges.

114 For these reasons, I find that the *CCAA* gives the Court the ability to rank the Priority Charges ahead of CRA's security interest arising out of the deemed trusts.

Order accordingly.

Footnotes

1 RSC 1985, c C-36 as amended, ss 11.2, 11.4, 11.51 11.52.

2 RSC, 1985, c 1 (5th Supp) 6.

3 RSC 1985, c C-8.

4 SC 1996, c 23.

5 Para 44 of the Initial Order provides that the Priority Charges constitute a charge on all of the debtors' property which, subject to s 34(11) of the *CCAA*, rank in priority to all other security interests, including trusts, liens, and encumbrances, statutory or otherwise.

6 RSC 1985, c B-3.

7 *Ted Leroy Trucking Ltd., Re*, 2010 SCC 60 (S.C.C.) at para 77, [2010] 3 S.C.R. 379 (S.C.C.).

8 *Century Services* at paras 15, 17.

9 *Indalex Ltd., Re*, 2013 SCC 6 (S.C.C.) at para 205, [2013] 1 S.C.R. 271 (S.C.C.).

10 ***Indalex*** at para 105.

11 *Hongkong Bank of Canada v. Chef Ready Foods Ltd.* (1990), [1991] 2 W.W.R. 136 (B.C. C.A.) at 140, (1990), 51 B.C.L.R. (2d) 84 (B.C. C.A.).

12 *Century Services* at paras 64-66.

13 ***Century Services*** at para 70.

14 *Century Services* at paras 65 and 70.

15 *Royal Bank v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411 (S.C.C.) .

16 *SC 1991, c 46.*

17 SA 1988, c P-4.05.

18 *First Vancouver Finance v. Minister of National Revenue*, 2002 SCC 49, [2002] 2 S.C.R. 720 (S.C.C.).

19 *Temple City Housing Inc., Re*, 2007 ABQB 786, 42 C.B.R. (5th) 274 (Alta. Q.B.), leave to appeal denied *Minister of National Revenue v. Temple City Housing Inc.*, 2008 ABCA 1, 43 C.B.R. (5th) 35 (Alta. C.A.).

20 *Rosedale Farms Limited, Hassett Holdings Inc., Resurgam Resources (Re)*, 2017 NSSC 160 (N.S. S.C.).

21 *RSC 1985, c E15.*

22 *Muscletech Research & Development Inc., Re* (2006), 19 C.B.R. (5th) 54 (Ont. S.C.J. [Commercial List]) at para 5; *Comstock Canada Ltd., Re*, 2013 ONSC 4756, 4 C.B.R. (6th) 47 (Ont. S.C.J.) at para 49; *Fairview Industries Ltd., Re* (1991), 109 N.S.R. (2d) 12, 11 C.B.R. (3d) 43 (N.S. T.D.); *CanaSea PetroGas Group Holdings Ltd., Re* (2014), 18 C.B.R. (6th) 283 (Ont. S.C.J.) at paras 13-14.

23 *Pacific National Lease Holding Corp., Re* (1992), 15 C.B.R. (3d) 265, 72 B.C.L.R. (2d) 368 (B.C. C.A. [In Chambers]) at para 30.

24 *Royal Oak Mines Inc., Re* (1999), 6 C.B.R. (4th) 314 (Ont. Gen. Div. [Commercial List]) at para 28.

25 *Re CanaSea PetroGas Group Holdings Ltd.*

26 *Elias v. Hutchison* (1980), 12 Alta. L.R. (2d) 241 (Alta. Q.B.) (at para 6), (1980), 35 C.B.R. (N.S.) 30 (Alta. Q.B.), aff'd (1981), 121 D.L.R. (3d) 95, 37 C.B.R. (N.S.) 149 (Alta. C.A.); *Christiansen v. Paramount Developments Corp.*, 1998 ABQB 1005 (Alta. Q.B.) (at para 24), (1998), 8 C.B.R. (4th) 220 (Alta. Q.B.); *Fitch v. Official Receiver* (1995), [1996] 1 W.L.R. 242 (Eng. C.A.); *Lyall, Re* (1991), 8 C.B.R. (3d) 82 (B.C. S.C.).

27 *Algoma Steel Inc., Re*, [2001] O.J. No. 1994 (Ont. S.C.J. [Commercial List]), leave to appeal refused, (2001), 147 O.A.C. 291, 25 C.B.R. (4th) 194 (Ont. C.A.).

28 At para 14.

29 *Concrete Equities Inc., Re*, 2012 ABCA 266 (Alta. C.A.) at paras 19, 24.

30 *Muscletech*, at para 5.

31 *Royal Oak*, at para 28.

32 *General Chemical Canada Ltd., Re* (2005), 7 C.B.R. (5th) 102 (Ont. S.C.J. [Commercial List]) at para 2.

33 *Target Canada Co., Re*, 2015 ONSC 303, 22 C.B.R. (6th) 323 (Ont. S.C.J.) at para 82.

34 *Temple City*, at para 13.

35 *Rosedale Farms*, at para 39.

36 *Ibid*, para 35.

37 *Ibid*, para 29.

38 *Rizzo & Rizzo Shoes Ltd., Re*, [1998] 1 S.C.R. 27 (S.C.C.) at para 21.

39 *Thibodeau c. Air Canada*, 2014 SCC 67, [2014] 3 S.C.R. 340 (S.C.C.).

40 *Thibodeau* at para 92.

41 *ATCO Gas & Pipelines Ltd. v. Alberta (Energy & Utilities Board)*, 2006 SCC 4, [2006] 1 S.C.R. 140 (S.C.C.).

42 *Nova Metal Products Inc. v. Comiskey (Trustee of)* (1990), 41 O.A.C. 282 (Ont. C.A.) at para 57.

43 Janis P Sarra, *Rescue!: Companies' Creditors Arrangement Act*, 2nd ed (Toronto: Carswell, 2013) at 199.

44 ***Indalex*** at para 59.

3.

Brief (docket entry # 5), Appellee's Brief (docket entry # 6) and Appellants' Reply thereto, and for the reasons articulated in the accompanying Memorandum, it is hereby ORDERED that:

1. The November 1, 2013 Order of the Bankruptcy Court is AFFIRMED; and

2. The Clerk of Court shall CLOSE this case statistically.

In re H & M OIL & GAS, LLC, Debtor.

Douglas J. Brickley, Chapter 11 Trustee, Plaintiff,

v.

Scattered Corporation and Leon A. Greenblatt, III, Defendants.

Bankruptcy No. 12–32785–BJH.
Adversary No. 13–3066–BJH.

United States Bankruptcy Court,
N.D. Texas,
Dallas Division.

Signed July 21, 2014.

Background: Trustee brought adversary proceeding against debtor oil and gas limited liability company's (LLC) postpetition lender for breach of court-approved debtor-in-possession (DIP) financing agreement and against debtor company's postpetition manager for, among other things, breach of fiduciary duty for his actions in relation to the DIP agreement. Manager counterclaimed against the estate for indemnification.

Holdings: Following trial, the Bankruptcy Court, Barbara J. Houser, J., held that:

(1) lender's failure to fund disputed requests pursuant to DIP agreement did not constitute breach of contract;

(2) even if lender's failure to fund disputed requests pursuant to DIP agreement was breach of agreement, there were no damages as required to support breach of contract claim;

(3) manager did not breach fiduciary duties he owed to debtor;

(4) even if manager breached fiduciary duties, prepetition secured lender's actions were an intervening and superseding cause of debtor company's alleged injuries;

(5) manager was entitled to award of $42,000 as an administrative priority claim against estate for wage claim; and

(6) manager was entitled to indemnification for his attorney fees and costs incurred in defending adversary proceeding.

Ordered accordingly.

1. Bankruptcy ⚷2043(1)

Bankruptcy court's "arising under" jurisdiction involves causes of action created or determined by a statutory provision of title 11. 28 U.S.C.A. § 1334(b).

2. Bankruptcy ⚷2043(1)

Bankruptcy court's "arising in" jurisdiction is not based on a right expressly created by title 11, but is based on claims that have no existence outside of bankruptcy. 28 U.S.C.A. § 1334(b).

3. Bankruptcy ⚷2043(3)

Bankruptcy Court's "related to" jurisdiction exists if the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy. 28 U.S.C.A. § 1334(b).

4. Bankruptcy ⇨2043(3)

That state law may affect a proceeding's resolution cannot be the sole basis by which a proceeding is excluded from the otherwise large net cast by bankruptcy court's "related to" jurisdiction. 28 U.S.C.A. §§ 157(b)(3), 1334(b).

5. Bankruptcy ⇨2048.2, 2048.4

Trustee's claims in adversary proceeding against debtor limited liability company's (LLC) postpetition lender for breach of court-approved debtor-in-possession (DIP) financing agreement and against debtor company's postpetition manager for, among other things, breach of fiduciary duty for his actions in relation to the DIP agreement, and manager's counterclaim against the estate for indemnification were "core" and therefore bankruptcy court had statutory authority to finally adjudicate the claims and counterclaim; the claims arose in and were inextricably linked to the court-approved DIP agreement, which was an integral part of debtor's bankruptcy case. 28 U.S.C.A. § 157(b)(1).

6. Bankruptcy ⇨2048.1, 2048.4, 2052

Bankruptcy court had constitutional authority to enter a final judgment on trustee's claims in adversary proceeding against debtor limited liability company's (LLC) postpetition manager for, among other things, breach of fiduciary duty for his actions in relation to court-approved debtor-in-possession (DIP) financing agreement, and manager's counterclaim against the estate for indemnification; the claims centered around manager's actions allegedly taken, or not taken, in his postpetition role as debtor's manager and would necessarily be resolved in the claims allowance process or stem from the bankruptcy itself. U.S.C.A. Const. Art. 3, § 1 et seq.; 28 U.S.C.A. § 157(b)(2)(C).

7. Contracts ⇨326

To prevail on a claim for breach of contract under Texas law, the plaintiff must establish the following elements: (1) the existence of a valid contract; (2) performance or tendered performance by the plaintiff; (3) breach of the contract by the defendant; and (4) damages sustained by the plaintiff as a result of the breach.

8. Bankruptcy ⇨3035.1

Failure of debtor limited liability company's (LLC) postpetition lender to fund disputed requests pursuant to court-approved debtor-in-possession (DIP) financing agreement did not constitute breach of contract under Texas law, where the disputed DIP requests were not made in compliance with the DIP agreement and, at the time the disputed DIP requests were made, debtor was in default under the terms of the DIP agreement thus excusing lender from funding.

9. Principal and Agent ⇨22(1), 123(6)

Under Texas law, agency or the scope of authority cannot be proven by the statements of the purported agent alone.

10. Bankruptcy ⇨3035.1, 3038

Even if failure of debtor oil and gas limited liability company's (LLC) postpetition lender to fund disputed requests pursuant to court-approved debtor-in-possession (DIP) financing agreement for funding debtor's drilling program was a breach of the DIP agreement, there were no resulting actual or consequential damages as required to support trustee's breach of contract claim against lender under Texas law; debtor did not obtain replacement financing and thus did not incur increased costs of lending, and the record was devoid of objective facts, figures, or data from which the amount of alleged lost profits could be ascertained.

11. Damages ⚷22, 23

In a breach of contract action under Texas law, damages may be broken into one of two categories: (1) actual (direct) damages, or (2) consequential damages.

12. Damages ⚷16

Under Texas law, direct damages are the necessary and usual result of the defendant's wrongful act; they flow naturally and necessarily from the wrong.

13. Damages ⚷23

Under Texas law, consequential damages are damages that occur naturally, but do not necessarily stem from the breach.

14. Damages ⚷23

Under Texas law, consequential damages are not recoverable unless the damages were foreseeable.

15. Damages ⚷23

In order to recover consequential damages in breach of contract action under Texas law, the damages must have been foreseeable by the parties, directly traced to the breach, and result from the breach.

16. Damages ⚷125

Under Texas law, the basic common law measure of damage for breach of a loan agreement is the difference between the contractual rate of interest and the rate of interest that the borrower is required to pay to obtain the money from another source; however, special or consequential damages reasonably within the contemplation of the parties at the time of the agreement may also be recovered.

17. Damages ⚷23

Under Texas law, to be liable for the consequential damages resulting from a breach of a loan commitment, the lender must have known, at the time the commitment was made, the nature of the borrower's intended use of the loan proceeds but need not know the details of the intended venture.

18. Fraud ⚷7

Under Texas law, the elements of a breach of fiduciary duty claim are: (1) a fiduciary relationship between the plaintiff and defendant; (2) the defendant must have breached his fiduciary duty to the plaintiff; and (3) the defendant's breach must result in injury to the plaintiff or benefit to the defendant.

19. Bankruptcy ⚷3622

Debtor limited liability company's (LLC) postpetition manager owed fiduciary duties to debtor under Texas law, including the duties of care and loyalty.

20. Corporations and Business Organizations ⚷1850

Under Texas law, the duty of care requires officers and directors to manage the company's affairs with diligence and prudence; due care is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances.

21. Corporations and Business Organizations ⚷1850

In general, officer's duty of care under Texas law will be satisfied if the officer's actions comport with the standard of the business judgment rule.

22. Corporations and Business Organizations ⚷1842

Texas business judgment rule provides that the negligence of directors, no matter how unwise or imprudent, does not constitute a breach of duty if the acts were within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved.

23. Corporations and Business Organizations ⚷1842

Texas courts do not apply the business judgment rule in cases where the challenged corporate decision lacks a business purpose, is tainted by a conflict of interest, is so egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision.

24. Corporations and Business Organizations ⚷1845

Under Texas law, the duty of loyalty dictates that a corporate officer or director must act in good faith and must not allow his or her personal interest to prevail over the interest of the corporation.

25. Corporations and Business Organizations ⚷1843, 1868

Under Texas law, while the duty of loyalty is generally directed towards a fiduciary's motivations in making a business decision, the duty of care concerns the care taken in the process by which that decision was reached; "interested" transactions are subject to a higher level of scrutiny.

26. Corporations and Business Organizations ⚷1845

Under Texas law, the duty of loyalty holds officers and directors to an extreme measure of candor, unselfishness and good faith, particularly where there is an interested transaction.

27. Corporations and Business Organizations ⚷1911

Under Texas law, whether an officer or director is "interested" in a business transaction, for purposes of breach of fiduciary duty claim, is a question of fact.

28. Corporations and Business Organizations ⚷1874

Under Texas law, "interested transactions," for purposes of breach of fiduciary duty claim, include those in which officers or directors derive personal profit as well as those which deprive the corporation of an opportunity to profit.

29. Corporations and Business Organizations ⚷1885

Under Texas law, a transaction between a fiduciary's corporation and another corporation in which the fiduciary has a significant financial interest is an interested transaction; in such a situation, an officer or director must not allow his personal interests to prevail over the interests of the corporations.

30. Bankruptcy ⚷3622

Failure of debtor oil and gas limited liability company's (LLC) postpetition manager to timely pay authority for expenditures issued by debtor's subcontractor related to drilling costs, with no resulting harm, did not constitute breach of fiduciary duty under Texas law.

31. Bankruptcy ⚷3622

Decision of debtor oil and gas limited liability company's (LLC) postpetition manager to not request funds under court-approved debtor-in-possession (DIP) financing agreement to prepay completion costs in accordance with authority for expenditures issued by subcontractor relating to drilling costs, based upon manager's interpretation of joint operating agreement with other oil and gas company, did not constitute breach of fiduciary duty under Texas law; manager's decision was the result of his informed business judgment.

32. Bankruptcy ⚷3622

Failure of debtor oil and gas limited liability company's (LLC) postpetition manager to take further action against debtor company for its alleged breach of court-approved debtor-in-possession (DIP) financing agreement did not constitute breach of fiduciary duty under Texas law; manager began to take action on behalf of debtor company to address its alleged breach of the DIP agreement, however, trustee's appointment divested manager of authority to take any further action on behalf of debtor company.

33. Bankruptcy ⚷3622

Even if debtor oil and gas limited liability company's (LLC) postpetition manager breached the fiduciary duties he owed to debtor company under Texas law by failing to pay authority for expenditures issued by debtor company's subcontractor related to drilling costs, prepetition secured lender's refusal to consent to a proposed settlement that would have resolved debtor company's dispute with subcontractor, prior to trustee's appointment, was an intervening and superseding cause of debtor company's alleged injuries; lender's refusal to consent to the settlement was not foreseeable, the consequences resulting from lender's actions were unexpected and extraordinary, and lender's actions altered the natural sequence of events to produce results that would not otherwise have occurred.

34. Bankruptcy ⚷2871, 2873

In order to qualify as an "actual and necessary cost," administrative expense claims against the estate must have arisen postpetition and as a result of actions taken by the trustee that benefited the estate. 11 U.S.C.A. § 503(b)(1)(A).

35. Bankruptcy ⚷2871

Terms "actual" and "necessary" of administrative expense provisions of the Bankruptcy Code are to be construed narrowly. 11 U.S.C.A. § 503(b)(1)(A).

36. Bankruptcy ⚷2926

Burden is on creditor asserting administrative expense claim to prove that its claim is for actual, necessary cost and expense of preserving estate. 11 U.S.C.A. § 503(b).

37. Bankruptcy ⚷2875

Debtor limited liability company's (LLC) postpetition manager was entitled to award of $42,000 as an administrative priority claim against debtor's estate for wage claim arising from transaction with debtor as a debtor-in-possession, where manager had received a prepetition salary of $6,000 per month and continued to serve as debtor's manager on a postpetition basis but was not paid a salary, he spent significantly more time managing debtor postpetition than he did prepetition, $6,000 per month for the services of the sole manager of the company was reasonable under the circumstances of the case, and manager's services were necessary for debtor to continue to operate on a postpetition basis. 11 U.S.C.A. § 503(b).

38. Bankruptcy ⚷2967.5

Under three-prong test for equitable subordination: (1) the claimant must have engaged in inequitable conduct, (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code; further, a claim should be subordinated only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct. 11 U.S.C.A. § 510(c).

39. Bankruptcy ⚷3622

Corporations and Business Organizations ⚷3646

Debtor limited liability company's (LLC) postpetition manager was entitled to indemnification under limited liability company regulations of debtor company for his attorney fees and costs incurred in defending adversary proceeding brought by trustee asserting breach of fiduciary duty for manager's actions in relation to court-approved debtor-in-possession (DIP) financing agreement; regulations provided that debtor company would indemnify manager if he acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of company, and following trial on trustee's breach of fiduciary duty claim, court had found that manager acted within the scope of his fiduciary duties and his actions fell within the scope of the business judgment rule.

40. Bankruptcy ⚷3035.1, 3622

Debtor limited liability company's (LLC) postpetition manager was entitled to indemnification under court-approved debtor-in-possession (DIP) financing agreement for his attorney fees and costs incurred in defending adversary proceeding brought by trustee asserting breach of fiduciary duty for manager's actions in relation to the DIP financing agreement; in his capacity as debtor company's manager, the manager qualified as an indemnitee under the terms of the DIP agreement, the indemnification provision of DIP agreement covered the activities that were the subject of trustee's complaint, and debtor, acting through manager, had actual knowledge of the indemnification provision set forth in the DIP agreement and thus the provision was enforceable under Texas law.

41. Contracts ⚷33

Indemnity ⚷27, 30(1)

Under Texas law, a contract which fails to satisfy the fair notice requirements when they are imposed is unenforceable as a matter of law.

42. Indemnity ⚷27, 30(1)

Under Texas law governing indemnity contracts, one fair notice requirement, the express negligence doctrine, requires that the intent of the parties must be specifically stated in the four corners of the contract, and the other requirement, of conspicuousness, mandates that something must appear on the face of the contract to attract the attention of a reasonable person when he looks at it; language may satisfy the conspicuousness requirement by appearing in larger type, contrasting colors, or otherwise calling attention to itself.

43. Indemnity ⚷27, 30(1)

Under Texas law, if both contracting parties have actual knowledge of inconspicuous indemnification provision, an agreement can be enforced even if the fair notice requirements were not satisfied.

44. Indemnity ⚷27

Under Texas law governing contracts, an indemnity clause must satisfy the standard of conspicuousness in the Texas Business and Commerce Code. V.T.C.A., Bus. & C. § 1.201(10).

45. Bankruptcy ⚷2825, 3622

Indemnification claim of debtor limited liability company's (LLC) postpetition manager for his attorney fees and costs incurred in defending adversary proceeding brought by trustee asserting breach of fiduciary duty for manager's actions in relation to court-approved debtor-in-possession (DIP) financing agreement would be allowed as a general unsecured claim; manager did not allege that the claim was entitled to priority.

Brian A. Kilmer, Brian D. Roman, Chamberlain, Hrdlicka, White, et al., Houston, TX, for Plaintiff.

Gregory James Jordan, Jordan Kowal and Apostol, LLC, Chicago, IL, Kenneth C. Johnston, Michael L. Scanlon, Kane, Russell, Coleman & Logan PC, Nathan M. Nichols, Rosa R. Orenstein, Orenstein Law Group, P.C., Dallas, TX, Carol Lynn Wolfram, Law Office of Carol Lynn Wolfram, Denton, TX, for Defendants.

MEMORANDUM OPINION

BARBARA J. HOUSER, Bankruptcy Judge.

The Court held a trial in this adversary proceeding on June 9–11, 2014. At the conclusion of the trial, the Court directed briefing on several issues raised at trial. The last of the post-trial briefs was submitted on June 17, 2014, following which the Court took the matter under advisement. This Memorandum Opinion contains the Court's findings of fact and conclusions of law pursuant to Federal Rules of Bankruptcy Procedure 7052 and 9014.

I. JURISDICTION, VENUE, AND STATUTORY AND CONSTITUTIONAL AUTHORITY[1]

In his Original Complaint [Dkt. No. 1] (the "**Complaint**"), Douglas Brickley, Chapter 7 trustee (the "**Trustee**") of the bankruptcy estate of H & M Oil & Gas, LLC ("**H & M**"), alleged various claims and causes of action against H & M's former Manager, Leon Greenblatt, III ("**Greenblatt**") and H & M's postpetition lender, Scattered Corporation ("**Scattered**"), including: (Count 1) breach of the Court-approved debtor-in-possession financing agreement (the "**DIP Agreement**") [Gr. Ex. H.1] against Scattered;[2] (Count 2) negligence and gross negligence against Scattered; (Count 3) alter ego/control theory against Scattered; (Count 4) breach of fiduciary duty against Greenblatt; (Count 5) equitable subordination of claims against Scattered and Greenblatt; (Count 6) objection to the administrative claim filed by Greenblatt; (Count 7) alter ego against Greenblatt; (Count 8) fraudulent conveyances under 11 U.S.C. § 548 against Scattered and Greenblatt; (Count 9) fraudulent conveyance under 11 U.S.C. § 544 and Texas law against Scattered and Greenblatt; (Count 10) recovery of avoided transfers under 11 U.S.C. § 550 against Scattered and Greenblatt; (Count 11) disallowance of claims under 11 U.S.C. § 502(d) against Scattered and Greenblatt; and (Count 12) recovery of attorneys' fees against Scattered. In his Second Amended Answer to Original Complaint and Counterclaim [Dkt. No. 63] (the "**Answer and Counterclaim**"), Greenblatt alleged a counterclaim against the H & M estate for indemnification under the DIP Agreement and H & M's Amended Regulations of Limited Liability Company (the "**LLC Regulations**") [Sc. Ex. B]. Scattered has alleged no counterclaims against the estate.

The majority of these claims were resolved prior to trial through either orders on dispositive motions or by voluntary

1. Although no party has challenged this Court's constitutional authority to enter a final judgment in this adversary proceeding, the Court will nonetheless independently analyze its statutory and constitutional authority. To the extent that the District Court disagrees with the parties' and this Court's conclusions that this Court has both statutory and constitutional authority to enter a final judgment, this Memorandum Opinion should be considered proposed findings of fact and conclusions of law.

2. The order approving the DIP Agreement was entered on July 9, 2012. Order (1) Authorizing Debtors to Incur Postpetition Secured Indebtedness; and (2) Granting Security Interests Pursuant to 11 U.S.C. § 364 (the "**DIP Order**") [Gr. Ex. I. 1]. Citations to "Gr. Ex." refers to exhibits entered into evidence by Greenblatt, "Tr. Ex." refers to exhibits entered into evidence by the Trustee, and "Sc. Ex." refers to exhibits entered into evidence by Scattered.

withdrawal by the Trustee.[3] As such, the only counts tried by the Court were: (1) as against Scattered, (Count 1) breach of the DIP Agreement and (Count 12) attorneys' fees;[4] (2) as against Greenblatt, (Count 4) breach of fiduciary duty, (Count 5) equitable subordination, and (Count 6) objection to administrative claim; and (3) as against the estate, Greenblatt's counterclaim for indemnification.

A. Subject Matter Jurisdiction and Venue

The U.S. District Court for the Northern District of Texas has subject matter jurisdiction over this adversary proceeding under 28 U.S.C. § 1334. Although bankruptcy courts do not have independent subject matter jurisdiction over bankruptcy cases and proceedings, 28 U.S.C. § 151 grants bankruptcy courts the power to exercise certain "authority conferred" upon the district courts by title 28. Under 28 U.S.C. § 157, the district courts may refer bankruptcy cases and proceedings to the bankruptcy courts for either entry of a final judgment (core proceedings) or proposed findings and conclusions (noncore, related-to proceedings). So, as relevant here, this Court exercises jurisdiction over the debtor's underlying Chapter 7 bankruptcy case and this adversary proceeding pursuant to the Order of Reference of Bankruptcy Cases and Proceedings Nunc Pro Tunc adopted in this district on August 3, 1984 (the "**Standing Order of Reference**"). Venue is proper here under 28 U.S.C. § 1409.

B. Statutory Authority

[1, 2] Section 1334(b) lists three types of proceedings over which the district court has jurisdiction—those "arising under title 11," those "arising in" a case under title 11, and those "related to" a case under title 11. 28 U.S.C. § 1334(b). The classification of a proceeding under § 1334 depends on the connection of the proceeding to the bankruptcy case. "Arising under" jurisdiction involves "causes of action created or determined by a statutory provision of title 11." *Faulkner v. Eagle View Capital Mgt. (In re The Heritage Org., L.L.C.),* 454 B.R. 353, 360 (Bankr. N.D.Tex.2011) (citing *Wood v. Wood (In re Wood),* 825 F.2d 90, 96 (5th Cir.1987)). "Arising in" jurisdiction is "not based on a right expressly created by title 11, but is based on claims that have no existence

3. *See* Agreed Order on Defendant Scattered Corporation's Motion for Judgment on the Pleadings and Plaintiff's (I) Motion to Strike Defendant Scattered Corporation's Motion for Judgment on the Pleadings, (II) Subject to Plaintiff's Motion to Strike, Plaintiff's Response to Defendant Scattered Corporation's Motion for Judgment on the Pleadings and, in the Alternative, (III) Plaintiff's Motion for Leave to File First Amended Original Complaint [Dkt. No. 20] (dismissing Counts 2 and 8–11 as against Scattered); Order Granting Defendant Scattered Corporation's Motion for Partial Summary Judgment [Dkt. No. 116] (granting summary judgment on Counts 3 and 5 as against Scattered); and Order Granting in Part and Denying in Part Leon A. Greenblatt, III's Motion for Partial Summary Judgment [Dkt. No. 161] (noting the Trustee's withdrawal of Counts 8 and 9 as against Greenblatt, which mooted Counts 10 and 11 as against Greenblatt, granting summary judgment on Counts 7 and 12 as against Greenblatt, and granting partial summary judgment on Count 4 of the Complaint as it relates to the Trustee's allegations for punitive damages as against Greenblatt and allegations that Greenblatt received any personal benefit from his alleged breaches of fiduciary duty).

4. As discussed in § II.A.1, *infra,* the Court finds that the Trustee failed to carry his burden on Count 1 (breach of the DIP Agreement). This Memorandum Opinion does not address Count 12, the related count for attorneys' fees, since the Trustee's claim for attorneys' fees depended upon the Trustee prevailing on Count 1.

outside of bankruptcy." *Faulkner,* 454 B.R. at 360 (citing *Wood,* 825 F.2d at 97). "Arising under" and "arising in" proceedings are "core" proceedings. 28 U.S.C. § 157(b)(1); *Stern v. Marshall,* — U.S. ——, 131 S.Ct. 2594, 2605, 180 L.Ed.2d 475 (2011); *U.S. Brass Corp. v. Travelers Ins. Grp., Inc. (In re U.S. Brass Corp.),* 301 F.3d 296, 304 (5th Cir.2002).

[3, 4] In comparison, "related to" jurisdiction exists if "the outcome of that proceeding could conceivably have any effect on the estate being administered in bankruptcy." *Celotex Corp. v. Edwards,* 514 U.S. 300, 308 n. 6, 115 S.Ct. 1493, 131 L.Ed.2d 403 (1995) (quoting *Pacor, Inc. v. Higgins,* 743 F.2d 984, 994 (3d Cir.1984)); *U.S. Brass,* 301 F.3d at 304. "That state law may affect a proceeding's resolution cannot be the sole basis by which a proceeding is excluded from the otherwise large net cast by 'related to' jurisdiction." *Hartley v. Wells Fargo Bank, N.A. (In re Talsma),* 509 B.R. 535, 542 (Bankr. N.D.Tex.2014) (citing 28 U.S.C. § 157(b)(3)). Proceedings that involve merely "related to" jurisdiction and do not otherwise arise under the Bankruptcy Code or arise in a bankruptcy case are "non-core." *Faulkner,* 454 B.R. at 360.

A bankruptcy judge's authority in cases and proceedings differs depending on whether the subject matter is "core" or "non-core." 28 U.S.C. § 157(b)–(c). A bankruptcy court may hear and determine (*i.e.,* enter a final order in) all cases filed under title 11 and all proceedings within a bankruptcy court's "core" authority. *Id.* § 157(b)(1). Section 157(b)(2) provides a nonexclusive list of such core proceedings. *Id.* § 157(b)(2). In non-core proceedings, the statute limits the bankruptcy court to issuing proposed findings of fact and conclusions of law to the district court, *id.* § 157(c)(1), unless the parties consent to the bankruptcy court's issuance of a final judgment, *id.* § 157(c)(2).

[5] With this framework in mind, the Court now returns to the claims and counterclaim at issue in this adversary proceeding. First, the Court concludes that the claims by and among the Trustee and Greenblatt are each core. Specifically, the Trustee's objection to the administrative claim filed by Greenblatt (Count 6) is core under 28 U.S.C. § 157(b)(2)(B), and his request for equitable subordination of such claim (Count 5) is a matter arising under 11 U.S.C. § 510(c). Similarly, the Trustee's allegations regarding Greenblatt's actions (or inactions) as H & M's postpetition Manager, as well as Greenblatt's related claim for indemnification, are core because they arise in and are inextricably linked to the Court-approved DIP Agreement, which was an integral part of H & M's Chapter 11 bankruptcy case. As such, the Court has statutory authority to hear and finally determine Counts 4–6 of the Complaint, as well as Greenblatt's counterclaim for indemnification against the estate.

Second, Count 1 of the Complaint, alleging that Scattered breached the Court-approved DIP Agreement, is core under 28 U.S.C. § 157(b)(2)(O). Further, this claim arises under the Bankruptcy Code and the statutory framework governing a debtor-in-possession's ability to obtain postpetition financing. Alternatively, the claim arises in a case under title 11 because, although breach of contract claims exist outside of bankruptcy, a breach of the DIP Agreement would not exist independent of H & M's bankruptcy case and this Court's entry of the DIP Order.

The Court's analysis of its authority, however, does not end here. Now that the Court has determined that it has statutory authority to finally adjudicate the claims and counterclaim, it must determine whether it also has constitutional authority.

C. Constitutional Authority

In *Stern v. Marshall,* ––– U.S. ––––, 131 S.Ct. 2594, 180 L.Ed.2d 475 (2011), the U.S. Supreme Court held that, notwithstanding the bankruptcy court's statutory authority under 28 U.S.C. § 157(b)(2)(C) to adjudicate an estate's counterclaim against a creditor, the bankruptcy court lacked constitutional authority to enter a final judgment on the state-law counterclaim because such claim would "not [be] resolved in the process of ruling on a creditor's proof of claim." *Id.* at 2620; *see also BP RE, L.P. v. RML Waxahachie Dodge, L.L.C.,* 735 F.3d 279, 286 (5th Cir. 2013) ("Thus, 'Congress may not bypass Article III simply because a proceeding may have *some* bearing on a bankruptcy case; the question is whether the action at issue stems from the bankruptcy itself or would necessarily be resolved in the claims allowance process.' ") (citing *Stern,* 131 S.Ct. at 2618); *Frazin v. Haynes & Boone, LLP (In re Frazin),* 732 F.3d 313, 317–20 (5th Cir.2013) (concluding that two of three counterclaims would necessarily be resolved in the bankruptcy court's award of attorneys' fees and were therefore within the bankruptcy court's constitutional authority under *Stern*).

[6] Here, the Trustee's claims against Greenblatt, as well as Greenblatt's counterclaim for indemnification, each center around Greenblatt's actions allegedly taken (or not taken) in his postpetition role as H & M's Manager. Greenblatt's actions as postpetition Manager of H & M are also the subject of the $42,000 administrative claim Greenblatt filed against the H & M estate. *See* Administrative Priority Expense Proof of Claim [Gr. Ex. X.1] at ¶¶ 2, 4 (the "**Greenblatt Wage Claim**") ("The Debtor owed me monies for wages, which accrued during the pendency of the above-captioned bankruptcy case at a rate of Six Thousand Dollars ($6,000) per month.... The wages owing to me arise as a result of services that I provided to the Debtor in my role as the Debtor's Manager."). Thus, this Court concludes that it has the constitutional authority to enter a final judgment on the Trustee's claims against Greenblatt (Counts 4–6), as well as Greenblatt's counterclaim for indemnification, as these claims would "necessarily be resolved in the claims allowance process" or "stem[ ] from the bankruptcy itself." *BP RE,* 735 F.3d at 286 (citing *Stern,* 131 S.Ct. at 2618)); *The Cadle Co. v. Moore (In re Moore),* 739 F.3d 724, 728 (5th Cir.2014).

The Trustee's claims against Scattered (although based on state law) relate to the conduct of the parties under the DIP Agreement during the pendency of H & M's Chapter 11 bankruptcy case. If not for the bankruptcy and this Court's entry of the DIP Order, the Trustee's claim for Scattered's alleged breach of the DIP Agreement would not exist. Therefore, the Court concludes that it has constitutional authority to enter a final judgment on Count 1 of the Complaint (breach of the DIP Agreement) because the claim "stems from the bankruptcy itself," *Stern,* 131 S.Ct. at 2618, and "relate[s] entirely to matters integral to the bankruptcy case." *See Miller v. Greenwich Capital Fin. Prods., Inc. (In re Am. Bus. Fin. Servs., Inc.),* 471 B.R. 354, 362 (Bankr.D.Del.2012) (finding constitutional authority to enter a final order on, among other claims, breach by a lender of a debtor-in-possession financing agreement).

II. LEGAL ANALYSIS

As noted previously, the claims and counterclaim remaining for trial were: (1) as against Scattered, Count 1 (breach of the DIP Agreement) and Count 12 (attorneys' fees); (2) as against Greenblatt, Count 4 (breach of fiduciary duty), Count 5 (equitable subordination), and Count 6 (objection to administrative claim); and (3) as against the estate, Greenblatt's counterclaim for indemnification under the LLC Regulations and the DIP Agreement. As detailed below, the Court finds and concludes that the Trustee has failed to carry his burden of proof on all counts and shall take nothing by his Complaint. Greenblatt is entitled to a judgment on his counterclaim for indemnification under the DIP Agreement in the amount of $420,145 in attorneys' fees and $28,831.40 in related expenses, plus the following amounts should the Trustee appeal the judgment to be entered in accordance with this Memorandum Opinion: (1) $30,000 for post-trial motions before this Court, (2) $35,000 for an appeal to the district court, (3) $25,000 for an appeal to the Fifth Circuit, (4) $25,000 for an application for writ of certiorari to the U.S. Supreme Court, and (5) $15,000 if that writ is granted, which will be allowed as an administrative expense claim against H & M's Chapter 11 estate. Alternatively, if this Court erred in allowing Greenblatt's indemnification claim under the DIP Agreement, Greenblatt is entitled to a judgment in the same amounts on his counterclaim for indemnification under the LLC Regulations, which will be allowed as a general unsecured claim.

A. Count 1: Breach of the DIP Agreement (Brickley v. Scattered)

[7] "To prevail on a claim for breach of contract, the plaintiff must establish the following elements: (1) the existence of a valid contract; (2) performance or tendered performance by the plaintiff; (3) breach of the contract by the defendant; and (4) damages sustained by the plaintiff as a result of the breach." *S. Elec. Servs., Inc. v. City of Houston,* 355 S.W.3d 319, 323–24 (Tex.App.–Houston [1st Dist.] 2011, pet. denied).

Here, the parties do not dispute that the DIP Agreement was an existing and valid contract, so the Court will focus its analysis on the remaining elements. For the reasons set forth below, the Court finds that the Trustee failed to carry his burden of proof and, as such, his breach of contract claim against Scattered fails.

1. Scattered's Failure to Fund the Disputed DIP Requests Was Not a Breach of the DIP Agreement.

[8] The Trustee alleges that H & M performed all of its obligation under the DIP Agreement, including being in compliance with all material terms of the agreement and making proper borrowing requests. According to the Trustee, Scattered then breached the DIP Agreement by failing to fund two borrowing requests: (1) a request in the amount of $925,000 made on October 4, 2012 (Gr. Ex. V.2), and (2) a request in the amount of $350,000 made on October 18, 2012 (Gr. Ex. V.3) (together, the "**Disputed DIP Requests**"). Scattered counters by arguing that the Disputed DIP Requests were not made in compliance with the DIP Agreement and, in any event, H & M was in default under the DIP Agreement when the Disputed DIP Requests were made, thus excusing Scattered from its obligation to fund. As discussed below, the Court agrees with Scattered on both points.

a) The Disputed DIP Requests Were Not Made in Compliance with the DIP Agreement.

As explained in more detail below, the Court finds that neither of the Disputed DIP Requests was made in compliance with the DIP Agreement. Specifically, § 2.2 of the DIP Agreement states that:

> H & M may request an Advance hereunder by giving the Lender a borrowing request no later than 2:00 p.m. (prevailing Central Time), one Business Day before the date of the proposed Advance. Each Borrowing Request shall specify the following information:
>
> (a) the principal amount of the requested Advance; and
>
> (b) the proposed date for making of such Advance, which shall be a Business Day.

DIP Agreement [Gr. Ex. H.1] at § 2.2. Thus, to be proper, a draw request must (1) be made by H & M, (2) state the principal amount of the requested advance, and (3) state the proposed funding date.[5] In light of these requirements, the Court will address the Disputed DIP Requests in reverse chronological order.

The $350,000 Disputed DIP Request was submitted by David Jones ("**Jones**"),[6] purportedly on H & M's behalf. The request states the principal amount of the requested advance ($350,000), but does not give the proposed funding date. DIP Draw Request [Gr. Ex. V.3] at 002294. Because the $350,000 Disputed DIP Request does not contain the information expressly required by § 2.2(b) of the DIP Agreement, Scattered was not required to fund the request pursuant to the plain language of the DIP Agreement and its failure to fund was not a breach of that agreement.

The $925,000 Disputed DIP Request was also submitted by Jones, but with the signature block of "H & M Resources, LLC," not H & M. DIP Draw Request [Gr. Ex. V.2] at 001833. Although this request does give the principal amount of the requested advance ($925,000) and the proposed funding date (October 5, 2012), it was not submitted by H & M and, thus, does not comply with the express requirements of § 2.2 of the DIP Agreement. Because Jones was in charge of drilling operations for H & M Resources, which is H & M's wholly-owned subsidiary, the Court recognizes the technicality of this finding. However, the DIP Agreement clearly dictates what is required to make a proper funding request, including that a request may only be made by H & M, which did not occur here. Thus, Scattered was not required to fund the request pursuant to the plain language of the DIP Agreement and its failure to fund was not a breach of that agreement.

Moreover, even if Jones's use of H & M Resources' signature block was an oversight, there is also a dispute regarding whether Jones had authority to request advances under the DIP Agreement on H & M's behalf, to which the Court will now turn. To determine whether Jones had authority to request funds under the DIP Agreement on H & M's behalf, the Court will first consider the LLC Regulations. Section 8.01 of the LLC Regulations states that "the Manager (hereinafter designat-

5. The Court notes that the first and second draw requests under the DIP Agreement (Gr. Exs. Q.2 and S.2, respectively) also do not appear to comply with the terms of § 2.2 of the DIP Agreement. However, § 8.3 of the DIP Agreement contains an anti-waiver clause, which states that "[n]o failure or delay by Lender in exercising any right or power hereunder shall operate as a waiver thereof, nor shall any single or partial exercise of any such right or power, or any abandonment or discontinuance of steps to enforce such a right or power, preclude any other or further exercise thereof or the exercise of any other right or power."

6. Greenblatt hired Jones to run H & M's oil and gas operations. Although it is unclear in the record whether Jones was employed by H & M or H & M's non-debtor subsidiary H & M Resources, LLC ("**H & M Resources**"), or both, it is undisputed that Jones was not a manager of H & M. JPTO [Dkt. No. 144] at 12, ¶ 35.

ed) [Greenblatt] shall have the sole and exclusive right to manage the business of the Company [H & M], including, without limitation, the right and power to: . . . (c) execute any and all agreements . . . and instruments necessary or convenient in connection with the management, maintenance and operation of Company property; (d) borrow money. . . ." LLC Regulations [Sc. Ex. B] at § 8.01(d). Section 8.05, in turn, permits the Manager to employ "such agents, attorneys and employees as he deems appropriate" and to "delegate or assign to such agents, attorneys and employees such duties and responsibilities . . . described in Section 8.01 or otherwise, as the Manager may deem appropriate or necessary." *Id.* at § 8.05. Under the LLC Regulations, it is clear that Greenblatt, as Manager, had sole authority to make draw requests under the DIP Agreement on H & M's behalf, unless he delegated his authority to Jones. As discussed below, there is insufficient evidence in the record to find such a delegation occurred.

The issue surrounding Jones's authority to request funds under the DIP Agreement appears to arise from the fact that Greenblatt concurrently served as both H & M's Manager and an officer of Scattered. As such, at trial, the parties propounded their respective positions regarding whether "official" draw requests went directly from Jones to Greenblatt, as an officer of Scattered, or from Jones to Greenblatt, as H & M's Manager, who then determined when/if to forward the request to Scattered. If the former, the Trustee has a better argument that the $925,000 Disputed Draw Request was valid.

At trial, Greenblatt testified that, as H & M's Manager, he was the only party with authority to request funds under the DIP Agreement and that he did not delegate that authority to Jones, nor would he delegate the authority to borrow money on behalf of H & M to any employee or agent. According to Greenblatt, Jones would send requests for advances under the DIP Agreement to him, in his capacity as H & M's Manager, and he would then determine whether to forward the requests to Scattered.

The Trustee's counsel, however, argued that Jones had authority to request funds under the DIP Agreement and would send requests to Greenblatt in his capacity as an officer of Scattered. Indeed, the Trustee somewhat impeached Greenblatt's testimony on this point with prior deposition testimony in which Greenblatt stated that Jones was authorized to make funding requests to Scattered under the DIP Agreement. Scattered, however, rehabilitated Greenblatt's testimony by reference to multiple other instances within the same deposition where Greenblatt stated his belief that Jones was forwarding the requests to him in his capacity as H & M's Manager, not as Scattered's officer.

Jones's own testimony regarding his actions did nothing to clarify the issue. While on the witness stand, Jones testified that he believed that he had authority to request funds directly from Scattered on H & M's behalf because Greenblatt never told him that he could not. Jones, however, could not recall any conversion with Greenblatt in which Greenblatt expressly authorized him to request funds on H & M's behalf. Further, when questioned regarding his belief as to Greenblatt's capacity in receiving the Disputed DIP Requests, Jones testified that he gave no consideration to which capacity Greenblatt served when he sent emails requesting funds under the DIP Agreement. And, although Jones cc'ed Scattered's counsel on the Disputed DIP Requests, Jones further testified that he cc'ed attorneys on the emails without considering whether the attorneys represented H & M or Scattered. By the conclusion of trial, the evidence amounted to Greenblatt, on the one hand, stating that he did not delegate authority to request funds under the DIP Agreement to Jones, and Jones, on the other hand, stating his belief that he had authority because Greenblatt never told him otherwise.

[9] Jones's personal belief in his authority, without more, is insufficient to prove he had authority to request funds directly from Scattered under the DIP Agreement. Indeed, under Texas law, agency or the scope of authority cannot be proven by the statements of the purported agent alone. *Valley Ranch Dev. Co., Ltd. v. F.D.I.C.,* 960 F.2d 550, 553 (5th Cir. 1992) (citing *Claus v. Gyorkey,* 674 F.2d 427, 434 n. 7 (5th Cir.1982)). As such, Jones could not create authority via his personal beliefs; instead, the operative acts are those attributable to Greenblatt. And, as both Jones and Greenblatt testified, Greenblatt did not expressly confer on Jones the authority to request funds under the DIP Agreement. Moreover, Greenblatt did more than just blindly forward Jones's funding requests to Scattered. In fact, the record shows that the second request for funds under the DIP Agreement initiated by Jones and sent to Greenblatt was for $500,000. DIP Request Email [Gr. Ex. R.2] at 001835. As Greenblatt testified, however, he reduced the request to $400,000 to reflect the correct amount, as discussed between Jones and Greenblatt, prior to forwarding the request to Scattered, who ultimately funded the $400,000.

After carefully considering the evidence, the Court finds that Jones did not have authority to request funds under the DIP Agreement on H & M's behalf. As such, the Disputed DIP Requests did not comply with the terms of § 2.2 of the DIP Agreement, and Scattered was not obligated to fund.

b) At the Time the Disputed DIP Requests Were Made, H & M Was in Default Under the Terms of the DIP Agreement, Thus Excusing Scattered from Funding.

The Court finds that, even if the Disputed DIP Requests were made in accordance with the DIP Agreement, an "Event of Default" had occurred under the DIP Agreement, thus excusing Scattered from funding the requests, as the Court will now explain. Article VII of the DIP Agreement defines what constitutes an "Event of Default" under the agreement. Particularly, § 7.1 states:

> 7.1 If any of the following events ("Events of Default") shall occur:
>
> (m) the bringing of a motion, **taking of any action** or the filing of any plan of reorganization or liquidation or disclosure statement attendant thereto **by one or both of the Debtors** in its chapter 11 case or the Chapter 11 Cases: (1) to obtain additional financing under § 364(c) or (d) of the Bankruptcy Code not otherwise permitted pursuant to this Agreement; (ii) to grant any Lien on the Collateral; (iii) to use cash collateral under § 363(c) of the Bankruptcy Code without the prior written consent of the Lender; or (iv) **any other action or actions adverse to the Lender or its rights and remedies hereunder or its interest in the Collateral.**

DIP Agreement [Gr. Ex. H.1] at § 7.1(m) (emphasis added).

Scattered relies upon § 7.1(m)(iv) to argue that H & M's called default under the Second Interim Agreed Order Granting (I) Debtor's Motion for Order Authorizing Use of Cash Collateral, (II) Granting Adequate Protection to the Prepetition Secured Lender, (III) Scheduling a Subsequent Hearing and (IV) Granting Related Relief (the "**Second Interim Cash Collateral Order**") [Gr. Ex. K.1], which resulted in H & M's inability to use cash collateral, resulted in a corresponding event of default under the DIP Agreement. Additional background is needed to place this argument into context.

Under the Second Interim Cash Collateral Order, upon an event of default, H & M's right to use cash collateral would terminate automatically three business days after receiving a notice of default from its prepetition secured lender, Prospect Capital Corporation ("**Prospect**"). Joint Pretrial Order [Dkt. No. 144] (the "**JPTO**") at 12, ¶ 33; Second Interim Cash Collateral Order [Gr. Ex. K.1] at ¶ 11(b). On October 5, 2012, Prospect sent an email to H & M informing it that Prospect considered an election made by Hibernia Resources, LLC ("**Hibernia Resources**") [7] to treat H & M as a non-consenting party on well DF 319 A # 5 a default under the Second Interim Cash Collateral Order. JPTO [Dkt. No. 144] at 12, ¶ 38. Prospect followed this email with a formal notice of default dated October 9, 2012. Prospect Default Letter [Gr. Ex. L.3] at 1 ("[H & M's] failure to pay [Hibernia Resources] pursuant to that certain AFE ... dated October 4, 2012, constitutes an event of default under paragraph 11 of the [Second Interim] Cash Collateral Order."). Thus, H & M's authority to use cash collateral automatically terminated on October 12, 2012.[8]

Under § 4.2 of the DIP Agreement, a condition precedent to each advance was that "at the time of and immediately after giving effect to such Advance, no Default or Event of Default shall have occurred and be continuing...." DIP Agreement [Gr. Ex. H.1] at § 4.2(d). Scattered argues that H & M's called default under the Second Interim Cash Collateral Order triggered §§ 7.2(m)(iv) and 4.2 of the DIP Agreement and, thus, Scattered's obligation to fund the Disputed DIP Requests never arose.

In response, the Trustee argues that § 7.2(m)(iv) of the DIP Agreement was not triggered because it specifically requires "the bringing of a motion, taking of any action or the filing of any plan of reorganization or liquidation or disclosure statement attendant thereto," none of which occurred here. Further, according to the Trustee, H & M's called default under the Second Interim Cash Collateral Order, and corresponding alleged default under the DIP Agreement, arose not from an action but from inaction, *i.e.*, H & M's failure to pay Hibernia Resources for completion costs.

Under the plain language of the DIP Agreement, to trigger a default under § 7.1(m)(iv) H & M must have taken an "action" and such action must have been "adverse" to Scattered or its rights and remedies under the DIP Agreement or its interest in its collateral. The Court will address these two requirements in turn.

First, Greenblatt, on H & M's behalf and as its Manager, interpreted the payment terms of the Joint Operating Agreement (the "**JOA**") [9] and consciously decid-

7. Hibernia Resources acted as operator under a Joint Operating Agreement to which H & M was a party.

8. The Court notes that Prospect sent an email to H & M on September 6, 2012 [Gr. Ex. M.2] advising H & M of a default under the Second Interim Cash Collateral Order; however, the record shows H & M continued to use Prospect's cash collateral without objection.

9. The Court entered an order on September 10, 2012 granting H & M's request to assume the JOA. *See* Order Granting First Amended Motion to Assume Executory Contract Pursuant to 11 U.S.C. § 365(d)(2) [Gr. Ex. L.1].

ed not to prepay Hibernia Resources for the completion costs, thus triggering Prospect's decision to call a default under the Second Interim Cash Collateral Order that lead to Scattered declaring a default under the DIP Agreement. The Court finds that Greenblatt's acts, as H & M's Manager, constitute "actions" under the terms of § 7.1(m).

Second, H & M's actions in this regard were adverse to Scattered. As stated in the DIP Order:

> H & M, having advised the Court that it intends to undertake a drilling program to increase the value of its bankruptcy estate, does not have sufficient available sources of working capital or cash to operate its business without the proposed DIP Financing from [Scattered]. Similarly, Anglo–American,[10] which is a holding company and owner of H & M, does not have sufficient available sources of working capital or cash to provide to H & M to allow H & M to operate its business without the proposed DIP Financing from [Scattered]. The ability of the Debtors to immediately obtain sufficient working capital and liquidity through the DIP Financing is vital to the preservation and maximization of the value of the Debtors' assets and properties, and in particular, to the Debtors' ability to successfully implement any plan of reorganization. Given the need to undertake drilling to maintain lease rights, absent the granting of relief as requested herein, the Debtors and their estates will suffer immediate and irreparable harm.

DIP Order [Gr. Ex. I.1] at ¶ F. Further, as reflected in H & M's budget associated with the DIP Order, H & M's predominant sources of cash were Prospect's cash collateral, which was the subject of the Second Interim Cash Collateral Order, and advances under the DIP Agreement. *See* H & M Oil & Gas, LLC Operating Budget [Tr. Ex. 7] (the "**DIP Budget**"). Indeed, during the six-month period of the DIP Budget, H & M anticipated an aggregate of $16,300,874 in "Total Available Cash," with draws under the DIP Agreement representing only $4,950,000 of this amount.

As such, (1) without access to cash collateral, H & M had insufficient funds to pay its day-to-day operating expenses and continue its drilling programs; (2) use of cash collateral and advances under the DIP Agreement were intertwined and both were necessary to keep H & M afloat and permit it to continue its drilling operations, including maintaining its interests in the wells and the underlying property that served as Scattered's collateral; and (3) H & M's conscious decision to not pay Authority for Expenditures ("**AFEs**") issued by Hibernia Resources for completion costs was an action adverse to Scattered and its interests in its collateral[11] that

This order modified the terms of the JOA so that Greenblatt Exhibits A.1 (JOA) and B.1 (Ratification and Amendment of Operating Agreement), combined, represent a complete copy of the JOA, as assumed.

10. "Anglo America" refers to Anglo–American Petroleum Corp., H & M's sole member. LLC Regulations [Sc. Ex. B] at 1.

11. Although the Court later finds that (1) H & M's decision to not pay the AFEs was proper under the JOA, and (2) Hibernia Resources did not have a right to issue the Notice(s) of Non–Consent under the JOA, *see* § II.B.2.b), *infra*, H & M's action was nevertheless adverse to Scattered due to the fact that Prospect decided to call a default under the Second Interim Cash Collateral Order and H & M lost the right to use Prospect's cash collateral. Prospect called the default based upon Hibernia Resources issuing the Notice(s) of Non–Consent, which was caused by H & M deciding not to pay AFEs requesting prepayment of completion costs. *See* Gr. Exs. L.3 (Prospect Default Letter) and T.2 (Notice of Non–Consent).

triggered a default under § 7.1(m)(iv) of the DIP Agreement and relieved Scattered of its obligation to fund the Disputed DIP Requests.

2. Even if Scattered's Failure to Fund the Disputed DIP Requests was a Breach of the DIP Agreement, the Trustee Failed to Prove Any Resulting Actual or Consequential Damages.

[10] Even though the Court finds that Scattered did not breach the DIP Agreement, it will nonetheless analyze the Trustee's alleged damages. In this regard, Scattered argues that (1) the Trustee failed to prove any actual or consequential damages arising from the alleged breach, and (2) H & M waived its ability to seek consequential damages under § 8.4(c) of DIP Agreement. The Court will address these arguments in turn.

The Court finds Scattered's initial argument regarding damages persuasive. Even if this Court were to find that Scattered's failure to fund the Disputed DIP Requests was a breach of the DIP Agreement, the Trustee failed to prove any resulting damages.[12] Without proof of damages, the Trustee's claim for breach of contract fails. *See, e.g., S. Elec. Servs., Inc.,* 355 S.W.3d at 323–24 (Tex.App.–Houston [1st Dist.] 2011, pet. denied) (listing damages as an element of a breach of contract claim).

[11–15] In a breach of contract action, damages may be broken into one of two categories: actual (direct) damages or consequential damages. The Texas Supreme Court has held that "[i]n an action for breach of contract, actual damages may be recovered when the loss is the natural, probable, and foreseeable consequence of the defendant's conduct." *Mead v. Johnson Group, Inc.,* 615 S.W.2d 685, 687 (Tex. 1981). "Direct damages are the necessary and usual result of the defendant's wrongful act; they flow naturally and necessarily from the wrong." *Arthur Andersen & Co. v. Perry Equip. Corp.,* 945 S.W.2d 812, 816 (Tex.1997). On the other hand, consequential damages are damages that occur naturally, but do not necessarily stem from the breach. *Id.; RAJ Partners, Ltd. v. Darco Const. Corp.,* 217 S.W.3d 638, 647 (Tex.App.–Amarillo 2006, no pet.). Moreover, consequential damages are not recoverable unless the damages were foreseeable. *Arthur Andersen,* 945 S.W.2d at 816; *Mead,* 615 S.W.2d at 687. Accordingly, in order to recover consequential damages, the damages must have been foreseeable by the parties, directly traced to the breach, and result from the breach. *See Mead,* 615 S.W.2d at 687.

[16, 17] More specifically, "the basic common law measure of damage for breach of a loan agreement is the difference between the contractual rate of interest and the rate of interest that the borrower is required to pay to obtain the money from another source; however, special or consequential damages reasonably within the contemplation of the parties at the time of the agreement may also be recovered." *Tex. Commerce Bank Reagan v. Lebco Constr., Inc.,* 865 S.W.2d 68, 74 n. 2 (Tex.App.–Corpus Christi 1993, writ denied), *overruled on other grounds, John & Higgins of Tex., Inc. v. Kenneco Energy, Inc.,* 962 S.W.2d 507 (Tex.1998) (citations

12. Prior to trial, and after a full evidentiary hearing, the Court issued its Memorandum Opinion and Order [Dkt. No. 162] in which it granted the Defendants' respective motions to exclude the expert testimony of John Bittner, the Trustee's only proposed expert on damages arising from Scattered's alleged breach of contract, on the ground that that the Trustee failed to meet his burden to prove that the testimony and report were reliable under the standards of Federal Rules of Evidence 702 and 703.

omitted); *see also Basic Capital Mgmt. Inc. v. Dynex Commercial Inc.,* 402 S.W.3d 257, 264–65 (Tex.App.–Dallas 2013, pet. denied) (analyzing direct and consequential damages in a failure-to-lend context). "To be liable for the consequential damages resulting from a breach of a loan commitment, the lender must have known, at the time the commitment was made, the nature of the borrower's intended use of the loan proceeds but [need] not [know] the details of the intended venture." *Basic Capital Mgmt., Inc. v. Dynex Commercial, Inc.,* 348 S.W.3d 894, 903 (Tex.2011).

Here, however, the Trustee argues that, due to the unique nature of this transaction, the general rules governing damages in failure-to-lend cases should not govern because: (1) the contract at issue is not a standard loan agreement, but rather is a debtor-in-possession loan agreement that was approved by this Court and is an integral part of H & M's bankruptcy proceeding; (2) the terms of the loan—*i.e.,* a second lien position—cannot be replicated in the marketplace, so there is no "replacement" loan against which to measure direct damages; (3) H & M is an oil and gas company and, as such, calculating consequential damages is not as straight forward as it would be in other industries; and (4) there is "significant" evidence of lost value. Plaintiff Douglas J. Brickley's Post–Trial Brief [Dkt. No. 172] ("**Trustee's Post–Trial Brief**") at ¶ 3. The "significant" evidence of lost value, as alleged by the Trustee, is generally comprised of the following: (1) as Scattered was aware, H & M intended to use the funds advanced to it under the DIP Agreement to assist it in undertaking a program to drill three additional wells; (2) it is undisputed that H & M would not seek to drill additional wells, nor would Scattered provide financing for additional wells, unless each believed that the wells would increase the value of the estate; (3) the average cost for H & M to drill a well was approximately $2 million per well, so the total cost of the drilling program would be approximately $6 million; and (4) "[w]ithout question, this Court can infer that it was more likely than not that if the Debtor had drilled three wells, it was highly unlikely that all three wells would have been unsuccessful;" thus, according to the Trustee, the Court may determine some loss to the estate from the presumed success of the drilling program "which value could at least be defined as $6.0M, plus some integral amount." *Id.* at ¶ 3.

From the Court's perspective, the Trustee has alleged multiple, alternative measures of damages [13] arising from Scattered's alleged breach of the DIP Agreement, including that H & M suffered damages: (1) of $7.2 million, representing the outstanding availability under the DIP Agreement when the alleged breach occurred, or at least $925,000, representing the amount of the first Disputed DIP Request; (2) in an amount that equates to lost profits, *i.e.,* an amount that the Court believes represents loss to the estate based on the presumed success of the drilling program; (3) the incurrence of $335,526.91 in attorneys' fees and expenses related to (i) H & M's dispute with Hibernia over prepayment of well completion costs, (ii) the litigation surrounding the appointment of the Trustee, and (iii) the costs of the Trustee and his professionals in H & M's Chapter 11 case; [14] (4) $100,000 related to the Trus-

13. In his pretrial brief, the Trustee also requests $14.2 million for "loss of value" damages. These damages were the subject of an expert report authored by John Bittner, which was excluded from trial. *See* Memorandum Opinion [Dkt. No. 162]. As such, this measure of damage will not be addressed by the Court in this Memorandum Opinion.

14. H & M's case was converted from one under Chapter 11 to one under Chapter 7 of tee's settlement payment to Hibernia regarding the prepayment of well completion costs; and (5) damages associated with H & M's inability to complete the drilling program and reorganize for the benefit of creditors. *See* Trustee's Pre–Trial Brief at ¶ 13; Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 9.[15] As explained below, however, the Trustee has failed to carry his burden of proof as to each alleged measure of damages.

As an initial matter, it is undisputed that, once Scattered's alleged breach of the DIP Agreement occurred, H & M did not obtain an alternative loan. Although the Court appreciates the unique nature of Scattered's agreement to lend on a fully subordinated basis to Prospect's first lien position, and the arguable unavailability of a loan on substantially similar terms from a third party,[16] H & M's failure to obtain replacement financing leaves this Court with no evidence upon which it could award actual damages in the form of increased costs of lending. Moreover, the Trustee cites to no authority for his argument that the general rules governing the award of damages in a failure to lend case, like this one, should not apply. Nor could the Court find any authority to support the Trustee's argument. As such, the Court's analysis will focus on the availability of special or consequential damages in the form of (1) lost profits, (2) outstanding availability under the DIP Agreement, and (3) fees and expenses arising in the underlying bankruptcy case.

With respect to the proper measure for calculating lost profits, the Supreme Court of Texas has explained that:

> [r]ecovery for lost profits does not require that the loss be susceptible of exact calculation. *White v. Southwestern Bell Tel. Co.,* 651 S.W.2d 260, 262 (Tex. 1983); *Southwest Battery Corp. v. Owen,* 131 Tex. 423, 115 S.W.2d 1097, 1098 (1938). However, the injured party must do more than show that they suffered some lost profits. The amount of the loss must be shown by competent evidence with reasonable certainty. *White,* 651 S.W.2d at 262; *Southwest Battery,* 115 S.W.2d at 1098. What constitutes reasonably certain evidence of lost profits is a fact intensive determination. **At a minimum, opinions or estimates of lost profits must be based on objective facts, figures, or data from which the amount of lost profits can be ascertained.**

Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex.1992) (emphasis added) (citations omitted); *see also Basic Mgmt., Inc.,* 402 S.W.3d at 267–68 (applying the standard for lost profits propounded in *Holt Atherton* in the context of an alleged breach-of-loan-commitment claim).

Here, notably missing from the evidentiary record is any factual basis upon which this Court may calculate the "integral amount" that the Trustee alleges represents lost profits related to the anticipated drilling program. Indeed, when pressed by the Court during closing argument at trial, the Trustee's counsel could not quantify this amount or provide the Court with figures it could use to quantify this amount. Without some form of objective, non-speculative evidence (such as credible evidence regarding the probability

the Bankruptcy Code on June 5, 2013. JPTO at 11, ¶ 4.

15. The Court could find no evidence in the record supporting the Trustee's last alleged measure of alleged damages. As such, it will not be addressed further in this Memorandum Opinion.

16. There is no evidence in the record that the Trustee ever attempted to obtain alternative funding.

of a successful drilling program in the relevant fields, historical profits generated per well in the relevant fields, etc.), there is nothing in the record upon which this Court could base its calculation. *See, e.g., Burkhart Grob Luft Und Raumfahrt GmbH & Co. KG v. E–Systems, Inc.,* 257 F.3d 461, 467 (5th Cir.2001) ("A plaintiff's failure to show either the existence or amount of lost profits will necessarily prevent their recovery."); *Tex. Instruments, Inc. v. Teletron Energy Mgmt., Inc.,* 877 S.W.2d 276, 280 (Tex.1994) (holding there was no evidence to prove lost profits with reasonable certainty because there was no history of profits and, even though there was evidence of a market, the viability of the product was in doubt because it was a new product that had not yet been created); *Ramco Oil & Gas Ltd. v. Anglo–Dutch (Tenge) L.L.C.,* 207 S.W.3d 801, 824 (Tex.App.–Houston [14th Dist.] 2006, pet. denied) ("The fervent hope of Brickhill and Schaefer for Plaintiffs' success in obtaining financing, buying the Kazakhtenge interests, and producing and marketing oil and gas from the Tenge Field under Schaefer's production plan is not enough to warrant recovery of lost profits."). *See also Miga v. Jensen,* 96 S.W.3d 207, 216–17 (Tex. 2002) (stating that contract damages should not put plaintiff in a better position than if the contract had been honored by giving the plaintiff a risk-free investment); *Reardon v. LightPath Techs., Inc.,* 183 S.W.3d 429, 442 (Tex.App.–Houston [14th Dist.] 2005, pet. denied) (holding that plaintiffs' requested fraud damages were speculative and would provide them with the windfall of a riskless investment in a high-risk field). In short, the record is simply devoid of the required "objective facts, figures, or data from which the amount of lost profits may be ascertained." *Holt Atherton,* 835 S.W.2d at 84.

Further, the Court was not able to find, nor has the Trustee cited to, any case law holding that damages for failure to fund under a loan agreement are properly measured by outstanding availability. Instead, in his post-trial brief, the Trustee argues that the unfunded amounts represent benefit-of-the-bargain damages; [17] however, part of the "bargain" was that H & M would be obligated to repay the amounts borrowed. Indeed, each advance was accompanied by a corresponding liability on H & M's books, resulting in a neutral effect on H & M's net value. The fact that Scattered's lien position was subordinate to Prospect's does not somehow alleviate H & M's obligation to repay the funded amounts. As stated by Scattered in its post-trial brief, "$7.2 million is not a damage; it is a cost that the Plaintiff has avoided by not having to perform. As such, it must be subtracted from the Plaintiff's gross receipts or profits." Scattered Corporation's Trial Brief in Opposition to the Plaintiff's Claim that he is Entitled to Recover Costs or Lost Profits Damages [Dkt. No. 167] at 5 (citing *Qaddura v. Indo–European Foods, Inc.,* 141 S.W.3d 882, 889 (Tex.App.–Dallas 2004, no pet.) ("The benefit of the bargain is measured by the prevailing party's anticipated receipts and losses caused by the breach less any cost or other loss he has avoided by not having to perform."); *Lafarge Corp. v. Wolff, Inc.,* 977 S.W.2d 181, 187 (Tex.App.–Austin 1998, writ denied) ("A party's expectation interest is measured by his anticipated receipts and losses caused by the breach less any cost or other loss he has avoided by not having to perform.)). From the Court's perspective, availability under the DIP Agreement is not a proper measure of damages.

Finally, the Court finds that the estate's incurrence of attorneys' fees and expenses

17. Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 4.

allegedly arising from Scattered's failure to fund are not a proper measure of consequential damages either. "To be liable for the consequential damages resulting from a breach of a loan commitment, the lender must have known, at the time the commitment was made, the nature of the borrower's intended use of the loan proceeds but not the details of the intended venture." *Basic Capital Mgmt., Inc.,* 348 S.W.3d at 903. Further, consequential damages are not recoverable unless they were foreseeable. *Arthur Andersen & Co.,* 945 S.W.2d at 816; *Mead,* 615 S.W.2d at 687.

For example, in *Stuart v. Bayless,* 964 S.W.2d 920, 921 (Tex.1998), the Texas Supreme Court overturned an award of consequential damages, finding that the damages were not foreseeable. *Id.* There, a law firm sued a former client for non-payment, and argued that, as a result of her nonpayment, the firm was unable to finance cases that it would have taken on contingency. *Id.* The law firm was successful at trial, and the jury awarded the law firm $500,000 for the lost contingency fees that it could have earned. However, the Texas Supreme Court found that such a loss was not foreseeable. *Id.* ("[I]t would be a rare case in which an attorney or law firm could demonstrate that the failure of a client to pay its bills gave rise to a recovery of contingent fees that might have been earned from other clients."). Similarly, in *Petco Animal Supplies, Inc. v. Schuster,* 144 S.W.3d 554, 566 (Tex.App.–Austin 2004, no pet.), an action brought by a pet owner to recover damages allegedly incurred when the pet escaped from its groomer and was killed in traffic, the court found that the plaintiff could not recover lost wages as consequential damages because the "[l]ost wages [while searching for the pet] ... ha[d] too attenuated a connection to [the defendant's] conduct under her breach of contract theory."

Here, it is undisputed that Scattered was aware that H & M would use amounts drawn under the DIP Agreement to fund its drilling program. DIP Order [Gr. Ex. I.1] at ¶ F ("H & M, having advised the Court that it intends to undertake a drilling program to increase the value of tis bankruptcy estate....") and p. 12 (reflecting the signature of Scattered's counsel on the DIP Order). The Trustee's requested damages, however, go far beyond those attributable to a potential drilling program and cannot be found to have been foreseeable.

The Trustee's "domino effect" argument on this point may be summarized as follows: (1) Scattered's failure to fund under the DIP Agreement led to non-payment of AFEs; (2) nonpayment of AFEs led to Hibernia Resources issuing notices deeming H & M a non-consenting party with respect to two wells (each a "**Notice of Non–Consent**"); (3) issuance of the Notices of Non–Consent led to Prospect declaring a breach under the Second Interim Cash Collateral Order and termination of H & M's right to use cash collateral; (4) termination of H & M's right to use cash collateral and the issuances of the Notices of Non–Consent played a role in the appointment of a Trustee; and (5) the estate then incurred substantial attorneys' fees and other expenses related to the appointment of a trustee and the resulting settlement with Hibernia.[18] The Court finds that the consequential damages allegedly suffered by H & M are far too remote and attenuated to be a foreseeable consequence of Scattered's alleged failure to fund and, as such, cannot serve as a proper measure of consequential damages.

18. *See* § II.B.2.b), *infra,* for additional background regarding the circumstances surrounding the issuance of the AFEs and the Notices of Non–Consent.

Further, in addition to being too remote, the Court finds that it would be improper to charge Scattered for attorneys' fees and costs that do not appear to have arisen from Scattered's alleged actions, but instead from the prepetition relationship between H & M and Prospect. Indeed, the acrimonious relationship between H & M and Prospect became evident to the Court[19] when Prospect filed its first motion to appoint a trustee only two days into H & M's bankruptcy case, well before H & M entered into the DIP Agreement or Scattered's alleged failure to fund under it. Although Prospect's first motion to appoint a trustee was denied, its second request was granted. The Court notes, however, that the primary reason that the Trustee was appointed was because, after the Court denied its first motion to appoint a trustee, Prospect purchased all outstanding general unsecured claims against the H & M estate at par. At the hearing on Prospect's second motion to appoint a trustee, Prospect made it abundantly clear to the Court that it would not consent to a plan proposed by H & M while under Greenblatt's management. Thus, although the second motion to appoint a trustee was based on substantially the same grounds as those alleged against Greenblatt in the Complaint, the Court specifically found that it did not need to address those allegations at the hearing on Prospect's second trustee motion in light of Prospect's purchase of the remainder of the prepetition debt owed by H & M. Trial Tr., Nov. 14, 2012, at 215:15–216:15 (Bankr.Case No. 12–32785 at Dkt. No. 175). In fact, because H & M, as debtor-in-possession, could not confirm a plan of reorganization now that Prospect owned all prepetition claims against it and would not support a Greenblatt-led plan, H & M acquiesced to the Trustee's appointment. *Id.*

Clearly, Prospect's desire to oust Greenblatt as H & M's Manager through the appointment of a trustee arose prior to, and independent of, Scattered's actions as alleged in the Complaint. Thus, there is simply no causal connection between Scattered's actions, as alleged in the Complaint, and H & M's incurrence of attorneys' fees and costs associated with the Trustee's appointment.

Another contributing factor to the fees and costs associated with the Trustee's appointment was H & M's inability to use cash collateral, which occurred after Prospect declared a default under the Second Interim Cash Collateral Order. The alleged default was based on Hibernia Resources issuing a Notice of Non–Consent to H & M due to its failure to prepay completion costs under the JOA. As discussed in § II.B.2.b), *infra,* however, the JOA did not permit Hibernia Resources to issue the Notice of Non–Consent for failure to prepay completion costs. As such, Prospect declared a breach under the Second Interim Cash Collateral Order based on Hibernia Resources' improper issuance of the Notice of Non–Consent.

For all of these reasons, and based on the record before it, the Court finds that it would be improper to award damages against Scattered for the fees and expenses associated with the litigation surrounding the Trustee's appointment.

The Trustee also seeks to recover from Scattered the $100,000 H & M paid to the Hibernia entities as part of the Court-approved settlement. *See* § II.B.3, *infra* for a discussion of the settlement agree-

19. The Court will take judicial notice of its dockets in the main case and this adversary proceeding. *Sec. & Exch. Comm'n v. First Fin. Group of Tex.,* 645 F.2d 429, 433 n. 6 (5th Cir.1981) (noting that "a court may take judicial notice of its own records"); *In re Wells,* 426 B.R. 579, 587 n. 2 (Bankr.N.D.Tex.2006).

ment. The record shows, however, that the settlement that the Trustee negotiated with the Hibernia entities was virtually identical to the settlement negotiated between H & M and the Hibernia entities while Greenblatt acted as H & M's Manager and prior to the Trustee's appointment. *See id.* The only material difference in the two settlements was that the Trustee-negotiated settlement required a $100,000 payment to the Hibernia entities, while the Greenblatt-led settlement did not. Prospect refused to consent to Greenblatt's more favorable settlement, but consented to the Trustee's less favorable one, which required the expenditure of $100,000 of its cash collateral. In short, Scattered should not be charged with foreseeing Prospect's refusal to make a rational business decision with respect to the estate's settlement with the Hibernia entities.

Finally, the Trustee seeks to charge Scattered for certain fees and costs incurred in administering H & M's bankruptcy case. What the Trustee's argument fails to recognize, however, is that H & M's estate would need to be administered, and the related costs and expenses of professionals incurred, regardless of Scattered's alleged actions and the Trustee's appointment. There is simply nothing in the record indicating that such costs could have been avoided had Scattered funded the Disputed DIP Requests. Because such costs would have existed regardless of Scattered's actions, the Court finds that it would be improper to award damages against Scattered for the costs of administering H & M's bankruptcy case.

The Court will now turn to Scattered's second argument, which it raised for the first time in its post-trial brief,[20] that H & M waived its right to seek consequential damages pursuant to § 8.4(c) of the DIP Agreement, which states

> Waiver of Consequential Damages, Etc. To the extent permitted by applicable law, the Debtors, or either of them, shall not assert and hereby waives any claim against any Indemnitee on any theory of liability, for special, indirect, consequential or punitive damages (as opposed to direct or actual damages) arising out of, in connection with, or as a result of this Agreement or any agreement or instrument contemplated hereby and thereby, the Transactions, any Advance or the use of the proceeds thereof.

DIP Agreement [Gr. Ex. H.1] at § 8.4(c). For the reasons explained below, this Court concludes that Scattered waived this defense by not pleading it or otherwise raising it prior to trial.

Under Federal Rule of Civil Procedure 8(c), as made applicable to this adversary proceeding by Federal Rule of Bankruptcy Procedure 7008, waiver is an affirmative defense that is subject to forfeiture and waiver if not properly and timely raised. FED.R.CIV.P. 8(c).

> Generally, under Rule 8(c)[,] affirmative defenses must be raised in the first responsive pleading. However, where the matter is raised in the trial court in a manner that does not result in unfair surprise ... technical failure to comply precisely with Rule 8(c) is not fatal. An affirmative defense is not waived if the defendant raised the issue at a pragmatically sufficient time, and [the plaintiff] was not prejudiced in its ability to respond.

Kariuki v. Tarango, 709 F.3d 495, 508 (5th Cir.2013) (citing *Pasco ex rel. Pasco v. Knoblauch,* 566 F.3d 572, 577 (5th Cir. 2009)) (internal quotations omitted).

Based on the record before it, the Court finds and concludes that Scattered waived

20. Scattered's Post–Trial Brief [Dkt. No. 171] at 6, 10, 13.

the affirmative defense of waiver by addressing it for the first time in its post-trial brief. Due to this timing, Scattered failed to raise the defense at a pragmatically sufficient time, and to allow Scattered to raise the affirmative defense post-trial would result in prejudice to the Trustee.

B. Count 4: Breach of Fiduciary Duty (Brickley v. Greenblatt)

[18] To prevail and recover damages on his breach of fiduciary duty claim, the Trustee must show that: (1) Greenblatt had a fiduciary relationship with H & M, (2) Greenblatt breached his fiduciary duties to H & M, and (3) Greenblatt's breach resulted in injury to H & M or benefit to Greenblatt.[21] *See Navigant Consulting, Inc. v. Wilkinson,* 508 F.3d 277, 283 (5th Cir.2007); *In re ReoStar Energy Corp.,* No. 12–CV–046–A, 2012 WL 3184726, at *5 (N.D.Tex. Aug. 3, 2012). Intentional breach of fiduciary duty is a tort for which the Trustee may recover exemplary damages. Tex. Civ. Prac. Rem. Code § 41.003. For the reasons explained below, the Court finds that the Trustee has failed to carry his burden of proof, and thus concludes that the Trustee's breach of fiduciary duty claim against Greenblatt fails.

1. As its Manager, Greenblatt Owed Fiduciary Duties to H & M.

[19] As an initial matter, the Court notes that the parties do not dispute that Greenblatt served as H & M's Manager from August 1, 2008 to November 14, 2012. JPTO at 11, ¶¶ 22–23. As its Manager, Greenblatt owed fiduciary duties to H & M, including the duties of care and loyalty. To determine whether Greenblatt breached those fiduciary duties, a brief overview of the relevant standard is necessary.

[20–23] "The duty of care requires officers and directors to manage the company's affairs with diligence and prudence." *Roth v. Mims,* 298 B.R. 272, 285 (N.D.Tex. 2003) (citing *Gearhart Indus., Inc. v. Smith Int'l, Inc.,* 741 F.2d 707, 719 (5th Cir.1984)). "Due care is defined as that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances." *Id.* (citations and internal quotations omitted). In general, the duty of care will be satisfied if the officer's actions comport with the standard of the business judgment rule. *Gearhart,* 741 F.2d at 723 n. 9.

> The Texas business judgment rule, which originated in *Cates v. Sparkman,* 73 Tex. 619, 11 S.W. 846, 849 (1889), provides that the negligence of directors, no matter how unwise or imprudent, does not constitute a breach of duty if the acts were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved." *Resolution Trust Corp. v. Acton,* 844 F.Supp. 307, 315 (N.D.Tex. 1994) (quoting *Cates,* 11 S.W. at 849). Texas courts, like other jurisdictions, do not apply the business judgment rule in cases where the challenged corporate decision "lacks a business purpose, is tainted by a conflict of interest, is so

21. In its Order Granting in Part and Denying in Part Leon A. Greenblatt, III's Motion for Partial Summary Judgment [Dkt. No. 161], the Court previously ruled that "[n]o damages are recoverable from Greenblatt as to any personal benefit alleged to have been gained or received by him for any breach of fiduciary duty," based on the Trustee's failure to provide evidence raising a genuine issue of material fact in response to Greenblatt's no evidence motion for summary judgment on this issue. Accordingly, in its damages analysis, the Court will only consider whether Greenblatt's alleged breach of fiduciary duty resulted in injury to H & M.

> egregious as to amount to a no-win decision, or results from an obvious and prolonged failure to exercise oversight or supervision." *Resolution Trust,* 844 F.Supp. at 314.

Roth, 298 B.R. at 282–83.

[24–29] On the other hand, "[t]he duty of loyalty dictates that a corporate officer or director must act in good faith and must not allow his or her personal interest to prevail over the interest of the corporation. The duty of loyalty requires an extreme measure of candor, unselfishness, and good faith on the part of the officer or director." *Landon v. S & H Mktg. Grp.,* 82 S.W.3d 666, 672 (Tex.App.–Eastland 2002, no pet.) (citing *Int'l Bankers Life Ins. Co. v. Holloway,* 368 S.W.2d 567, 577 (Tex.1963)). "While the duty of loyalty is generally directed towards a fiduciary's motivations in making a business decision, the duty of care concerns the care taken in the process by which that decision was reached." *Kaye v. Lone Star Fund V (U.S.), L.P.,* 453 B.R. 645, 680 (N.D.Tex.2011). Further, "interested" transactions are subject to a higher level of scrutiny.

> The duty of loyalty holds officers and directors to an "extreme measure of candor, unselfishness and good faith," particularly where there is an interested transaction. *International Bankers Life Insurance Co. v. Holloway,* 368 S.W.2d 567, 577 (Tex.1963). Whether an officer or director is "interested" is a question of fact. *Id.* Interested transactions include those in which officers or directors derive personal profit as well as those which deprive the corporation of an opportunity to profit. *Assurance Systems Corp. v. Jackson (In re Jackson),* 141 B.R. 909, 916 (Bankr.N.D.Tex. 1992). A transaction between a fiduciary's corporation and another corporation in which the fiduciary has a significant financial interest is also an interested transaction. *Id.* In such a situation, an officer or director must not allow his personal interests to prevail over the interests of the corporations. *Gearhart Industries, Inc. v. Smith International, Inc.,* 741 F.2d 707, 719–20 (5th Cir.1984).

Mims v. Roth (In re Performance Nutrition, Inc.), 239 B.R. 93, 110 (Bankr. N.D.Tex.1999).

With these precedents in mind, the Court will now turn to whether Greenblatt breached the duties of care and loyalty he owed to H & M as its Manager by: (1) failing to timely pay drilling costs, (2) not requesting funds under the DIP Agreement to prepay completion costs, and (3) not taking action against Scattered related to its alleged breach of the DIP Agreement. *See* Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 11 (listing alleged breaches).[22]

2. Greenblatt Did Not Breach the Fiduciary Duties He Owed to H & M.

Before the Court begins its analysis regarding Greenblatt's alleged breaches of fiduciary duty, additional background is required to put the Trustee's arguments into context. On February 4, 2004, H & M Resources, as operator, and Costas Oil & Gas, Ltd., as non-operator, entered into the JOA. H & M and Hibernia Holdings, LLC ("**Hibernia Holdings**")[23] succeeded

22. Many of the breaches alleged in the Trustee's Post–Trial Brief overlap or are duplicative. *See* Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 11. As such, the Court has shortened the Trustee's list to that contained in this Memorandum Opinion, which, as categorized, covers all material, alleged breaches described in the Trustee's Post–Trial Brief. But, to be clear, the Court finds no breaches of fiduciary duty by Greenblatt on the record before it.

23. Hibernia Holdings, LLC is the parent company of Hibernia Resources. Hibernia Holdings holds the ownership interests, while

to the interests of Costas as non-operators under the JOA. JPTO at 11, ¶ 10. H & M owned a 80.875% working interest in various oil and gas leases located on the Holt Ranch in Martin County, Texas, while Hibernia Holdings owned the remaining 19.125% working interest. *Id.* at 10, ¶¶ 11–12.

On August 8, 2012, H & M Resources and Hibernia Resources entered into a Subcontract Agreement whereby Hibernia Resources agreed to serve "as a subcontractor to serve in the nature of a contract operator pursuant to the JOA to drill and complete and rework any oil and gas wells on the Property." Subcontract Agreement [Gr. Ex. C.1] at 1. In its role as contract operator, Hibernia Resources undertook to begin drilling operations on various well sites located on the Martin County property, which included: (1) the Dorothy Faye 319A # 5 (the "**DF 319A # 5**"); (2) the Holt Ranch 248 # 2 (the "**HR 248 # 2**"); (3) the Dorothy Faye K # 13; and (4) the Dorothy Faye 320 # 6.

As relevant here, the Trustee's breach of fiduciary duty allegations against Greenblatt revolve around Greenblatt, as H & M's Manager, allegedly (1) not timely requesting funds under the DIP Agreement, and/or (2) either directing that H & M late pay, or not pay, AFEs issued to H & M by Hibernia Resources as operator under the JOA. The costs addressed in the AFEs at issue fall into two categories: (1) costs for initially drilling a well (referred to as drilling costs), and (2) costs for completing a well to production (referred to as completion costs). The parties disagree as to when H & M was required to pay each of these costs, as well as the risks to H & M associated with failing to timely pay these costs. With this distinction in mind, the Court will now return to the Trustee's allegations.

a) Failure to Timely Pay AFEs Related to Drilling Costs, With No Resulting Harm, Does Not Constitute a Breach of Fiduciary Duty.

[30] The Trustee argues that Greenblatt directed H & M to late-pay multiple AFEs related to drilling costs, which shows a pattern of mismanagement, particularly in light of the multiple risks associated with failing to pay drillings costs, including (1) H & M losing its interests in the underlying properties due to drilling obligations imposed by the leases, (2) Hibernia Resources issuing a Notice of Non–Consent that could, in turn, result in H & M incurring substantial penalties associated with being deemed a non-consenting party under the JOA, (3) potential litigation with Hibernia Resources related to the failure to timely pay, and (4) violations of the DIP Agreement and/or the Second Interim Cash Collateral Order. The Trustee argues that repeated late payments, in light of the risks associated with such late payments, do not reflect the actions of a prudent manager.

As discussed below, the Court disagrees that a pattern of late payments, without any resulting harm, can serve as the basis for a claim of breach of fiduciary duty. At trial, Greenblatt's unrefuted testimony was that he always intended for H & M to pay the drilling costs; it was not a question of if H & M would pay, but when. As testified to by Carl Carter, Chief Financial Officer of Hibernia Holdings (the parent company of Hibernia Resources), the JOA includes notice and grace period provisions that permitted H & M to delay payments without risking the immediate issuance of a Notice of Non–Consent. Indeed, as Carter testified, the JOA gave H & M fifteen days to pay for amounts billed in an AFE. If the payment was not timely received,

Hibernia Resources performs the drilling operations.

Hibernia Resources could choose to send a notice demanding payment, at which point payment was due within five days. *See* JOA [Gr. Ex. A.1] at § 15.14 ("Should Non–Operator fail to pay its share of the costs of drilling any well hereunder within 15 days from receipt of an invoice therefore in accordance with Article XV.15.13 hereto, Operator shall give written notice to Non–Operator of such default, and if payment is not received within 5 days from receipt by Non–Operator of such notice, Operator may at its election declare such Non–Operator to be a non-consenting party. . . ."). In fact, the record shows that H & M never received a Notice of Non–Consent for failure to pay drilling costs, nor was there any evidence of injury to H & M resulting from Greenblatt's decision to late-pay drilling costs.

As previously detailed, one of the three required elements for a claim of breach of fiduciary duty is injury. Based on the record before it, however, the Court cannot find that Greenblatt's decision to direct H & M to late-pay certain AFEs for drilling costs resulted in injury to H & M. As such, even if the late payments were somehow imprudent, there was no resulting injury to H & M and, without a showing of injury, this Court cannot find a breach of fiduciary duty.

b) Greenblatt's Decision Not to Request Funds Under the DIP Agreement to Prepay Completion Costs, Based upon His Interpretation of the JOA, Was Not a Breach of Fiduciary Duty.

[31] The Trustee also alleges that Greenblatt breached his fiduciary duties by failing to direct H & M to timely request funds under the DIP Agreement to prepay completion costs in accordance with the AFEs issued by Hibernia Resources, as a prudent manager would do, particularly in light of the attendant risks (as detailed in § II.B.2.a), *supra*). The Trustee points to evidence showing that (1) in late September and early October 2012, there were significant amounts due for completion costs, including $923,700.87[24] for well DF 319 A # 5 (Tr. Ex. 15) and $917,889 for well HR 248 # 2 (Tr. Ex. 18), (2) the full amount of the DIP was outstanding when these AFEs were issued, and (3) nonpayment of the completion costs ultimately led to the issuance of the Notices of Non–Consent on both of these wells (Gr. Ex. T.2 and M.3). Although the Trustee acknowledges Greenblatt's argument that the JOA does not permit Hibernia Resources to issue a Notice of Non–Consent for failure to prepay completion costs, he disagrees with Greenblatt's interpretation of the JOA and argues that, in any event, the prudent action would have been for Greenblatt to direct H & M to prepay the completion costs and then proceed under the audit/protest procedures in the JOA. *See* JOA [Gr. Ex. A.1] at Ex. C, Art. 1 ¶¶ 4–5. According to the Trustee, this action would have alleviated substantially all of the associated risk, and was the only prudent course of action.

In response, Greenblatt argues that the express terms of the JOA do not permit Hibernia Resources to issue a Notice of Non–Consent based solely on H & M's failure to prepay completion costs; instead, the only penalty for non-payment is interest accrual. Further, at trial, Greenblatt testified that his reason for not paying the completion costs under protest was that he believed it was necessary for him to follow the express terms of the JOA, particularly since H & M was in bankrupt-

24. During closing argument, the Trustee's counsel explained that Hibernia Resources had received a payment of $25,870. Thus, although the AFE at Tr. Ex. 15 indicates that $949,571.21 was owing, the correct amount was $923,700.87.

cy and he did not want to take actions contrary to the JOA that might further inflame the adversarial relationship between H & M and Prospect. *See* Gr. Ex. X.2 (email from Greenblatt to Jones dated October 4, 2012 stating that "[w]e do not have the itemized bill required by the JOA and I am not going to catch shit from the court, Prospect or anyone else for not following the procedures set forth in [the] assumed JOA."); Gr. Ex. P.4 (email from Greenblatt to various attorneys dated November 11, 2012, stating that "[H & M] made every effort to pay timely consistent with the JOA.... [Hibernia Resources] refused to submit the itemization of estimated invoices required in VII C. It is not gross mismanagement to enforce the terms of a contract."). Finally, after Hibernia Resources issued the Notices of Non–Consent, H & M, at Greenblatt's direction, initiated an adversary proceeding against Hibernia Resources seeking, among other things, a declaratory judgment that Hibernia Resources did not have the right to declare H & M a non-consenting party for failure to prepay completion costs. *See* Complaint for Declaratory Judgment, Adv. Proc. No. 12–3237 [Gr. Ex. M.1]. According to Greenblatt, these actions were both consistent with his fiduciary duties to H & M and the terms of the JOA.

To determine whether Greenblatt's decision to not prepay completion costs under AFEs issued by Hibernia Resources was a breach of fiduciary duty, the Court must consider the operative documents. As its starting point, the Court will first turn to the Notices of Non–Consent issued by Hibernia Resources to H & M on October 4, 2012, regarding well DF 319 A # 5 (Gr. Ex. T.2), and October 10, 2012, regarding well HR 248 # 2 (Gr. Ex. M.3). Each of these notices solely and specifically reference JOA § 15.14, which states:

> Should Non–Operator [H & M] fail to pay its share of the **costs of drilling** any well hereunder within 15 days from receipt of an invoice therefore, in accordance with Article XV.15.13 herein, Operator shall give written notice to Non–Operator of such default and if payment is not received within 5 days from receipt by Non–Operator of such notice, **Operator may at its election declare such Non–Operator to be a non-consenting party for the proposed drilling operation under the terms of Article VI.B.2[25] of this agreement.**

JOA [Gr. Ex. A.1] at § 15.14 (emphasis added). In turn, JOA § 15.13 states:

> Each Non–Operator shall be obligated to pay Operator **in advance** for its proportionate share of all estimated **costs to casing point** of any well drilled pursuant hereto in which Non–Operator has agreed to participate subject to Article VI.B.1. Operator shall furnish each Non–Operator with an appropriate invoice for each such well drilled hereun-

25. JOA Article VI.B establishes the relationship between consenting and non-consenting parties to a well. In general terms, the entire cost and risk of conducting the drilling operations is borne by the consenting parties in their agreed-upon proportions. *Id.* at Art. VI.B.2 (Operations by Less than All Parties). If the well produces oil and/or gas in paying quantities, the consenting parties complete and equip the well to produce, also at their sole cost and risk. *Id.* The well is then turned over to the "operator," here Hibernia Resources, to be operated by it at the expense and for the account of the consenting parties. *Id.* There is a non-consent "penalty" of 300%, which gives the consenting parties the right to recover 300% of their respective costs for: (1) all newly acquired surface equipment beyond the wellhead connections, (2) drilling, reworking, deepening, plugging back, testing, and completing the well, and (3) the cost of all newly acquired equipment in the well. *Id.* at § VI.B.2(a) and (b).

der and each Non–Operator shall pay its share of such costs within 15 days of receipt of such invoices any amounts not timely paid in accordance therewith shall bear interest at the rate provided for in paragraph I.3.B of the accounting procedure attached hereto as Exhibit "C"[26]. Non–Operator will not be billed more than thirty (30) days prior to commencement of the proposed operation, unless Operator is invoiced and required to make any such payment.

Id. at § 15.13 (emphasis added).

Although not focused on by the parties, the Court also notes Article VII.B (Liens and Payment Defaults), pursuant to which each non-operator grants to the operator a "lien upon its oil and gas rights in the Contract Area, and a security interest in its share of oil and/or gas when extracted and its interest in all equipment, to secure payment of its share of expenses, together with interest thereon at the rate provided in Exhibit "C." Further pursuant to this section:

> If any party fails or is unable to pay its share of expense within sixty (60) days after rendition of a statement therefor by Operator, the non-defaulting parties, including Operator, shall, upon request by Operator, pay the unpaid amount in the proportion that the interest of each such party bears to the interest of all such parties. Each party so paying its share of the unpaid amount shall, to obtain reimbursement thereof, be subrogated to the security rights described in the foregoing paragraph.

Id. at Art. VII.B. Similarly, Article VII.C (Payment and Account), states that:

> Operator, at its election, shall have the right from time to time to demand and receive from the other parties **payment in advance** of their respective shares of the estimated amount of the **expense to be incurred in operations** hereunder during the next succeeding month, which right may be exercised only by submission to each such party of an itemized statement of such estimated expense, together with an invoice for its share thereof. Each such statement and invoice for the payment in advance of estimated expense shall be submitted on or before the 20th day of the next preceding month. Each party shall pay to Operator its proportionate share of such estimate within fifteen (15) days after such estimate and invoice is received. **If any party fails to pay its share of said estimate within said time, the amount due shall bear interest as provided in Exhibit "C" until paid.** Proper adjustment shall be made monthly between advances and actual expense to the end that each party shall bear and pay its proportionate share of actual expenses incurred, and no more.

Id. at Art. VII.C.

With these provisions in mind, the Court will now turn to whether Greenblatt's actions, based upon his interpretation of the JOA, constituted a breach of fiduciary duty. As explained below, the Court concludes that Greenblatt's interpretation of the JOA was correct; thus, his decision to abide by the terms of the JOA was not a breach of fiduciary duty.

Section 15.14 of the JOA permits Hibernia Resources to deem H & M a non-

26. JOA Exhibit C, paragraph I.3.B provides that if payment is not timely made, "the unpaid balance shall bear interest monthly at the prime rate in effect at Bank of Oklahoma on the first day of the month in which delinquency occurs plus 1% or the maximum contract rate permitted by the applicable usury laws in the state in which the Joint Property is located, whichever is the lesser, plus attorneys' fees, court costs, and other costs in connection with the collection of unpaid amounts."

consenting party based upon H & M's failure to timely pay *drilling* costs after the issuance of required notices by Hibernia Resources and the passage of various grace periods. JOA [Gr. Ex. A.1] at § 15.14 ("Should Non–Operator [H & M] fail to pay its share of the **costs of drilling** . . . Operator may at its election declare such Non–Operator to be a non-consenting party. . . ."). Notably, the Court could not find, nor did the Trustee cite to, any provision of the JOA similar to § 15.14 that authorized Hibernia Resources to deem H & M a non-consenting party based upon its failure to timely prepay *completion* costs. Thus, from the Court's perspective, the operative question is whether the "costs of drilling," as used in JOA § 15.14, include completion costs.

The JOA is silent as to the distinction between drilling and completion costs. However, Hibernia Resources and H & M Resources also executed the Subcontract Agreement, which was agreed to by H & M. Subcontract Agreement [Gr. Ex. C.1] at 1, 5. Pursuant to § 3.1 of the Subcontract Agreement, "[t]he parties intend this Agreement to be a supplement to and an integral part of the JOA. . . . This Agreement, together with the JOA, is to be construed as a 'Joint Operating Agreement' for all purposes under Texas law, including without limitation, Chapter 127, Texas Civil Practice & Remedies Code." *Id.* at § 3.1. Pursuant to the Subcontract Agreement, costs for "drilling" and costs for "completion" are separate and distinct costs.

> The term "Drilling" shall mean all operations, including, but not limited to, directional control other than sidetracking, reasonable, necessary and incident to the drilling of a well to its projected depth, including preparation of roads and drillsite, testing and logging, **but excluding completion operations.**

Id. at 1 (emphasis added). While,

> [t]he term 'Completion' and 'Recompletion' shall mean a single stage or multistage operation **intended to complete a well as a producer** of oil and gas in one or more zones, including, but not limited to the setting of production casing, perforating, well stimulation and production testing completed in such operation **resulting in an oil or gas well capable of flowing or being pumped.**

Id. (emphasis added).

When read in conjunction, the Court finds the JOA and the Subcontract Agreement to be unambiguous regarding the scenario under which Hibernia Resources may issue a Notice of Non–Consent. Pursuant to § 15.14 of the JOA, Hibernia Resources may only deem H & M to be a non-consenting party in the event that it fails to timely pay drilling costs.[27] Per the JOA, the penalty for failing to prepay completion costs are the accrual of interest, which is secured, along with the unpaid amounts, by a lien against H & M's interests as described in Article VII.B of the JOA.

As such, the Court concludes that Greenblatt correctly interpreted the JOA. The Court recognizes that prepaying the completion costs per the AFEs subject to protest was an option available to H & M; however, that course of action also had attendant risks, such as legal costs associ-

27. The Court notes that the JOA is based upon the A.A.P.L. Form 610–1982. This form was subsequently updated by the A.A.P.L. Form 610–1989. The 1989 form contains additional provisions in Article VII, including VII.D (Defaults and Remedies). Article VII.D.3 (Deemed Non–Consent) permits the operator to deliver a written notice of non-consent to a defaulting party who fails to timely pay either drilling or completion costs. This provision is missing from the 1982 form.

ated with enforcing the terms of the JOA in seeking a return of the funds and Hibernia Resources having the funds on-hand to repay H & M. Accordingly, the Court concludes that Greenblatt did not breach his fiduciary duties to H & M when he decided not to prepay completion costs.

Further, the Court concludes that Greenblatt's actions in this regard fall within the business judgment rule. Although Greenblatt served as both H & M's Manager and an officer of Scattered, he was not an insider of Hibernia Resources and his dealings with Hibernia Resources were not an "interested" transaction subject to heightened scrutiny. Under the JOA, H & M had two potential options when dealing with Hibernia's issuance of AFEs demanding prepayment of completion costs. Although the Trustee argues that paying the amounts under protest was the "more prudent" course of action, the evidence does not show that Greenblatt's decision to enforce the terms of the JOA lacked a business purpose, was tainted by a conflict of interest, or was the result of an obvious and prolonged failure to exercise oversight or supervision. Thus, the Court finds and concludes that Greenblatt's decision to not prepay completion costs based upon his interpretation of the JOA was the result of his informed business judgment and, as such, was not a breach of the fiduciary duty of care he owed to H & M as its Manager.

c) Greenblatt's Failure to Take Further Action Against Scattered for Its Alleged Breach of the DIP Agreement Was Not a Breach of Fiduciary Duty.

[32] The Trustee alleges that Greenblatt breached his fiduciary duties to H & M when he failed to direct that H & M take action against Scattered in relation to its alleged breach of the DIP Agreement. The record, however, clearly shows that action was taken against Scattered, as reflected in the demand letter sent by Anderson Tobin PLLC, on behalf of H & M, to Scattered dated October 12, 2012. Tr. Ex. 85 (the "**Demand Letter**"). The Demand Letter states that "[b]y not funding the [$925,000] advance, Lender is in default of the [DIP] Agreement and has potentially caused [H & M] to default on certain payment obligations. [H & M] demands that Lender immediately fund the $925,000 advance." *Id.*

Although Greenblatt testified that he first directed that the Demand Letter be sent, he then directed that it be rescinded. But, the Demand Letter had already been sent, and counsel for the Trustee and Scattered stipulated on the record that the Demand Letter was actually received by Scattered. *See* JPTO at 11, ¶ 40. On November 28, 2012, the Trustee was appointed and Greenblatt was no longer in control of H & M. Order Approving Appointment of Trustee [Gr. Ex. P.1].

Based upon this record, the Court finds that Greenblatt began to take action on behalf of H & M to address Scattered's alleged breach of the DIP Agreement; however, the Trustee's appointment divested Greenblatt of authority to take any further action on behalf of H & M. Moreover, the Court has already found that Scattered did not breach the DIP Agreement. *See* § II.A.1, *supra.* Because Scattered did not breach the DIP Agreement, Greenblatt's alleged failure to take action against Scattered for breaching the DIP Agreement cannot constitute a breach of fiduciary duty to H & M.

3. Had Greenblatt Breached the Fiduciary Duties He Owed to H & M, Prospect's Actions Were an Intervening and Superseding Cause of H & M's Alleged Injuries.

[33] Although the Court previously found that Greenblatt did not breach the

fiduciary duties he owed to H & M, it will nonetheless address Greenblatt's argument that his actions were not the proximate cause of the alleged injuries suffered by H & M. More specifically, Greenblatt argues that Prospect's refusal to consent to a proposed settlement that would have resolved H & M's dispute with Hibernia Resources, prior to the Trustee's appointment, was an intervening cause of H & M's injuries. As discussed below, the Court finds Greenblatt's argument on this point persuasive and concludes that Prospect's actions were an intervening and superseding cause of H & M's alleged injuries. Additional background regarding the proposed settlement is necessary to place the Court's conclusion into context.

After entry into the Subcontract Agreement in August 2012, Hibernia Resources generally stepped into H & M Resources' shoes as operator under the JOA. Subcontract Agreement [Gr. Ex. C.1] at 1. In this capacity, Hibernia Resources would send AFEs to H & M, requesting payment or prepayment of expenses that were due after various notice and grace periods. The Trustee argues that H & M's failure to pay AFEs issued for prepayment of completion costs, which was done at Greenblatt's direction, led to Hibernia Resources issuing the Notices of Non–Consent in October 2012 and the resulting "domino effect" that led to H & M incurring the substantial damages that are the subject of this adversary proceeding.

After the Notices of Non–Consent were issued, however, H & M and Hibernia Resources began discussing potential settlement terms. Both Jones, who negotiated on H & M's behalf, and Carter, the Chief Financial Officer of Hibernia Holdings, testified that H & M and Hibernia Resources reached an agreement in early November 2012, the material terms of which included, among other things, that H & M would convey certain property interests to Hibernia Holdings and receive other property from Hibernia Holdings in exchange. *See also* email from Jones to David Belzer of Prospect dated November 6, 2012 [Gr. Ex. M.4] (explaining the terms of the proposed conveyance). Jones testified that, because Prospect held a lien on the properties proposed to be conveyed to Hibernia Holdings, Hibernia Holdings was requiring Prospect's consent to the settlement. According to Jones, the exchange of properties was very favorable to H & M and Prospect, which would be granted a lien on the to be acquired property. However, Prospect refused to consent to the settlement, which was never consummated. Soon thereafter, on November 28, 2012, the Trustee was appointed. Order Approving Appointment of Trustee [Gr. Ex. P.1] at 1.

After his appointment, the Trustee entered into negotiations with the Hibernia entities to resolve the issues between the parties. As Carter testified, the Trustee ultimately reached a settlement with the Hibernia entities on terms identical to the Jones-negotiated settlement with one exception—the Trustee's settlement included a $100,000 payment to the Hibernia entities that was not part of the Jones-negotiated settlement. Although Prospect had refused to consent to the Jones-negotiated settlement (which was more favorable to H & M), Carter testified that Prospect did consent to the Trustee-negotiated settlement. The Trustee then filed a motion seeking Court approval of his settlement with the Hibernia entities, which the Court granted.[28]

28. *See* Order Granting Trustee's Expedited Motion to Compromise Controversy with Hibernia Resources, LLC and Hibernia Holdings, LLC Pursuant to Fed. R. Bankr.P. 9019 [Dkt. No. 260], entered March 8, 2013.

With this background in mind, the Court will now return to Greenblatt's argument that Prospect's refusal to approve the Jones-negotiated settlement was an intervening cause of H & M's alleged $100,000 injury. Under Texas law, an intervening act is not necessarily a new and independent cause merely because it, in addition to the defendant's negligence, causes the plaintiff's injury. "Generally speaking, if the intervening force was foreseeable at the time of the defendant's negligence, the force is considered to be a concurring cause of the plaintiff's injuries, and the defendant remains liable for the original negligence." *Dew v. Crown Derrick Erectors, Inc.,* 208 S.W.3d 448 (Tex.2006) (internal quotation marks omitted); *see also Penrod v. Schecter,* 319 S.W.3d 737, 745 (Tex.App.–El Paso 2009, pet. denied). A new and independent cause, as opposed to a concurring cause, is typically not only unforeseeable, but its consequences are unexpected or extraordinary. *Dew,* 208 S.W.3d at 451. The event "alters the natural sequence of events, produces results that would not otherwise have occurred, is an act or omission not brought into operation by the original wrongful act of the defendant, and operates entirely independently of the defendant's allegedly negligent act or omission." *Columbia Rio Grande Healthcare v. Hawley,* 284 S.W.3d 851, 857 (Tex.2009) (citing *Dew,* 208 S.W.3d at 451). The, "threshold, and often controlling, inquiry" is whether the intervening act and its consequences were foreseeable. *Dew,* 208 S.W.3d at 452.

Here, the record shows that, prior to the Trustee's appointment: (1) H & M had negotiated a favorable settlement that would have resolved all of the issues between H & M and the Hibernia entities, (2) Court approval of that settlement would have stopped the alleged damages at issue here from accruing,[29] and (3) Prospect refused to consent to the settlement and release its liens on the properties to be transferred to Hibernia Holdings in exchange for obtaining a lien on property to be transferred to H & M as part of the settlement. The Court, however, cannot discern any rational business justification for Prospect's refusal to consent to the Jones-negotiated settlement. The only evidence before the Court establishes that the property exchange (and hence the collateral exchange) was favorable to H & M and Prospect. Moreover, within weeks of refusing to consent to the Jones-negotiated settlement, Prospect consented to a virtually identical settlement negotiated by the Trustee, which was identical in its treatment of Prospect and its liens, but required the estate's expenditure of $100,000 of Prospect's cash collateral.

Based upon the facts established at trial, the Court finds that it was not foreseeable that Prospect, an established investment company, would act contrary to its own pecuniary interest and with no apparent business purpose in refusing to consent to the Jones-negotiated Hibernia settlement. Further, the consequences of Prospect's refusal to consent to the Jones-negotiated settlement, including the Trustee's negotiation of a settlement with the Hibernia entities on materially worse terms than those negotiated by H & M and the various fees and costs alleged in the Complaint, were extraordinary and not of the same nature as the damages that would have otherwise arisen from Greenblatt's decision to not prepay completion costs.

Further, as Greenblatt testified at trial, upon resolution of H & M's default under the Second Interim Cash Collateral Order and the DIP Agreement, Scattered would

29. Based on its approval of the less-favorable, Trustee-negotiated settlement, the Court would likely have approved the Jones-negotiated settlement.

have resumed funding under the DIP Agreement. Thus, with the Jones-negotiated settlement in place, a significant portion of the alleged damages at issue here would not have accrued, including: (1) the $7.2 million, or alternatively $925,000, related to Scattered's alleged failure to fund, as Scattered would have resumed funding under the DIP Agreement; (2) the lost profits, as H & M would have had sufficient funds to proceed with its drilling program on at least an interim basis,[30] and (3) the $100,000 plus attorneys' fees and costs related to the Trustee-negotiated Hibernia settlement, as that settlement would never have occurred. The only alleged damages that would not have been prevented by Prospect's consent to the Jones-negotiated settlement were the fees and costs associated with the Trustee's appointment and the costs of administering H & M's estate. Though as discussed in more detail in § II.A.2, *supra*, it was Prospect's purchase of all general unsecured claims against the H & M estate, at par, and its refusal to consent to any plan proposed by H & M under Greenblatt's management that caused the Court to appoint the Trustee.

As such, the Court finds and concludes that (1) Prospect's refusal to consent to the Jones-negotiated settlement was not foreseeable, (2) the consequences resulting from Prospect's actions were unexpected and extraordinary, and (3) Prospect's actions altered the natural sequence of events to produce results that would not otherwise have occurred. Thus, Prospect's decision not to approve the Jones-negotiated settlement was an intervening and superseding cause of H & M's alleged injuries.

C. Count 6: Objection to Administrative Wage Claims (Brickley v. Greenblatt)

As reflected in his Wage Claim, Greenblatt has asserted a claim for compensation for postpetition services rendered as H & M's Manager for the period from H & M's bankruptcy petition date (April 30, 2012) through November 2012. Wage Claim [Gr. Ex. X.1] at 1. According to Greenblatt, his claim is entitled to administrative priority pursuant to 11 U.S.C. § 503(b)(1)(A). *Id.*

The Trustee objected to Greenblatt's Wage Claim on multiple grounds, including that (1) Greenblatt failed to show he is entitled to the amounts requested, (2) there is no written agreement entitling Greenblatt to the amounts requested, and (3) Greenblatt failed to previously disclose his claim to the Court and parties in interest, including by failing to include such amounts in the budget to the Second Interim Cash Collateral Order.

The Court's analysis of the Trustee's objection must begin with § 503(b) of the Bankruptcy Code. Specifically § 503(b)(1)(A), which governs the allowance of administrative expense claims against a bankruptcy estate, states, in relevant part, that: "[a]fter notice and a hearing, there shall be allowed administrative expenses . . ., including—(1)(A) the actual, necessary costs and expenses of preserving the estate including—(i) wages, salaries, and commissions for services ren-

30. There is nothing in the record indicating whether or not, upon consummation of the Jones-negotiated settlement, Prospect would have rescinded its notice of default and/or agreed to permit H & M to continue to use its cash collateral. However, even if Prospect did not consent, the Code permits the Court to authorize the use of cash collateral after notice and a hearing so long as Prospect can be adequately protected. 11 U.S.C. § 363(c)(2), (e).

dered after the commencement of the case. . . ." 11 U.S.C. § 503(b)(1)(A)(i).

[34–36] According to the Fifth Circuit,

> In order to qualify as an "actual and necessary cost" under section 503(b)(1)(A), a claim against the estate must have arisen postpetition and as a result of actions taken by the trustee that benefitted the estate. *See Toma Steel Supply, Inc. v. TransAmerican Natural Gas Corp. (In the Matter of TransAmerican Natural Gas Corp.),* 978 F.2d 1409, 1416 (5th Cir.1992) (finding that a "prima facie case under § 503(b)(1) may be established by evidence that (1) the claim arises from a transaction with the debtor-in-possession; and (2) the goods or services supplied enhanced the ability of the debtor-in-possession's business to function").

Total Minatome Corp. v. Jack/Wade Drilling, Inc. (In re of Jack/Wade Drilling, Inc.), 258 F.3d 385, 387 (5th Cir.2001) (request for administrative expense status under § 503(b)(1)(A)); *see also Lasky v. Phones For All, Inc. (In re Phones For All, Inc.),* 262 B.R. 914, 918 (N.D.Tex.2001) ("Accordingly, an expense is entitled to administrative priority treatment only if (1) it results from a transaction between the claimant and the trustee of the bankruptcy estate or a debtor in possession; and (2) the benefit to the debtor, and hence the right to payment, accrues postpetition."), *aff'd,* 288 F.3d 730 (5th Cir. 2002). The terms "actual" and "necessary" are to be construed narrowly. *NL Indus., Inc. v. GHR Energy Corp.,* 940 F.2d 957, 966 (5th Cir.1991). Greenblatt bears the burden of proving that his claim is for actual, necessary costs and expenses of preserving the estate. *In re TransAmerican Natural Gas Corp.,* 978 F.2d 1409, 1416 (5th Cir.1992).

The testimony at trial and the stipulations among the parties establish that Greenblatt served as H & M's Manager on an "at will" basis, with no employment contract. During his prepetition service, Greenblatt received a monthly salary of $6,000 per month. JPTO at 12, §§ 22–23. Although Greenblatt continued to serve as H & M's Manager on a postpetition basis, he was not paid a salary by H & M and H & M's postpetition budgets filed with the Court did not disclose any payment or accrual of Greenblatt's salary. *Id.* at ¶¶ 24–25. As such, the issue becomes whether Greenblatt was entitled to continue to receive his salary on a postpetition basis.

Although there is no written employment agreement, Greenblatt alleges that the LLC Regulations permit him to be compensated. Specifically, § 8.06 of the LLC Regulations state that:

> [t]he Manager shall receive compensation for his services and activities on behalf of the Company as determined by the Members from time to time, and he shall be reimbursed for all reasonable costs and expenses incurred by him on behalf of the Company.

LLC Regulations [Sc. Ex. B] at § 8.06. When questioned at trial, however, Greenblatt was unable to offer any evidence showing that H & M's sole member, Anglo American, had approved his salary. As such, the Court cannot find that the LLC Regulations entitle Greenblatt to a set salary of $6,000 per month. Such finding, however, is not conclusive of whether Greenblatt's services qualify for administrative expense status under § 503(b).

At trial, Greenblatt's unrefuted testimony was that, although he received a prepetition salary of $6,000 per month, he stopped taking this salary about a month prepetition "because he didn't want to pick a fight" with Prospect, H & M's prepetition secured lender, whom Greenblatt believed would not permit him to receive a postpetition salary paid from its cash collateral. However, Greenblatt further testified that he continued to manage H & M and perform services on H & M's behalf after the bankruptcy filing. *See also* JPTO at 12, ¶ 25 ("After the filing of the Debtor's bankruptcy, Greenblatt continued to manage the Debtor and performed services on behalf of the Debtor."). According to Greenblatt, his postpetition services included "overseeing all the matters of the Debtor," including operations, financing, and making business decisions. He also testified that he spent significantly more time managing H & M postpetition than he did prepetition. Per Greenblatt, H & M required his services and he believed that the company would have been out of business otherwise. Greenblatt's unrefuted testimony clearly showed that he performed postpetition services as H & M's Manager and that those services benefited the estate.

Finally, the Court does not find persuasive the Trustee's argument that Greenblatt's failure to previously disclose his administrative claim is a ground for disallowance. First, the Court notes that H & M disclosed that Greenblatt served as its prepetition Manager at a salary of $6,000 per month. *See* Statement of Financial Affairs [Bankr.Case No. 12–32785, Dkt. No. 65] at 8 (question 23). And, although Greenblatt's salary does not appear on any Court-approved budgets, Greenblatt adequately explained why his salary was not budgeted for payment from Prospect's cash collateral and there is nothing in the record indicating that Greenblatt waived his right to seek allowance of an administrative claim for postpetition services rendered. Further, Greenblatt openly appeared before this Court, and other parties in interest, as H & M's Manager. Therefore, there can be no argument that parties were unaware that Greenblatt was continuing to act as H & M's Manager postpetition or that Greenblatt's Wage Claim is contrary to a prior agreement to waive his salary. Thus, the Court finds that Greenblatt's failure to disclose his postpetition salary prior to filing his Wage Claim does not act as a bar to Greenblatt seeking allowance of an administrative claim for postpetition services rendered.

[37] Accordingly, based upon Greenblatt's unrefuted testimony, the Court finds that (1) the $42,000 reflected in the Wage Claim arose from a transaction with H & M as a debtor-in-possession, (2) Greenblatt's services enhanced H & M's ability to function on a postpetition basis, and (3) Greenblatt's services were necessary for H & M to continue to operate on a postpetition basis. Further, the Court finds that a salary of $6,000 per month for the services of the sole Manager of H & M is reasonable compensation under the circumstances of this case. Accordingly, the Wage Claim will be allowed in the amount of $42,000 as an administrative priority claim against H & M's Chapter 11 estate.

D. Count 5: Equitable Subordination (Brickley v. Greenblatt)

In Count 5, the Trustee asks the Court to subordinate Greenblatt's Wage Claim on the grounds that: (1) Greenblatt's alleged breaches of fiduciary duty constitute the inequitable conduct necessary for equitable subordination, and (2) Greenblatt's actions caused substantial damages to H & M. Trustee's Pre–Trial Brief [Dkt. No. 125] at ¶ 55. The basis for the requested subordination is 11 U.S.C. § 510(c), which states, in relevant part, that:

> (c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
>
> (1) under principles of equitable subordination, subordinate for purposes of

distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. . . .

11 U.S.C. § 510(c).

[38] In the Fifth Circuit, courts follow a three-prong test when considering a request for equitable subordination: "(1) the claimant must have engaged in inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code." *Wooley v. Faulkner (In re SI Restructuring, Inc.),* 532 F.3d 355, 360 (5th Cir.2008) (citing cases). Further, "a claim should be subordinated only to the extent necessary to offset the harm which the debtor or its creditors have suffered as a result of the inequitable conduct." *Id.* at 360–61 (citing cases).

As discussed in § II.B.2, *supra,* the Court previously found that Greenblatt did not breach the fiduciary duties he owed to H & M as its Manager. As such, those allegations cannot serve as a basis for equitable subordination. Further, after a thorough review of the record, the Court could find no other conduct by Greenblatt that would warrant application of § 510(c) to Greenblatt's Wage Claim. Finally, even if Greenblatt had participated in inequitable conduct, there is nothing in the record showing that (1) the alleged improprieties injured either H & M or its creditors, or (2) that Greenblatt benefited from such alleged actions. Thus, the Court finds that the Trustee has failed to carry his burden of proof for equitable subordination of Greenblatt's Wage Claim, and thus concludes that the Trustee's equitable subordination claim fails.

E. Counterclaim: Indemnification Under the LLC Regulations and the DIP Agreement (Greenblatt v. H & M)

In his Answer and Counterclaim, Greenblatt alleges that he is entitled to indemnification for his attorneys' fees and costs incurred in defending this adversary proceeding under both the LLC Regulations and the DIP Agreement. The Court will address these in turn.

1. Greenblatt Is Entitled to Indemnification Under the LLC Regulations.

[39] Section 16.02 of the LLC Regulations state that:

> Actions by Members. In any threatened, pending or completed action or suit by or in the right of the Company or any Member, to which a Manager or Member is a party or is threatened to be made a party, involving an alleged cause of action by a Member or Members for damages arising from the activities of the Manager or Member in the management of the internal affairs of the Company as prescribed by these Regulations or by the laws of the State of Texas, or both, the **Company shall indemnify such Manager or Member against loss, liability or expense, including attorneys' fees, actually and reasonably incurred, if he or it acted in good faith and in a manner reasonably believed to be in or not opposed to the best interests of the Company as specified in this section, except that no indemnification shall be made in respect of any claim, issue or matter as to which the Manager or Member shall have been adjudged to be liable for gross negligence, willful misconduct or breach of fiduciary obligation in the performance of his or its duty to the Company,** unless and only to the extent that the court in which such ac-

> tion or suit is brought shall determine upon application that, despite the adjudication of liability but in view of all circumstances of the case, the Manager or Member is fairly and reasonably entitled to indemnity for such expenses which such court shall deem proper.

LLC Regulations [Sc. Ex. B] at § 16.02 (emphasis added).

In his Post–Trial Brief, the Trustee alleges that Greenblatt is not entitled to indemnification under the LLC Regulations because: (1) he "acted in bad faith and in a manner opposed to the best interest of H & M," and (2) he is liable to H & M for his "gross negligence,[31] willful misconduct, and/or his breach of fiduciary obligations." Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 82.[32] As explained below, however, the Court disagrees with the Trustee on these points.

Because the Court has already found that Greenblatt acted within the scope of his fiduciary duties owed to H & M, and that his actions fell within the scope of the business judgment rule, the Court cannot find that his actions were grossly negligent or constituted willful misconduct. *See* § II.B.2, *supra* for this Courts' analysis of the Trustee's breach of fiduciary duty claim. As reflected by the record, and as discussed above, Greenblatt's actions were taken in good faith and in a manner that was not opposed to H & M's best interests. As such, the Court finds and concludes that Greenblatt is entitled to indemnification under LLC Regulations § 16.02 for any "loss, liability or expense, including attorneys' fees, actually and reasonably incurred" in defending against the Complaint.

2. Greenblatt Is Entitled to Indemnification Under the DIP Agreement.

[40] The Court will now turn to Greenblatt's allegation that he is entitled to indemnification under § 8.4 of the DIP Agreement, which states:

> (b) Indemnification by the Debtors. The Debtors shall indemnify the Lender [Scattered] and each Related Party of the Lender (each such Person being called an "Indemnitee") against, and to hold each Indemnitee harmless from, any and all losses, claims, damages, liabilities and related expenses, including the fees, charges and disbursements of any counsel for any Indemnitee, incurred by or asserted against any Indemnitee **arising out of, in connection with, or as a result of** (i) the execution or delivery of this Agreement and each other or any agreement or instrument contemplated hereby, **the performance**

31. Because the LLC Regulations do not define the term "gross negligence," the Court will turn to Texas law. LLC Regulations [Sc. Ex. B] at § 19.02 (Governing Law). According to the Texas Civil Practices and Remedies Code:

> "Gross negligence" means an act or omission: (A) which when viewed objectively from the standpoint of the actor at the time of its occurrence involves an extreme degree of risk, considering the probability and magnitude of the potential harm to others; and (B) of which the actor has actual, subjective awareness of the risk involved, but nevertheless proceeds with conscious indifference to the rights, safety, or welfare of others.

TEX. CIV. PRAC. & REM.CODE § 41.001(11); *see also e2 Creditors Trust v. Stephens, Inc. (In re e2 Communications, Inc.)*, 354 B.R. 368, 404 (Bankr.N.D.Tex.2006) (relying on the definition of "gross negligence" contained in § 41.001 when analyzing indemnity provisions).

32. The Court notes that the Trustee has not alleged independent claims against Greenblatt for negligence and/or willful misconduct, but is instead arguing those actions as express exceptions to the indemnification provision of the LLC Regulations. Trustee's Pre–Trial Brief [Dkt. No. 125] at ¶ 82.

> **by the parties hereto of their respective obligations hereunder or the consummation of the Transactions**[33] **or any other transactions contemplated hereby,** (ii) any Advance or the use of the proceeds therefrom, . . . or (iv) **any actual or prospective claim, litigation, investigation or proceeding relating to any of the foregoing, whether based on contract, tort or any other theory** and regardless of whether any Indemnitee is a party thereto; provided, however, that such indemnity shall not, as to any Indemnitee, be available to the extent that such losses, claims, damages, liabilities or related expenses are determined by a court of competent jurisdiction by final and non-appealable judgment to have resulted solely from the gross negligence or willful misconduct of such Indemnitee.

DIP Agreement [Gr. Ex. H.1] at § 8.4(b) (emphasis added). As stipulated by the parties, the indemnity provisions of § 8.4(b) survived termination of the DIP Agreement. JPTO at 15, ¶ 66.

The Trustee attacks Greenblatt's claim for indemnification under the DIP Agreement on multiple fronts, including that: (1) the indemnity provision does not extend to Greenblatt as H & M's Manager; (2) the acts alleged in the Complaint do not fall within the scope of the indemnity provision; (3) the indemnification does not comply with the fair notice requirements of Texas law; and (4) Scattered's breach of the DIP Agreement bars Greenblatt's indemnification claim. Trustee's Pre–Trial Brief [Dkt. No. 125] at ¶¶ 60–71. Because the Court previously found that Scattered did not breach the DIP Agreement, *see* § II.A.1, *supra*, this Memorandum Opinion will only address the first three of the Trustee's arguments.

a) Greenblatt, in His Capacity as H & M's Manager, Qualifies as an "Indemnitee" Under the Terms of the DIP Agreement.

The Trustee argues that the indemnification provision does not extend to Greenblatt, in his capacity as H & M's Manager, for several reasons. First, the Trustee argues that, in his Counterclaim, Greenblatt only claimed indemnification as an officer of Scattered; however, Greenblatt has been sued in his capacity as H & M's Manager. Second, the Trustee argues that his breach of fiduciary duty claim against Greenblatt arises independent of the DIP Agreement and the parties' performance thereunder. Finally, the Trustee argues that the indemnity provision does not comply with applicable law. The Court will address these arguments in turn.

The Trustee argues first that, in his counterclaim, Greenblatt has only alleged indemnification as an officer of Scattered. Specifically, the Trustee cites to "Def.'s Countercl. 12,"[34] which the Court will interpret as a reference to paragraphs 117–120 of the Answer and Counterclaim, which state:

> 117. In addition, paragraph 8.4(b) of the DIP Loan requires H & M to indemnify and hold Greenblatt harmless from any and all losses, claims, damages, liabilities and related expenses, including the fees, charges and disbursements of any counsel for Greenblatt, for any claims asserted against Greenblatt aris-

33. "'Transactions' means the execution, delivery and performance by the Debtors of this [DIP] Agreement and the other agreements executed in connection herewith, the borrowing of Advances and the use of the proceeds thereof." DIP Agreement [Gr. Ex. H.1] at § 1.1(xx).

34. Trustees' Pre–Trial Brief [Dkt. No. 125] at ¶ 78.

ing out of, in connection with, or as a result of the execution or performance of the DIP Loan, based on any theory, including tort theory of liability. Greenblatt asserts that his actions, if any, in the performance of the DIP Loan were not grossly negligent as he believes they were in compliance with the specific terms of the joint operating agreement and the DIP Loan and thus also not the product of willful misconduct. All to the contrary, any actions on his part were in good faith and reasonable.

118. The definition of Indemnitee contained in paragraph 8.4(b) of the DIP Loan includes any Related Party to the Lender. The Lender is Scattered Corporation.

119. The definition of "Related Parties" contained in the DIP Loan includes affiliates of the Lender, and their respective directors, officers, employees, agents, attorneys and advisors of the Lender.

120. The Trustee has asserted in the Complaint that Greenblatt was the Secretary for Scattered Corporation.

Amended Answer and Counterclaim [Dkt. No. 63] at 12, ¶¶ 117–120.[35] Although the Court believes that the Amended Answer and Counterclaim could have been more artfully drafted, the Court finds that the Trustee's interpretation of the Counterclaim, which appears to focus on paragraph 120 without regard the language of the surrounding paragraphs, is far too restrictive. The Counterclaim must be read in its entirety, and the Court will not read paragraph 120 as an express limitation on the allegations contained in paragraphs 117–119 of the Counterclaim.

Accordingly, the Court finds that Greenblatt has alleged that he is entitled to indemnification under § 8.4(b) of the DIP Agreement as a "Related Party" indemnitee. As such, the relevant inquiry now becomes whether Greenblatt does, in fact, qualify as an Indemnitee under the express terms of the DIP Agreement.

Section 8.4(b) of the DIP Agreement states that "[t]he Debtors shall indemnify the Lender [Scattered] and each Related Party of the Lender (each such Person being called an 'Indemnitee'). . . ." DIP Agreement [Gr. Ex. H.1] at § 8.4(b). As such, the Court's analysis must focus on the parameters of the term "Related Party." Of relevance here, the DIP Agreement contains the following definitions:

Related Parties means, with respect to any specified Person [Scattered], such Person's Affiliates and the respective directors, officers, employees, agents, attorneys and advisors of such Person and such Person's Affiliates.

Person shall mean any natural person, corporation, limited liability company . . . or other entity.

Affiliates means, with respect to a specified Person [Scattered], another Person that directly, or indirectly through one or more intermediaries, Controls or is Controlled by or is under common Control with the Person Specified [Scattered].

Control means the possession, directly or indirectly, of the power to direct or cause the direction of the management or policies of a Person, whether through the ability to exercise voting power, by contract or otherwise.

As stipulated by the parties, H & M is owned 100% by Anglo American and Anglo American is owed 100% by Scattered.

35. In turn, paragraphs 115–116 of the Counterclaim relate to Greenblatt's claim for indemnification under the LLC Regulations.

JPTO at 11, ¶¶ 13, 16. Based upon the unambiguous language of the DIP Agreement, coupled with the parties' stipulations, it is clear that, at the relevant time, Scattered owned and controlled Anglo American, and, in turn, Anglo American owned and controlled H & M. As such, both Anglo American and H & M were Affiliates of Scattered. As an Affiliate of Scattered, H & M's directors, officers, employees, agents, attorneys and advisors each qualified as a Related Party. Thus, the Court finds that, as H & M's Manager, Greenblatt qualifies as an Indemnitee under § 8.4(b) of the DIP Agreement.

b) The Indemnification Provision Covers the Activities that are the Subject of the Complaint.

Next, the Trustee argues that Greenblatt's alleged breaches of fiduciary duty arise independently from the DIP Agreement and, as such, do not fall within the scope of DIP Agreement's indemnity provision. To analyze this argument, the Court must consider the relevant provisions of the DIP Order, the DIP Agreement, and the Complaint.

The DIP Order shows that the primary purpose of the DIP Agreement was to provide funding for H & M's drilling program. "H & M, having advised the Court that it intends to undertake a drilling program to increase the value of its bankruptcy estate, does not have sufficient available sources of working capital or cash to operate its business without the proposed DIP Financing from [Scattered].... Given the need to undertake drilling to maintain lease rights, absent the granting of relief as requested herein, the Debtors and their estates will suffer immediate and irreparable harm." DIP Order [Gr. Ex. I.1] at ¶ F.

Turning next to the DIP Agreement, § 8.4(b) states, in relevant part, that:

> [t]he **Debtors shall indemnify [each Indemnitee] against,** and to hold each Indemnitee harmless from, any and **all losses, claims, damages, liabilities** and related expenses, including the fees, charges and disbursements of any counsel for any Indemnitee, incurred by or asserted against any Indemnitee **arising out of, in connection with, or as a result of** (i) the execution or delivery of this Agreement and each other or any agreement or instrument contemplated hereby, **the performance by the parties hereto of their respective obligations hereunder or the consummation of the Transactions [1] or any other transactions contemplated hereby** ... **or (v) any actual** ... **litigation** ... **relating to any of the foregoing,** whether based on contract, tort or any other theory and regardless of whether any Indemnitee is a party thereto....

DIP Agreement [Gr. Ex. H.1] at § 8.4(b) (emphasis added). The plain and unambiguous language of this provision contains an indemnification for damages and liabilities, including attorneys' fees and expenses, "arising out of, in connection with, or as a result of" the parties' performance under the DIP Agreement.

Finally, a review of the Complaint shows that each of Greenblatt's alleged breaches arise out of, in connection with, or as a result of H & M's performance under the DIP Agreement while Greenblatt was its Manager. Indeed, the Trustee summarizes the alleged breaches in his post-trial brief, generally as follows: (1) failing to timely pay for drilling costs [from funds drawn under the DIP Agreement], (2) failing to timely request funds under the DIP Agreement to pay drilling and completion costs, (3) instructing Jones to delay the first draw under the DIP Agreement, (4) allowing H & M to be declared a non-consenting party for failure to prepay expenses [from funds drawn under the DIP Agreement], (5) subjecting H & M to significant risk for failure to pay completion costs [from funds drawn under the DIP Agreement], (6) creating a situation whereby H & M was immediately in default under the cash collateral order [by failing to prepay completion costs with funds drawn under the DIP Agreement], (7) failing to timely take action against Scattered for refusing to fund the Disputed DIP Requests, (8) putting H & M's access to DIP financing at risk, and (9) putting H & M's acreage at risk for failure to meet drilling obligations [by failing to draw funds under the DIP Agreement]. *See* Trustee's Post–Trial Brief [Dkt. No. 172] at ¶ 11. Clearly, the Trustee's allegations would not exist absent the DIP Agreement and, as such, do not arise independently from the DIP Agreement (as alleged by the Trustee) so as to remove Greenblatt from the ambit of the agreement's indemnity provision.

Accordingly, based upon the plain and unambiguous language of the DIP Agreement, the Court finds and concludes that Greenblatt is an "Indemnitee" under the DIP Agreement and that his alleged actions arose out of, in connection with, or as a result of H & M's performance under the DIP Agreement, while Greenblatt was acting as its Manager, and fall under the scope of the indemnity provisions of § 8.4(b) of the DIP Agreement. Thus, Greenblatt is entitled to indemnification for "all losses, claims, damages, liabilities and related expenses, including the fees, charges and disbursements of any counsel" incurred in defending against the Trustee's claims against him. DIP Agreement [Gr. Ex. H.1] at § 8.4(b).

c) The Indemnification Provision of the DIP Agreement is Enforceable Under Applicable Law.

Now that the Court has determined that Greenblatt qualifies as an Indemnitee under the DIP Agreement and that the Trustee's claims are within the scope of § 8.4(b) of the DIP Agreement, it must determine whether § 8.4(b) is enforceable under applicable law. In arguing that § 8.4(b) is not enforceable, the Trustee alleges that: (1) the DIP Agreement is an ambiguous contract that must be construed against Scattered and in favor of H & M, and (2) the indemnity provisions do not comport with the "fair notice" requirements under Texas law. The Court will address these arguments in turn.

First, the Trustee argues that the DIP Agreement, particularly the indemnity provision, is ambiguous and should be construed against Scattered and in favor of H & M. Trustee's Pre–Trial Brief [Dkt. No. 125] at ¶¶ 62, 64–65. When pressed at trial, however, the Trustee's counsel admitted that his allegations of ambiguity were not pleaded in the Complaint or in his answer to the Answer and Counterclaim. Further, although the issue of ambiguity is found in the JPTO, it was included with the express annotation that both Scattered and Greenblatt objected to its inclusion because it was outside the scope of the Trustee's pleadings. JPTO at 45, ¶ 183 ("Contested Issues of Law")

Given the Trustee's failure to plead ambiguity and the Defendants' objection to its inclusion in the JPTO, the Court concludes that the Trustee waived his argument that the DIP Agreement is ambiguous. *Arsement v. Spinnaker Exploration, Co., LLC,* 400 F.3d 238, 246 (5th Cir.2005) ("It goes without saying that a pre-trial order controls the scope and course of trial; a claim or issue not included in the order is waived, unless presented at trial without objection"). Nonetheless, the Court has reviewed the DIP Agreement and finds that the document, including the indemnity provision, is not ambiguous and will, therefore, decline the Trustee's request that the indemnity provisions be construed against Scattered.[36]

[41–43] The Trustee next argues that, under Texas law, the indemnity provision of the DIP Agreement is unenforceable. Trustee's Pre–Trial Brief [Dkt. No. 125] at ¶¶ 66–71. According to the Trustee, to be enforceable, the indemnity provision must satisfy the "fair notice" requirements, which include: (1) the "express negligence rule," and (2) the conspicuousness requirement. *Dresser Indus. v. Page Petroleum, Inc.,* 853 S.W.2d 505, 508 (Tex.1993). As summarized by the Texas Supreme Court:

> A contract which fails to satisfy either of the fair notice requirements when they are imposed is unenforceable as a matter of law. *See Dresser Indus., Inc. v. Page Petroleum, Inc.,* 853 S.W.2d 505, 509–10 (Tex.1993); *see also U.S. Rentals, Inc. v. Mundy Serv. Corp.,* 901 S.W.2d 789, 792 (Tex.App.–Houston [14th Dist.] 1995, writ denied). One fair notice requirement, the express negligence doctrine, requires that "the intent of the parties must be specifically stated in the four corners of the contract." *Ethyl Corp. v. Daniel Constr. Co.,* 725 S.W.2d 705, 707 (Tex.1987). The other requirement, of conspicuousness, mandates "that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it." *Dresser,* 853 S.W.2d at 508 (quoting *Ling & Co. v. Trinity Sav. & Loan Ass'n,* 482 S.W.2d 841, 843 (Tex. 1972)). Language may satisfy the conspicuousness requirement by appearing in larger type, contrasting colors, or otherwise calling attention to itself. *Littlefield v. Schaefer,* 955 S.W.2d 272, 274–75 (Tex.1997). However, if both contracting parties have actual knowledge of the [benefits] plan's terms, an agreement can be enforced even if the fair notice requirements were not satisfied. *Dresser,* 853 S.W.2d at 508 n. 2 (citing *Cate v. Dover Corp.,* 790 S.W.2d 559, 561 (Tex. 1990)).

Storage Processors, Inc. v. Reyes, 134 S.W.3d 190, 192 (Tex.2004) (footnote omitted).

[44] As to the conspicuousness requirement, an indemnity clause must satisfy the standard of conspicuousness in the Texas Business and Commerce Code. *Dresser,* 853 S.W.2d at 511 ("We thus adopt the standard for conspicuousness contained in the [Business & Commerce] Code for indemnity agreements.... When a reasonable person against whom a clause is to operate ought to have noticed it, the clause is conspicuous."); *Enron Corp. Sav. Plan. v. Hewitt Assocs., L.L.C.,* 611 F.Supp.2d 654, 672 (S.D.Tex.2009). Pursuant to the Texas version of the Uniform Commercial Code:

> "[c]onspicuous," with reference to a term, means so written, displayed, or presented that a reasonable person against which it is to operate ought to have noticed it. Whether a term is "conspicuous" or not is a decision for the court. Conspicuous terms include the following: (A) a heading in capitals equal to or greater in size than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same or lesser size; and (B) language in the body of a record or display in larger type than the surrounding text, or in contrasting type, font, or color to the surrounding text of the same size, or set off from surrounding text of the

36. The Court also notes that there is no evidence in the record indicating which party drafted the DIP Agreement.

same size by symbols or other marks that call attention to the language.

TEX. BUS. & COMM.CODE § 1.201(10).

The indemnification provision at issue here is found in Article 8 of the DIP Agreement titled "Miscellaneous," which contains a hodgepodge of 12 sections addressing matters ranging from where notices should be sent and the validity of the electronic transmission of documents to execution of the document in multiple counterparts and the severability of provisions. Tucked in among these is § 8.4, which is titled "Expenses: Indemnity: Damage Waiver." The text of Section 8.4(b) is neither in capitals nor bold. Instead, the font matches that contained in various other provisions of the DIP Agreement, including the more mundane provisions of Article 8. There is simply nothing in the text or presentation of § 8.4(b) that sets it apart from the remainder of the agreement or that would otherwise draw a reasonable person's notice.

Accordingly, the Court finds that § 8.4(b) fails to meet the conspicuousness requirement under Texas law. And, because the fair notice elements are interpreted in the conjunctive, the Court need not address whether the provision meets the express negligence rule. Thus, unless an exception to the fair notice requirements applies, the indemnification provision is not enforceable under Texas law.

As stated above, however, an exception to the fair notice requirements exists when the indemnitor had actual notice or knowledge of the indemnification provision. *Cleere Drilling Co. v. Dominion Expl. & Prod., Inc.*, 351 F.3d 642, 647 (5th Cir. 2003) ("Even if we assume ... that the pertinent language of the Contract is not sufficiently conspicuous to meet the second prong of the subject test, we are convinced that the requirement of fair notice—both elements, *i.e.*, express negligence and conspicuousness—is irrelevant in the face of Dominion's actual knowledge of the subject provisions of the Contract."); *Dresser,* 853 S.W.2d at 508 n. 2. This exception is a question of fact. *Enron,* 611 F.Supp.2d. at 674. "Actual notice or knowledge is in the nature of an affirmative defense to a claim of lack of fair notice." *U.S. Rentals,* 901 S.W.2d at 793. Therefore, the indemnitee bears the burden of proving notice or knowledge of the agreement. *Id.* Types of evidence that an indemnitee can use to meet its burden include evidence of specific negotiation of the indemnity, evidence of prior dealings of the parties, or "proof that the provision had been brought to the indemnitor's attention." *Enron,* 611 F.Supp.2d. at 673.

Here, there is no doubt in the Court's mind that H & M was aware of the indemnification provision in the DIP Agreement. Notably, the DIP Agreement was approved by this Court at H & M's specific request. *See* DIP Order [Gr. Ex. I.1] at 1 ("Came on to be considered the Debtor's Application...."); JPTO at 12, ¶ 26 ("On July 2, 2012, H & M sought the Court's approval to enter into a post-petition loan agreement with Scattered [Doc. No. 87]."). Indeed, the motion for approval of the DIP Agreement was filed and prosecuted on H & M's behalf by its bankruptcy counsel, Anderson Tobin, PLLC, a firm with a not insignificant bankruptcy practice. *See id.* at 12 (reflecting signature of attorney Aaron Tobin of Anderson Tobin, PLLC on H & M's behalf). Indemnity provisions, like the one contained in the DIP Agreement, are almost always included in debtor-in-possession financing agreements, as any experienced bankruptcy counsel knows. Further, although the Trustee himself may not have had actual knowledge of § 8.4(b) of the DIP Agreement, because negotiation and execution of the document occurred prior to his appointment, it is H &

M's knowledge on this point that is relevant. Based on the facts of this case, the Court concludes that it is appropriate to impute H & M's actual knowledge of the indemnity provision to the Trustee. *See, e.g., Askanase v. Fatjo,* 130 F.3d 657, 666–67 (5th Cir.1997) (addressing imputation of officers' and directors' knowledge to debtor and, thus, to court-appointed trustee of debtor's bankruptcy estate).

After careful consideration of the facts, the Court finds that H & M, acting through Greenblatt as its Manager, had actual knowledge of the indemnification provision set forth in the DIP Agreement. Thus, the Court concludes that the indemnification provision found at § 8.4(b) of the DIP Agreement is enforceable and need not comply with the fair notice requirements.

3. Determination of the Amount and Priority of Greenblatt's Claims for Indemnification Under the LLC Regulations and the DIP Agreement.

The Court will now turn to the amount and priority of Greenblatt's claims for indemnification. Initially, Greenblatt requested indemnification for his attorneys' fees incurred in defending against the Trustee's claims in the amount of $427,227.50 and $28,861.10 in related expenses, plus prospective fees in the event that a judgment in Greenblatt's favor is appealed.[37] Affidavit of Rosa Orenstein [Gr. Ex. R.4] at ¶¶ 8–9. The Trustee objected to certain of these fees at the hearing and, as a result, Greenblatt modified his request to $420,710 [38] in attorneys' fees and $28,831.40 in expenses, plus prospective fees in the event that a judgment in Greenblatt's favor is appealed. Revised Fee Summary [Gr. Ex. R.4.A]. With these agreed-upon reductions, the Trustee's counsel stated on the record that, subject to this Court's *in camera*[39] review of the unredacted time entries and verification that none relate to a separately-pending adversary,[40] the Trustee had no further objection to the amounts requested.

Based upon its independent review of Gr. Ex. R.4.C, the Court finds that an additional $565.00 in fee reductions is appropriate, as follow:

Date	Timekeeper	Rate	Hours	Reduction
11/14/13	NMN	$225	.1	$22.50
11/15/13	NMN	$225	1.1	$247.50
11/18/13	NMN	$225	.2	$45.00
12/05/13	NMN	$225	.5	$112.50
12/10/13	NMN	$225	.5	$112.50
01/29/14	NMN	$250	.1	$25.0
Total:				**$565.00**

37. The requested amounts are: (1) $30,000 for post-trial motions before this Court, (2) $35,000 for an appeal to the district court, (3) $25,000 for an appeal to the Fifth Circuit, (4) $25,000 for an application for writ of certiorari to the U.S. Supreme Court, and (5) $15,000 if that writ is granted. Affidavit of Rosa Orenstein [Gr. Ex. R.4] at ¶ 9.

38. Gr. Ex. R.4.A lists initial fees requested as $427,227.50, with voluntary reductions of $6,220. While on the stand, however, Greenblatt's counsel testified that an additional fee reduction of $297.50 was accidentally excluded, so that voluntary reductions totaled $6,517.50, not $6,220; thus total requested fees total $420,710, not the $421,007.50 reflected on Gr. Ex. R.4.A.

39. Unredacted copies of the invoices underlying Greenblatt's indemnity claim were admitted into evidence under seal and provided to the Court for *in camera* review. Invoices [Gr. Ex. R.4.C].

40. *Brickley v. Greenblatt,* Adv. Proc. No. 13–3214 (the "**1519 Main Adversary Proceeding**").

Each of the above-referenced entries appears to be related to the 1519 Main Adversary Proceeding and, based upon the information provided in Gr. Ex. R.4.B, was not previously removed from Greenblatt's calculation.

With this additional reduction, the Court finds that Greenblatt is entitled to indemnification for $420,145 in attorneys' fees incurred in defending against the Trustee's claims and $28,831.40 in related expenses, plus the following amounts should the Trustee appeal the judgment to be entered in accordance with this Memorandum Opinion: (1) $30,000 for post-trial motions before this Court, (2) $35,000 for an appeal to the district court, (3) $25,000 for an appeal to the Fifth Circuit, (4) $25,000 for an application for writ of certiorari to the U.S. Supreme Court, and (5) $15,000 if that writ is granted. Further, the Court finds that such amounts represent reasonable attorneys' fees and expenses in relation to this adversary proceeding and any resulting appeal.

Now that the Court has determined the amount of Greenblatt's indemnification claim, it will turn to the priority of such claim. Greenblatt argues, and the Trustee agrees, that any allowed indemnification claim arising under the DIP Agreement should be entitled to priority as an administrative claim against H & M's Chapter 11 bankruptcy estate, while any allowed indemnification claim arising under the LLC Regulations should be classified as a general unsecured claim. *See* Plaintiff Douglass J. Brickley's Post–Trial Brief [Dkt. No. 172] at ¶ 22 ("Thus, if this Court finds that Mr. Greenblatt is entitled to indemnification under the DIP Agreement, it would appear that Mr. Greenblatt would be entitled to assert a Chapter 11 administrative expense claim.... Similarly, if the Court concludes that Mr. Greenblatt is entitled only to indemnification under H & M's Amended Regulations, ... then Mr. Greenblatt's indemnification claim should be an unsecured claim."); Leon A. Greenblatt, III's Post Trial Brief [Dkt. No. 172] at ¶ 31 ("Greenblatt's indemnification claim under the DIP Agreement is asserted as a Chapter 11 administrative expense claim....", while indemnification under the LLC regulations would be a general unsecured claim.). Despite the parties' agreement on this issue, the Court will nonetheless analyze the asserted priority for each claim.

As explained in § II.C, *supra,* to be entitled to administrative expense priority, a claim must meet the requirements of 11 U.S.C. § 503(b). According to the Fifth Circuit,

> In order to qualify as an "actual and necessary cost" under section 503(b)(1)(A), a claim against the estate must have arisen postpetition and as a result of actions taken by the trustee that benefitted the estate. *See Toma Steel Supply, Inc. v. TransAmerican Natural Gas Corp. (In the Matter of TransAmerican Natural Gas Corp.),* 978 F.2d 1409, 1416 (5th Cir.1992) (finding that a "prima facie case under § 503(b)(1) may be established by evidence that (1) the claim arises from a transaction with the debtor-in-possession; and (2) the goods or services supplied enhanced the ability of the debtor-in-possession's business to function").

Total Minatome Corp. (In the Matter of Jack/Wade Drilling, Inc.), 258 F.3d 385, 387 (5th Cir.2001); see also *Lasky,* 262 B.R. at 918 (N.D.Tex.2001) ("Accordingly, an expense is entitled to administrative priority treatment only if (1) it results from a transaction between the claimant and the trustee of the bankruptcy estate or a debtor in possession; and (2) the benefit to the debtor, and hence the right to payment, accrues post-petition."), *aff'd,* 288 F.3d 730 (5th Cir.2002). The Court will address the two factors established by the Fifth Circuit in turn.

[45] First, it is undisputed that Greenblatt's indemnification claim under the DIP Agreement arises from a postpetition transaction between debtor-in-possession H & M and Scattered. *See* JPTO at 12, ¶¶ 26–28. Further, as discussed in § II.E.2.b), *supra,* the Trustee's allegations against Greenblatt all arise out of, in connection with, or as a result of H & M's performance under the DIP Agreement while Greenblatt was its Manager. Thus, the Court finds that Greenblatt has satisfied the first prong.

Second, the purpose behind H & M and Scattered entering into the DIP Agreement was to supplement H & M's use of cash collateral so that it could undertake its drilling program. As reflected in the DIP Order, which was agreed to by H & M's counsel, "[t]he ability of the Debtors to immediately obtain sufficient working capital and liquidity through the DIP Financing is vital to the preservation and maximization of the value of the Debtors' assets and properties . . . . Given the need to undertake drilling to maintain lease rights, absent the granting of the relief as requested herein, the Debtors and their estates will suffer immediately and irreparable harm." DIP Order [Gr. Ex. I.1] at ¶ F. Further, the evidence shows that (1) H & M requested $800,000 in advances, (2) Scattered funded the full amount requested, and (3) the funds advanced by Scattered to H & M were of benefit to the estate. Although the fees and expenses incurred by Greenblatt did not themselves benefit the estate, Scattered's lending under the DIP Agreement clearly did and the postpetition agreement to indemnify was incurred so that H & M could receive the funding it required. Thus, the Court finds that Greenblatt has also met the second prong. Accordingly, the Court concludes that Greenblatt's indemnification claim under the DIP Agreement should be allowed as an administrative expense of H & M's Chapter 11 estate.

As noted previously, Greenblatt also alleges that he is entitled to indemnification under the terms of the LLC Regulations. Because Greenblatt does not allege that this claim is entitled to priority, the Court need not analyze the claim under 11 U.S.C. § 503(b). *See* Greenblatt's Post–Trial Brief [Dkt. No. 170] at ¶ 31. Accordingly, and in the event that this Court erred in allowing Greenblatt's indemnification claim under the DIP Agreement, the Court concludes that Greenblatt's indemnification claim under the LLC Regulations should be allowed as a general unsecured claim in H & M's bankruptcy case.

III. CONCLUSION

For the reasons explained herein, the Trustee takes nothing by his Complaint. Greenblatt is entitled to a judgment in his favor on his counterclaim for indemnification under the DIP Agreement in the amount of $448,976.40, plus prospective costs in the event that such judgment is appealed in the following amounts: (1) $30,000 for post-trial motions before this Court, (2) $35,000 for an appeal to the district court, (3) $25,000 for an appeal to the Fifth Circuit, (4) $25,000 for an application for writ of certiorari to the U.S. Supreme Court, and (5) $15,000 if that writ is granted, which shall be allowed as an administrative expense claim against H & M's Chapter 11 bankruptcy estate. Alternatively, if the Court erred in allowing Greenblatt's indemnification claim under the DIP Agreement, Greenblatt is entitled to a judgment in his favor on his counterclaim for indemnification under the LLC

Regulations in the same amounts, which shall be allowed as a prepetition general unsecured claim in H & M's bankruptcy case.

A judgment reflecting this ruling shall be entered separately. The Court hereby directs the parties' counsel to confer with each other and attempt to submit an agreed form of judgment consistent with this Memorandum Opinion to the Court within ten days of the entry of this Memorandum Opinion on the Court's docket. If no agreement can be reached, each party shall submit its own proposed form of judgment on or before the tenth day after entry of this Memorandum Opinion on the Court's docket, along with an explanation of why the other side's proposed judgment is improper.

In re Cody W. SMITH, Debtor.

Lowell T. Cage, Trustee, Plaintiff,

v.

Cody W. Smith & Tracy G. Smith, Defendants.

Bankruptcy No. 12–32096.
Adversary No. 14–03115.

United States Bankruptcy Court,
S.D. Texas,
Houston Division.

Signed Aug. 4, 2014.

Background: Chapter 7 trustee brought adversary proceeding to compel turnover of homestead proceeds that debtor had not reinvested in another homestead within six months of sale, and debtor moved to dismiss.

Holdings: The Bankruptcy Court, Jeff Bohm, Chief Judge, held that:

(1) allowed homestead exemption that debtor acquired, with no objection by any party in interest, in certain Texas realty was acquired subject to all the limitations set forth in Texas homestead exemption statute, including condition that, if debtor later sold property, he would have to reinvest proceeds in another homestead within six months to avoid losing homestead protection for proceeds;

(2) that debtor, prior to sale of homestead property, had already received his bankruptcy discharge did not alter fact that this sale triggered six month time limit for debtor to reinvest proceeds; and

(3) trustee did not have to file conditional objection to Texas state law homestead exemption validly claimed by debtor in residential Texas realty in order to preserve right to seek turnover.

Motion denied.

1. Bankruptcy 🔑2050

Regardless of whether bankruptcy court, as non-Article-III court, had constitutional authority to enter final decision on complaint filed by Chapter 7 trustee to compel turnover of proceeds from sale of debtor's homestead, because debtor had not reinvested proceeds in new homestead within requisite six month period allowed by Texas law, court had authority to deny debtor's motion to dismiss trustee's complaint as failing to state claim, as denial of motion was not final decision, and did not end litigation on merits. V.T.C.A., Property Code § 41.001(c).

2. Bankruptcy 🔑2793, 3063.1
Homestead 🔑77

Allowed homestead exemption that Chapter 7 debtor acquired, with no objection by any party in interest, in certain Texas realty was acquired subject to all of

4.

1924 CarswellAlta 11
Alberta Supreme Court [Appellate Division]

J.D. McArthur Co. v. Alberta & Great Waterways Railway

1924 CarswellAlta 11, [1924] 2 W.W.R. 1, [1924] 2 D.L.R. 118, 20 Alta. L.R. 174

J. D. McArthur Company, Limited (Plaintiff) Respondent v. Alberta and Great Waterways Railway Company (Defendant) Appellant

Scott, C.J., Stuart, Beck, Hyndman and Clarke, JJ.A.

Judgment: February 29, 1924

Counsel: *Frank Ford, K.C.*, and *H. H. Parlee, K.C.*, for defendant, appellant.
S. B. Woods, K.C., for plaintiff, respondent.

Subject: Corporate and Commercial; Property; Contracts
Related Abridgment Classifications
Business associations
III Specific matters of corporate organization
III.1 Directors and officers
III.1.g Fiduciary duties
III.1.g.iii Self-dealing transactions
III.1.g.iii.C Miscellaneous
Commercial law
V Sale of goods
V.5 Statutory contract
V.5.h Warranty
V.5.h.ii Implied warranty
V.5.h.ii.C Title free from encumbrance
Headnote
Corporations --- Directors and officers — Fiduciary duties — Self-dealing transactions — General
Sale of Goods --- Statutory contract — Warranty — Implied warranty — Title free from encumbrance
Sale of Goods — Companies — Contract — Sale of Goods Act, Alta. S. 14 — Implied Condition as to Title and Warranty as to Quiet Possession — Question Whether Circumstances "Such as to Show a Different Intention" — Sale by One Company to Another — Certain Persons Officials of Both Companies — Constructive Notice of Defect in Title — Imputation of Knowledge as a Matter of Law — Goods Covered by Description in Mortgage Given by Vendor Company to Secure Debentures — Terms of Act Authorizing the Mortgage — Description in Mortgage Extending Beyond That Given in the Act — Actual Intention of the Parties in Making the Sale — Subsequent Release of Liabilities Executed by Purchaser in Favour of Vendor — Scope and Effect of Release.
The defendant company, in 1909, made a mortgage to secure debentures, these debentures being guaranteed by the Alberta Government. The Act authorizing the guarantee provided that the mortgage was to cover the railway and terminals and also "the rolling stock and equipment present and future acquired for the purposes of the said lines" as well as the tolls, revenues, etc. The mortgage by its operative clause was extended to cover "the present and future rolling stock and equipment acquired for the purpose of the said lines and all real and personal property now or hereafter held or acquired for the purpose of the said lines and works connected therewith."
Defendant, after construction of its railway, owned a quantity of rails and fastenings left unused. It leased them to a lumber company for a spur to the latter's timber limits. When no longer required for that purpose (and the rails

having been damaged by fire) the defendant in 1919 sold them to the plaintiff, a construction company, controlled by M., who also had in 1913 acquired control of defendant company. As defendant was heavily indebted to plaintiff for construction work and advances, the purchase-price was, by agreement, credited on this indebtedness. Before any removal was attempted of these rails, etc., the Alberta Government, under an agreement in 1920, subsequently ratified by statute, ch. 54 of 1921, acquired the stock of defendant company, and, pursuant to an undertaking by M. in said agreement, plaintiff company released and forever discharged the defendant company "from all its present liabilities" to plaintiff "under construction contracts or otherwise."

Defendant company, now under Government control, subsequently disputed plaintiff's right to delivery of the rails and fastenings. In an action brought by the trustee mortgagee and the Government, Walsh, J. [1923] 3 W.W.R. 41, held that they were covered by the bond mortgage. But in the present action he held [1923] 3 W.W.R. 46, that, unless defendant could procure the discharge of said rails, etc., from the mortgage and so make good title and delivery, it was liable to plaintiff for the amount of the price thereof. This judgment was, in its effect, affirmed on appeal, Hyndman and Clarke, JJ.A. dissenting.

Stuart, J.A. held that the implied condition and warranty under sec. 14 of *The Sale of Goods Act* applied to the sale; that "the circumstances of the contract" were not "such as to show a different intention"; although the defendant company, having itself executed the mortgage, must be held as a matter of law to have had continued knowledge of its terms (notwithstanding that its control and entire staff of officials had been changed) yet the fact that certain persons were directors or officials of both companies did not, as a matter of law, impute notice to the plaintiff; even if notice of the Act authorizing the mortgage must be imputed to the plaintiff, notice of the terms of that Act would not (in view of the Act not employing the extended terms used in the operative clause of the mortgage as shown above) necessarily imply notice that the rails in question were covered by the mortgage; but in any case, even if, as a matter of law, there was imputable to the parties knowledge of the mortgage and constructive notice of its terms, it was quite another thing to say that the Court must find upon the facts that the vendor and purchaser intended there should be no implied condition that the vendor was to give a good title to the goods; it was in fact intended that a good title should be given to plaintiff; the burden of proof was to show an intention that there should be no such condition, and that had not been established; that the release, read in the light of the recitals in the agreement which stipulated that it should be given, and under all the circumstances, having regard to the fact that the dispute had not then emerged and no question about it had arisen, did not cover defendant's liability upon the implied condition or warranty created by sec. 14 of *The Sale of Goods Act*.

Scott, C.J. agreed in the result reached by Stuart, J.A.

Beck, J.A. held that the rails, etc., in question were not covered by the description of the property to be mortgaged as given in the Act authorizing the mortgage, and the added words in the mortgage were unauthorized and ineffective; otherwise he agreed substantially with Stuart, J.A.

Hyndman, J.A., dissenting, held that the circumstances of the contract were such as to show that there was no implied warranty of title; that, in view of the law that all persons dealing with a company are presumed to have notice of any statutes affecting the company, and of its regulations, and therefore to have notice of any restrictions upon the authority of directors and any formalities prescribed for the exercise of their powers, it must be assumed that plaintiff had at least constructive notice of defendant's affairs as to disposing of any of its assets with respect to the mortgage thereon; further, in view of the close re lationship between the two companies, the plaintiff must be held to have been aware of the mortgage and its effect.

Clarke, J.A., dissenting, held that the rails, etc., in question were subject to the mortgage, especially in view of the decision to that effect of Walsh, J. [1923] 3 W.W.R. 41, which judgment still stood; that the circumstances of the sale were such as to negative any implied condition of the right to sell, i.e., to give a perfect title, but were not such as to negative the implied warranty for quiet possession; but that the release included any liability of defendant thereunder or any liability such as was sought to be enforced in the action.

Appeal by defendant from judgment of Walsh, J. ([1923] 3 W.W.R. 46) holding plaintiff entitled, as between the parties, to delivery of certain rails and fastenings, under a contract of sale thereof, and, in default of good title and delivery being made, holding plaintiff (the purchaser) entitled to recover from defendant the amount of the purchase-price (credited to defendant at time of sale) with interest. The facts are set out in the judgment of Stuart, J.A., and are indicated in the first three paragraphs of the above headnote. Appeal dismissed with costs, with a slight modification. Hyndman and Clarke, JJ.A. dissented.

The appeal was heard by SCOTT, C.J., STUART, BECK, HYNDMAN and CLARKE, JJ.A.

***Scott, C.J.*:**

1 I agree in the result reached by Mr. Justice Stuart.

***Stuart, J.A.*:**

2 The defendant company was incorporated by Act of the provincial Legislature in 1909 with power to construct and operate a railway and power to issue debentures. By another Act of the same year the Lieutenant-Governor in Council was authorized upon certain conditions to guarantee these bonds or debentures which were to be secured by a mortgage to trustees covering the railway and terminals and also "the rolling stock and equipment present and future acquired for the purpose of the said lines," as well as the tools, rev enues, etc. The Standard Trust Company was selected as the trustee to whom the mortgage should be given.

3 On October 28, 1909, the mortgage, the parties to which were the defendant company, the said trustee, and also His Majesty as represented by the Government of Alberta, was executed. This mortgage recited the above-mentioned legislation, including the provision above quoted as to the mortgage covering "the rolling stock and equipment present and future acquired for the purpose of the railway." It contained a guarantee by the Government of the debentures or bonds secured by the mortgage. The operative clause of the mortgage, however, contained somewhat wider language than that used in the statute and in the recital. It covered "the present and future rolling stock and equipment acquired for the purpose of the said lines and *all real and personal property now or hereafter held or acquired for the purpose of the said lines and works connected therewith*."

4 Clause 12 of the mortgage provided that the directors of the company might at any time require the trustee to discharge from the operation of the mortgage certain portions of the property covered by it if declared by resolution of the company concurred in by the trustees to be unnecessary for its purposes and that the trustee should then upon the consent of the Government discharge such property from the mortgage. The clause then proceeded to say:

> And it is further declared that the company from time to time may with the like consent of the Government sell or dispose of any part of the equipment rolling stock motors machinery implements and other materials at any time held or acquired for the use and purposes of the said company

as might by resolution be declared to be no longer useful or necessary for the company's business.

5 It appears that the plaintiff company was what is generally known as a construction company and had contracted with the defendant company to build the line of railway authorized by the above-mentioned legislation. The railway had been built and the defendant company was in the fall of 1919 still indebted to the plaintiff in respect of this construc tion contract and in respect of advances in the way of loans in a very large sum of money, amounting in round figures to about $1,050,000. It is clear from the evidence that the plaintiff company had advanced as much as $5,000,000 to the defendant company by way of loan. What proportion, however, of the $1,050,000 was for construction cost and what proportion was due in respect of these advances or whether, indeed, the two were ever kept separate, does not very clearly appear from the evidence.

6 It also appears that Mr. J. D. McArthur completely controlled both the plaintiff company and the defendant company. He owned about three-fourths of the stock of the plaintiff and practically all that of the defendant.

7 In carrying out the construction of the railway the plaintiff company had purchased, of course, large quantities of equipment, rails and fastenings, and the purchase-price of these was charged up to and paid by the defendant company.

8 It may also be mentioned that Mr. J. D. McArthur owned or controlled either personally or through the plaintiff company other lines of railway in the province, of which one was the Edmonton and Dunvegan Railway, and the evidence is that there was considerable interchange of material and supplies between his companies and that upon the original purchase of the large lot of rails, of which the rails in question in this action were part, it was not definitely intended that they should certainly all be used for the purposes of the defendant company alone.

9 After the completion of the railway there was a quantity of these rails and fastenings left unused. Mr. McArthur, or rather, perhaps, the plaintiff company, controlled also a third company called the North West Lumber Company, Limited, a subsidiary company to the plaintiff, which owned some timber limits adjacent to the railway which had been constructed. This company, desiring to get the lumber or timber from these limits was obliged to construct a spur track some six or seven miles in length in order to connect with the defendant's railway. Some time prior to 1919 the defendant leased these unused rails and fastenings to the North West Lumber Co., Ltd., for a yearly rental, and they were laid down on this spur track which was used and operated by the lumber company and not by the defendant company. The timber limits were partly exhausted and partly destroyed by a fire which ran through them and which also injured considerably the rails which had been leased.

10 To set forth the succeeding facts I now quote from the evidence of Thomson, vice-president of the plaintiff company, as follows:

> Well, at Edmonton, in the fall of 1919, the matter was brought up by the manager of the railway company, the general manager, who took the position that as the rails had been damaged while in the service of the lumber company, they should be acquired by the lumber company; that the railway company should be reimbursed for them. The lumber company was not financially in a position to take them, but the McArthur Company was an enormous creditor of the railway company at that time, and the McArthur Company expressed themselves as being willing to purchase these rails from the railway company at a price to be fixed by the general manager of the railway company based on the then value of steel, the price being considerably more than had been paid by the railway company for the steel in the first place. The directors of the railway company had a meeting here in Winnipeg shortly after the conversation in Edmonton and they passed a resolution authorizing the sale of the rails to the McArthur Company. This was communicated to the general manager and he completed the transaction and the railway company was credited with the amount of the purchase price of the rails on the indebtedness of the railway company to the McArthur Company at that time.

11 I quote also from the minutes of a meeting of the board of directors of the defendant company held on November 28, 1919, as follows:

> The Chairman referred to a quantity of rails and fastenings which had been used for some years past by the North West Lumber Company, Ltd., in connection with its log spur near mile 100, and to the fact that these rails and fastenings had been badly damaged through use in the log spur, and by fire. He reported that efforts had been made to persuade the North West Lumber Company, Ltd., to purchase these rails and fastenings from the railway company, but without success, and that the J. D. McArthur Company, Limited, had expressed its willingness to buy the rails and fastenings and credit the purchase price on the indebtedness of this company to it.
>
> On motion duly made and seconded it was unanimously resolved that the Chief Engineer and General Manager of the Company be authorized to sell the rails and fastenings in the said spur to the J. D. McArthur Company, Limited, at the now current prices for such rails and fastenings.

12 The only record of this transaction other than the above minute is contained in a credit for $43,615.50, the price agreed upon, which was entered in favour of the defendant company on the books of account of the plaintiff company — a credit, that is, against the above-mentioned indebtedness of $1,050,000 — and in two reciprocal vouchers which

passed between the two companies referring to the transaction and showing its details. The voucher of the defendant company was duly signed by W. R. Smith, its general manager.

13 The rails and fastenings were, however, left where they had been for some months. In the meantime a great change took place in the position of the defendant company. It had become unable to meet the interest charges on its bonds. Mr. McArthur informed the Premier of the province that the defendant company could not carry on any longer. It was indebted to the Union Bank in the sum of $710,000. Accordingly in July, 1920, an agreement was entered into between Mr. McArthur personally and the Premier as Minister of Railways, whereby all the stock of the company was to be transferred to the Minister and McArthur was to pay the Union Bank the $710,000 and secure the release by the plaintiff company of all its claims against the railway as well as release all his personal claims against it. There was also an option in McArthur to repurchase the shares within three years upon specified terms. This agreement was later on in 1921 ratified by statute, ch. 54 of 1921, and is the schedule thereto. The members of the Executive Council of the province were made by this statute directors of the company and the Deputy Minister of Railways, Mr. Harvey, became general manager.

14 On July 23, 1920, the following release was executed by the plaintiff company in pursuance of the agreement by McArthur to obtain it.

> **Release**
>
> Know all men by these presents that J. D. McArthur Company Limited for divers good and valuable consideration doth hereby release and forever discharge The Alberta and Great Waterways Railway Company from all its present liabilities to the said J. D. McArthur Company, Limited, under construction contracts or otherwise.
>
> In witness whereof J. D. McArthur Company Limited has caused its corporate seal to be hereunto affixed attested by the hands of its proper officers this 23rd day of July, A.D. 1920.

15 On September 13, 1920, Mr. Harvey having apparently heard that the rails and fastenings were being removed from the spur, communicated with McArthur at Winnipeg, protesting against this and claiming them as still the property of the railway company. McArthur replied referring to the sale of November, 1919. Thereafter correspondence ensued between Mr. Boyle, then Attorney-General, and McArthur and Thompson, in which the transaction was fully explained to Mr. Boyle. The rails and fastenings were in fact, and by consent or arrangement, removed and shipped over the defendant company's line to Edmonton, but on their arrival in Edmonton the railway company, now, of course, entirely under government control, refused delivery to the plaintiff.

16 No consent had ever been given by the trustee mortgagee, the Standard Trust Company, nor by the Government, to the sale that had been made in November, 1919.

17 The rails were piled in the railway company's yards at Edmonton pending an attempted adjustment of the matter. Then in May, 1922, the present action was begun. In its amended statement of claim the plaintiff alleges the sale, the refusal to deliver, and, therefore, a "conversion" of the goods. Referring also to the defence to the original claim the plaintiff states that the defendant therein alleges that the sale was void. The plaintiff claims: (a) Possession of the rails and fastenings; (b) Damages, presumably for non-delivery or conversion, to the extent of $43,615.50; and (c) Alternatively, if the sale should be held void, judgment for the said sum as for money had and received.

18 The defendant: (1) Denied the sale in fact; (2) Alleges that the rails were covered by the bond mortgage and that the consents required by that mortgage had not been given; (3) Alleges that the Standard Trust Co. had required it to retain possession of the rails because their consent had not been given; (4) Alleges that it had not received the sum of money claimed or any part of it; (5) Pleads the release of July, 1920; (6) Denies the demand of delivery and conversion; and (7) Pleads *The Sale of Goods Ordinance*.

19 The Standard Trust Company as trustee, and the Crown represented by the Government of Alberta, also brought an action against the present plaintiff and the present defendant for an injunction and a declaration that the rails were covered by the bond mortgage.

20 The two actions were tried by Mr. Justice Walsh at the same time. In the latter action he gave judgment in favour of the Crown and the Standard Trust Co. ([1923] 3 W.W.R. 41). In the former, that is the present action, he gave judgment for the plaintiff for the amount claimed ([1923] 3 W.W.R. 46). From this judgment the present defendant appeals. There has been no appeal yet brought from the judgment in the other action.

21 The first question obviously is whether the chattels were in fact covered by the mortgage. It seems clear that they were. It appears from the evidence that they were only part of a much larger purchase of rails bought possibly by the construction contractors, the plaintiff company, but certainly delivered to the defendant company and paid for by it, so that they became its property. The fact of the resale shows that both parties considered that this was the position. If the rails in question had been from the beginning a distinct lot or parcel never really intended to be used by the defendant for the railway, but merely bought along with other material because of a cheap bargain and always intended to be diverted to other purposes than those of the railway, there might be some ground for contending that they were not covered by the words of the mortgage. But on the contrary they appear to have been at first just some uncertain unseparated portion of a larger lot undoubtedly bought generally for the purposes of the railway. The fact that some portion of this larger lot turned out not to be needed by the railway does not, it seems clear to me, prevent that portion from coming under the terms of the mortgage. I wish to add here, however, that I have come to this conclusion solely upon the words I quoted above from the operative clause of the mortgage, which were neither in the recital nor in the statute authorizing the mortgage, viz., "and all real and personal property now or hereafter held or acquired for the purpose of the said lines, etc." Whether the rails would have been covered by the words "rolling stock and equipment" is another question, to which it will be necessary to refer in another connection.

22 In November, 1919, therefore, the defendant sold to the plaintiff some goods and received in payment therefor a credit on its large indebtedness to the plaintiff. These goods the defendant had no right to sell. The goods were then in the possession of a third party, the North West Lumber Co., Ltd. They remained there for nearly a year. In the meantime the control of the defendant company passed into other hands but the fact of this change and that these other hands were those of the Crown, can make no difference in the legal principles to be applied. It was still the same company as when it sold the goods. About a year afterwards when the third party were preparing to deliver the chattels physically to the purchaser the vendor company stepped in and said:

> You cannot have these goods. They are covered by a mortgage and we had no right to sell them to you without the mortgagee's consent which we did not obtained.

23 Now obviously the legal rights of the parties in such a situation will depend, aside from the question of the release, upon the law relating to the sale of goods and more particularly upon that part of that law which has to do with the question of title and quiet possession.

24 Sec. 14 of *The Sale of Goods Act*, R.S.A., 1922, ch. 146, reads thus:

> In a contract of sale unless the circumstances of the contract are such as to show a different intention there shall be —
>
> (*a*) an implied condition on the part of the seller that in the case of a sale he has a right to sell the goods and that in the case of an agreement to sell he will have a right to sell the goods at the time when the property is to pass;
>
> (*b*) an implied warranty that the buyer shall have and enjoy quiet possession of the goods;
>
> (*c*) an implied warranty that the goods shall be free from any charge or incumbrance in favour of any third party not declared or known to the buyer before or at any time when the contract is made.

25 Under this section there was an implied condition that the defendant had the right to sell the goods "unless the circumstances of the contract are such as to show a different intention." The question at once arises, were the circumstances of the contract such as to show a different intention, i.e., an intention that there should be no condition as to the right to sell but that the sale was to stand and continue to be effective even if it should turn out that the defendant had no right to sell the rails at all? I think it should be borne in mind that this is a question of fact and not of law and since the question of the knowledge of the existence of the mortgage necessarily arises, I think also one must be careful to distinguish between the imputation, as a matter of law, to the parties to the contract of knowledge that the mortgage existed, and the finding as a fact that the contrary intention as to the right to sell being a condition precedent, existed. I do not think that the latter must necessarily follow from the former.

26 Let us examine for a moment the extent of the knowledge about the mortgage that is revealed in the record. No doubt the defendant company having itself executed the mortgage in 1909 must be held as a matter of law to have had continued knowledge of its terms. I say "matter of law" because an incorporated company has the faculty of knowledge only through its officers or directors and it is shown that in 1913 the whole control and ownership of the company and, therefore, its entire staff of officials was changed. It was then only that McArthur came into the company and got control of it, that is, four years after the mortgage was signed. Nevertheless as a matter of law knowledge of the existence of the mortgage and of its terms must doubtless be imputed to the defendant company.

27 But the situation is not exactly the same with respect to the plaintiff company. That company was not a party to the mortgage. It had nothing to do with the matter until four years after the mortgage was signed. It was a construction company which entered into a contract with the defendant railway company to construct the line for which it was to be paid a certain price and it had constructed the line and the defendant owed a large sum still upon that price.

28 Now comes in the question of McArthur's personal position. He owned practically all the shares in the defendant company and was president of it. But he owned only about three-fourths of the shares in the plaintiff company and whether he was a director of it or not or occupied any official position in it, I confess I am unable to discover from the record as presented to the Court, which is all I am entitled to act upon in the absence of oral admissions by counsel and I recall none. I had hoped to get more light from the signatures attached to some of the correspondence put in but as unfortunately so often happens, I find copies of letters put in which are not full copies at all because there is no copy of the signature given. Even the copy of the release put in does not indicate by whom it was signed or in what capacity that person signed it. I really, therefore, must decline to make assumptions of my own. The record simply does not show that McArthur occupied any official position in the plaintiff company.

29 The fact that he was president of one company and the majority shareholder in the other is not sufficient to impute to the latter company the knowledge that has been imputed to the former. I do not think there is any authority for such a proposition.

30 But the record does show that B. W. Thompson, and W. P. (or B.) McDougall and J. K. McLennan were directors or officials of both companies. And it will, therefore, make little difference if we assume that McArthur as well was a director of the plaintiff company. Then what is the rule in such a case as to notice? In 14A *Corpus Juris*, at p. 491, it is stated that:

> Where a common officer of two corporations improperly represents both where his or their interests are conflicting, a notice to him of the affairs of one of the corporations will not be imputable to the other,

and *In re Marseilles Extension Ry.*, L.R. 7 Ch. 161, 41 L.J. Ch. 345, 25 L.T. 858, 20 W.R. 254, is cited where Sir George Mellish and Sir W. M. James, L.JJ. laid down the rule.

31 It does not, indeed, appear whether the board of directors of the plaintiff company met as a board and adopted the purchase or who was there. But undoubtedly there was a conflict of interest. It was the interest of one company to get

as much for the goods as it could. It was the interest of the other to get them as cheaply as it could. And it is fairly clear from Thompson's evidence that he, as vice-president of the plaintiff company, had pretty much to do with the purchase.

32 Then, when we consider that there were a number of minority shareholders to the extent of one-fourth of the stock in the plaintiff company whose identity is not revealed, I doubt very much if the knowledge of officials of the defendant company of the existence of the mortgage should be imputed to the plaintiff as a matter of law merely because those officials were also officials of the plaintiff company. If in the view I take of the case it were necessary to do so I would be prepared to hold that it could not be so imputed.

33 But it is suggested that all persons dealing with a public company are chargeable with notice of the Acts of Parliament affecting that company. Assuming this to be true there are several points which seem to me to be worthy of observation. The mortgage was nowhere made a schedule to an Act of the Legislature. The Act of 1909 merely authorized the mortgage and by sec. 2 it stated merely that the mortgage should cover the "rolling stock and equipment." As I have pointed out, the operative clause 7 of the mortgage went much further and added a further phrase: "All real and personal property, etc." But this was not in the Act. And there is some reason, I think, for the suggestion that in railway parlance "rolling stock and equipment" would not necessarily cover such a lot of extra rails as is in question here. The *Standard Dictionary* defines "equipment" when referring to a railway as "rolling-stock and the rest of the apparatus necessary for operating a railway, as distinguished from the stations and trackage." And see *People v. St. Louis, etc. Ry.*, 52 N.E.R. 292, where equipment was held to mean "the necessary adjuncts of a railway as cars and locomotives." And the very fact that the draftsman of the mortgage added the further phrase mentioned shows that he considered that the word "equipment" might not be considered wide enough. I therefore think that it does not necessarily follow, even if notice of the Act of 1909 authorizing the mortgage must be imputed to the plaintiff, that notice of the terms of that Act would necessarily imply notice that the rails in question were covered by the mortgage. It would, perhaps not unreasonably, be probably assumed that the mortgage followed the exact wording of the authorizing Act.

34 Therefore, even as a matter of law, I do not think it is by any means clear that knowledge that the rails were covered by the mortgage should be imputed to the purchasing plaintiff.

35 But even if that were the correct view and such knowledge should, as a matter of law, be imputed to the plaintiff, that is not the real question which has to be decided. It is one thing to say that the Court would impute that knowledge to the plaintiff and would hold as a matter of law that the plaintiff had constructive notice of the mortgage and of its terms and that it covered these rails; but it is quite another thing to say that the Court must find upon the facts presented in the record that when making the sale and purchase this vendor and this purchaser entertained an intention that there should be no implied condition that the vendor was or would be able to give a good title to the goods. I do not think these business men were either crooks or fools. I do not think the plaintiff's officers in fact ever dreamt of giving a credit of 43,000 odd dollars on a large debt owed to them in return for goods which they were buying consciously with a defective title and as to which they were consciously prepared to accept merely whatever title or interest the defendant could give them. It seems to me to be a far more reasonable inference of fact to make that the parties, either through actual ignorance of the terms of the mortgage, or through forgetfulness of them or through a quite possible misinterpretation or misunderstanding of those terms, proceeded to make a real out-and-out sale and that, whatever their ignorance or forgetfulness or misapprehension, they did in fact both intend that a good full and complete title should be obtained by the purchasing company. The probability is that their minds were not directed consciously to the matter at all. We do not need to find affirmatively a conscious intention as a fact to make good title a condition precedent. The law implies that. The burden of proof is the other way and it must be shown that there was an intention that there should be no such condition. And upon all the facts and considering "the circumstances of the contract" I am clearly of opinion that such an intention has not been established and I, therefore, think the implied condition must still apply with all the consequences, whatever they may be.

36 If the subsequent events in regard to the change of ownership of the railway company and the release which was given as a part of that bargain had not occurred, there can surely be no doubt whatever as to what the rights of the buyer would have been. Referring to the breach of a condition as to title *Benjamin on Sale*, 5th ed., p. 598, says:

> As in the case of other conditions, the buyer may, on a breach, either sue for a return of the price as on a total failure of consideration where he has been compelled to surrender the chattel to the true owner, or he may elect to treat the condition as a warranty and sue for unliquidated damages for its breach.

37 And see *Eicholz v. Bannister*, 17 C.B. (N.S.) 708, 34 L.J.C.P. 105, 11 Jur. (N.S.) 15, 12 L.T. 76. It seems to me to be beyond doubt that if the plaintiff had paid in cash the $43,000 and had after all been forced, as it has been, to surrender the goods on account of the intervention of the mortgagee, it could have sued for a return of the price paid or at its option could have treated the breach of the condition as a warranty and sued for unliquidated damages. But the cash was never really paid. So that the problem would have been even simpler yet. The plaintiff could at its option have merely cancelled the credit given and restored its claim or account against the defendant to the position in which, or the amount at which, it stood before the credit was given, which it probably could have done without action at all, or it could have sued in damages as for the breach of a warranty. I do not think the Court could under the law as I understand it have forced the plaintiff to adopt the first course. The plaintiff could have claimed the right to adhere to the contract instead of rescinding it and its right to damages would have followed.

38 Then it seems clear that the only thing that can prevent the plaintiff from still exercising its option, either to restore the charge against the defendant on its books or to treat the breach as a breach of warranty and to sue for damages, is the release. And here we come to what is, perhaps, the most difficult point in the case. The question is whether upon the proper interpretation of the wording of the release it must be treated as a release of any such a claim for damages and of any right to restore the charge and still hold the amount as a debt due from the defendant company? I have already quoted the words of the release. What is the proper canon of construction of such a document? In *7 Halsbury*, p. 454, it is said:

> General words of release will be construed with reference to the surrounding circumstances and as being controlled by recitals and context so as to give effect to the object and purpose of the document.

39 There are no recitals in the document, which circumstance renders many of the precedents to some extent, perhaps, inapplicable. But the release was given in pursuance of the agreement between McArthur and the then Minister of Railways, Mr. Stewart, which was dated the same day, viz., July 23, 1920, and was, therefore, signed apparently concurrently therewith. This agreement is the schedule to the confirmatory Act of 1921 and it contains recitals and clauses which may undoubtedly be properly looked at in order to arrive at the intended scope of the release. Three of these recitals read thus:

> And whereas in addition to its ordinary operating accounts as a going concern the railway company is indebted to J. D. McArthur Company, Ltd., in a large amount of money in connection with the construction of its line of railway and is also indebted to the Union Bank of Canada in approximately the sum of $710,000 for advances made by the said Bank to the railway company.
>
> And whereas default has been made in the payment of interest on the said guaranteed bonds (referred to in an earlier recital) and the Government has decided to take over the said line of railway but has insisted on doing so free from all liability of the railway company to J. D. McArthur Company Ltd. and, or, The Union Bank of Canada.
>
> And whereas the owner, [i.e., McArthur personally] has agreed to arrange for the release and discharge of the last-mentioned liabilities of the railway company and to transfer all of the shares of its issued capital stock to the Government or its nominees on the terms and conditions herein set forth.

40 Then the first covenant in the agreement reads thus:

> The owner [i.e., McArthur personally] will forthwith arrange for and procure the absolute release and discharge of the railway company of all its *said* liabilities to J. D. McArthur Company Limited and the Union Bank of Canada.

41 Now clearly the actual release must be read in the light of these passages in the agreement which stipulated that it should be given.

42 And it must be remembered that while these documents were signed on July 23, 1920, some eight months after the sale of the rails and after the credit had been given by which the liabilities had been reduced by $43,000, no question had ever yet arisen as to the illegality of the sale. It was not until October, 1920, over three months later, that the new Government general manager intervened to stop the delivery of the rails when the North West Lumber Co., Ltd., in whose physical possession they had been for a number of years, proceeded to hand them over to the purchaser, the plaintiff.

43 In the first place I think it is very plain that the release cannot properly be construed as releasing that portion of the debt due from the defendant to the plaintiff which had been written off the latter's books and discharged by the credit entry. That could not have been the meaning of the parties because when the release was signed that portion of the debt was not supposed to exist at all. It was supposed, and in my opinion honestly supposed, to have been wiped out and paid, so that the release surely cannot be construed as intended to cover it.

44 But the question is whether the release should not be held to cover the liability upon the implied condition or the implied warranty created by sec. 14 of *The Sale of Goods Act*. So far as an implied condition is concerned that in itself is not a liability. The true liability would be to return the purchase-price as upon failure of consideration, as I have indicated. But the price had not been paid or received in cash. A credit had merely been given and received for a portion of a debt. So that all the plaintiff needed to do when the consideration failed was to cancel the credit, as it was entitled to do, and the debt remained or was restored. In this view the action of the plaintiff should have been simply upon the restored or reinstated debt. The case is a peculiar one but upon the best consideration I can give it, I do not think an action lay for money had and received. No money ever was in fact had or received in connection with the sale of these chattels. In the circumstances I do not think any amendment should be allowed so as to turn the claim into one upon the original but uncancelled and unreleased debt. There is a claim for damages as an alternative and I think the plaintiff should be restricted to this as leading to a more substantially just result.

45 But was the claim for damages covered by the release? Upon this point I have, after considerable anxious cogitation, come to the conclusion that it was not. It is true that there was at the time of the release a contingent liability for damages. But on a consideration of all the circumstances I do not think it was ever intended to be covered by the release. It was certainly not consciously thought of at the time. The transaction had been put through months before and the plaintiff practically had the rails in its possession. There is nothing to show that trouble was as yet anticipated about the matter. In fact no question about it arose until some months afterwards. The words of Lord Westbury in the House of Lords in the case of *L. & S.W. Ry. v. Blackmore*, L.R. 4 H.L. 610, at p. 623, 39 L.J. Ch. 713, 23 L.T. 504, 19 W.R. 305, are, it seems to me, entirely applicable to the circumstances of this case. He said:

> The general words in a release are limited always to that thing or those things which were especially in the contemplation of the parties at the time when the release was given. But a dispute that had not emerged, or a question which had not at all arisen, cannot be considered as bound and concluded by the anticipatory words of a general release.

46 I think those words cover this case completely. The dispute had not emerged, no question about it had arisen. It was all considered past and settled, when the release was given. Furthermore, observing the wording of the agreement in pursuance of which the release was given and which I have quoted above, it seems to me that we find an additional reason for the same conclusion. The first clause above quoted in the first recital in the agreement which refers to the relations existing between the present parties, recites that the railway company is "indebted to the plaintiff in a large amount of money"; and the next recital sets forth that the Government has insisted on the railway being free from all liability to the J. D. McArthur Co. and the next recites that the owner McArthur has agreed to arrange for the release and discharge of the "last-mentioned liabilities." The first operative clause on which the owner agrees to get the release

speaks of "said liabilities." Now, I think it is very significant that the first recital refers to indebtedness or to a *debt*. Of course, the word "liability" is a very general one and will, as a rule, include even contingencies. See *Cochran v. U.S.*, 157 U.S. 286. But it seems to me that when the references to "said liabilities" and "last-mentioned liabilities" are preceded by a distinct reference to indebtedness only it becomes not so certain that the word liability was intended to be used in the wider and general sense. Possibly if the dispute had been going on when the release was given even the suggestion I make about the recitals would not be in itself sufficient to narrow the general meanings of the word. But as it had not yet arisen or been thought of and as the recitals do make the suggestion, at least, of a limitation to indebtedness I think the release cannot properly be interpreted as covering the liability for breach of warranty of title and quiet possession. The addition of the words "or otherwise" in the release is entirely explicable by reference to the fact stated by Thomson that the plaintiff company had made extensive loans to the defendant and that the latter was indebted on loan account as well as on construction account.

47 I cannot, therefore, bring myself to believe that in giving this release the plaintiff company ever contemplated that it was releasing by anticipation a claim for damages for a subsequent and unexpected interference with its possession of this lot of rails which, I think, it honestly thought it had paid for and which it had practically had possession of for many months.

48 Nor do I discern the ground for criticizing McArthur for not mentioning the matter. He was paying the Union Bank $710,000. He was releasing indebtedness of over a million. To suggest that he should have recalled the fact that a comparatively insignificant portion of that debt had been cancelled by the sale to him some months before of a lot of used and damaged rails which the railway had never itself made any use of, seems to me to be exacting too much in the way of memory and disclosure of past and closed transactions. The history of this railway is in the statute books and the law reports and we know that it was the Government of the province that wanted to build it in the first place, that McArthur never came in until four years after the mortgage had been executed by the original promoters, the bonds sold and the money in the hands of the Government. The contract for and the cost of construction was under Government super vision under the statute of 1909. To me it is not surprising that the exact effect of the mortgage was not always present to the mind of McArthur or that he should have felt free to get for his construction company and his associates in it a little driblet on the enormous debt that the railway company owed it by the sale of these rails which, on the face of the statute, at least, it was quite possible to assume were not covered by the mortgage at all.

49 The learned trial Judge in his judgment gave the defendant an opportunity to make delivery of the rails free from the mortgage if it could secure a discharge. I would not disturb this part of the judgment. But I think there is one minor addition which should be made to it. It seems clear that the plaintiffs have had the advantage of the shipment of the rails to Edmonton and the defendant should be entitled to their ordinary freight charges for this service.

50 Then for the reasons given above, I am inclined to the view that it was not exactly a correct alternative to delivery to give judgment for the full sum for which credit was given as the price of the rails. I would have preferred only to allow damages to be assessed at the value of the rails at the time of the refusal to deliver. But I am not sufficiently confident of the correctness of this view to feel justified in insisting upon it when the insistence would in the circumstances make it difficult to arrive at the proper judgment to be entered owing to the diversity of opinion. I would, therefore, dismiss the appeal with costs except that I would modify the clause giving the defendant the option of delivering the rails by adding thereto a provision that if the defendant exercises the option of delivering the rails it may demand the proper freight charges for the carriage of the rails to Edmonton.

51 The second paragraph should also be amended by extending the time for the defendant to exercise its option of delivering the rails to thirty days from the entry of judgment in this appeal.

Beck, J.A.:

52 I would agree substantially with the opinion of my brother Stuart if in my opinion it were right to say that the rails in question are comprised in the mortgage.

53 Ch. 16 of 1909, *An Act to Provide for an Issue of Guaranteed Securities of The Alberta and Great Waterways Railway Company*, authorized (sec. 2) the securing of the guaranteed bonds "by mortgage to be made to trustees approved by the Lieutenant Governor in Council" and enacted that such mortgage "shall cover the railway above mentioned, including the said Edmonton terminals, and the rolling stock and equipment present and future acquired for the purpose of the said lines, also the tolls, revenues and incomes arising or to arise from the said line or lines, and the rights, privileges, franchises and powers of the company now or hereafter held in respect of and in connection with the said lines and the operation, maintenance and repair thereof."

54 Now as my brother Stuart points out the draftsman of the mortgage enlarged the description beyond what was authorized by the words of the statute by inserting in the description the words:

> All real and personal property now or hereafter held or acquired for the purpose of the said lines and works connected therewith.

55 Now it must be clear that, although it may be admitted for the sake of argument that the railway company might legally give a mortgage upon everything it owned to any ordinary creditor, yet the statute above mentioned authorized it to give a mortgage for the specific purpose of indemnifying the Government against its guarantee only upon such property as would come within the description set out in the statute. That description would cover the railway as a completely equipped operating system, which, upon enforcement of the mortgage either by sale or foreclosure, could be continued in operation without the acquiring of a dollar's worth of additional property. That was the purpose of the mortgage and as I think its sole purpose. It could scarcely have been intended by the Government to make the mortgage so wide that the railway company, while preserving its lines in complete equipment, should not be at liberty to deal freely with any miscellaneous property whether real or personal which it might in more or less accidental ways and for more or less secondary purposes acquire and which it should have no occasion to use in order to maintain lines in operation. The public dealing with the rail way company was to be considered and it is not to be thought that the Government intended to tie the railway company hand and foot so that, in every transaction with a member of the public over something outside the complete operating system of the road, the party dealing with the railway company should in each case have to run to the trustee mortgagee for a discharge. My opinion, therefore, is that the added words in the mortgage are ineffective.

56 And agreeing with my brother Stuart I think the rails in question are not covered by the description of the statute.

57 It would seem that this view is well supported by American authorities, most of which, however, are not available, but notes of which I have found: *Rubey v. Missouri Coal & M. Co.*, 21 Mo. App. 150, 189; *People v. St. Louis Etc. Ry.*, 52 N.E.R. 321, 345; *Chicago, M. & St. P. Ry. v. Hoyt*, 62 N.W.R. 189, 193; 89 Wis. 314; *St. Louis Etc. Ry. v. Sandal (Tex.)*, 3 Willson Civ. Cas. Ct. App. sec. 379; *Detroit Trust Co. v. Detroit Etc. Ry.*, 124 N.W.R. 45, 51; 159 Mich. 442; *In re Ferguson Con. Co.*, 183 Fed. 880, at p. 882.

58 Even if I am wrong in this view the doubt which must necessarily arise with regard to it aids the reasoning of my brother Stuart in favour of there being no intention on the part of the plaintiff company to buy, and no intention on the part of the railway company to sell, the rails otherwise than clear of incumbrances. Holding the view I do the only question remaining for me to decide is the remedy.

59 After consideration and discussion I think the plaintiff is entitled to a judgment for the amount for which it gave credit as the price of the rails, namely, $45,615.50, together with interest at five per cent per annum from the date upon which the credit was entered.

60 I would modify the judgment of the learned trial Judge ([1923] 3 W.W.R. 46) accordingly and give the costs of the appeal to the plaintiff company.

61 P.S. — In order to make an effective judgment of the Court I am ready to concur in the result reached by my brother Stuart.

***Hyndman, J.A.* (dissenting):**

62 This is an appeal from the judgment of Walsh, J. ([1923] 3 W.W.R. 46) in favour of the plaintiff for the sum of $43.615.50 and interest at five per cent from December 15, 1919.

63 The real issue is whether or not in the sale of the rails and fastenings in question, there was an implied warranty of title to the goods. Admittedly there was not an express warranty.

64 *The Sale of Goods Act*, R.S.A., 1922, ch. 146, sec. 14, enacts: [See *ante*, p. 184].

65 It is common ground that the Alberta & Great Waterways Railway Company owned the goods at the time of the sale. But it is contended that the plaintiff company did not know or had reason to believe that the goods were subject to a certain mortgage or charge held by the Standard Trust Company as trustee for the bondholders of the defendant company.

66 If the goods were those of the defendant company it seems to me, and the trial Judge so found, that they fell under the mortgage referred to, and therefore, any sale by the railway company of such goods must necessarily be subject to such encumbrance.

67 By virtue of chs. 16 and 46 of the statutes of 1909 the defendant company was incorporated, and authority was given to the Government of Alberta, to guarantee the bonds of the railway company, the mortgage to be made to a trustee. A mortgage was duly made to the Standard Trust Company and to my mind clearly comprised the goods referred to, at the date of the sale.

68 In the year 1913 J. D. McArthur obtained a controlling interest in the defendant company, and was at the same time the owner of a controlling interest in the plaintiff company. The latter company undertook the construction of the defendant's line of railway and from time to time received payment of the proceeds of the sale of the bonds, which bonds were secured by said mortgage of all the defendant company's assets present and future in favour of the Standard Trust Company.

69 In the fall of 1919 the railway company was a debtor of the plaintiff company to the extent of upwards of $1,000,000.

70 About November 28, 1919, an agreement was made between the parties, whereby the plaintiff would purchase said rails and credit the defendant with the agreed price thereof, namely, $43,615.50, and the transaction was so consummated.

71 The rails were left where they were until the fall of 1920. In the meantime, however, the financial difficulties of the defendant company necessitated an arrangement between the Government and the parties to this action, the upshot being that Mr. McArthur should transfer all his shares and interest in the Alberta & Great Waterways Railway Company to the Government, and the plaintiff company should release all its claims against the railway company.

72 This arrangement was carried into effect and confirmed by statute being ch. 54 of 1921 and the following release was executed: [See *ante*, p. 181].

73 The rails had been used by the North West Lumber Company, Limited, during logging operations of 1920 and in the latter part of that year and after the transaction and release just mentioned the plaintiff company proceeded to take possession thereof. A controversy as to their right to do so thereupon arose culminating in the present action in which it was decided that whilst the aforesaid mortgage was an effective encumbrance, nevertheless the defendants are liable for the price credited on plaintiff's account being a claim for money had and received in respect of a consideration which failed, the defendants having been unable to make a good and valid title to the goods in favour of the purchasers, there being an implied warranty of title by virtue of *The Sale of Goods Act*.

74 There is no evidence or suggestion of fraud in the transaction, and neither can there be any valid objection to these two companies trading with each other merely because the same personnel of the directorate or shareholders is common to them.

75 To my mind (apart from the effect of the said release) the simple issue to be determined is whether or not the circumstances of the contract are such as to show that there was no implied warranty of title or that the goods were free from encumbrance. In other words has the implied warranty been rebutted.

76 At common law the rule was exactly the reverse of the present statute, that is, there was no implied warranty from the mere contract itself and a vendor was not liable for a bad title unless there was fraud on his part, or an express warranty, or what is equivalent thereto by declarations or conduct: *Morley v. Attenborough*, 3 Ex. 500, 18 L.J. Ex. 148, 13 Jur. 282; *Chapman v. Speller*, 14 Q.B. 621, 19 L.J.Q.B. 239, 14 Jur. 652; *Hall v. Conder*, 2 C.B. (N.S.) 22, 26 L.J.C.P. 138, 3 Jur. (N.S.) 366; *Benjamin on Sale*, 6th ed., pp. 686 *et seq.*

77 Under all the circumstances of this case can it be properly said that the implied warranty is rebutted?

78 I think it must be admitted that if the purchasing company at the date of the transaction had known everything with regard to the defendant company's right, title and interest in the goods, and there was no express warranty of title or agreement to secure a release of the mortgage, this would sufficiently rebut the presumption, and it then must be taken that the plaintiff purchased the goods at its peril and that the vendor sold only such interest as it had.

79 The evidence discloses that the vendor company was incorporated by Act of the Legislature in the year 1909. At the same session another Act was passed authorizing the Government of the province on certain terms and conditions to guarantee payment of bonds of the company. Sec. 2 enacted:

> 2. The said bonds so guaranteed shall be secured by mortgage to be made to trustees approved by the Lieutenant Governor in Council and shall cover the railway above mentioned, including the said Edmonton terminals, and the rolling stock and equipment present and future acquired for the purposes of the said lines, also the tolls, revenues and incomes arising or to arise from the said line or lines, and the rights, privileges, franchises and powers of the company now or hereafter held in respect of and in connection with the said lines and the operation, maintenance and repair thereof, and subject only to the provisions of *The Railway Act of Alberta* and *The Railway Act of Canada*, whichever may be applicable to the railway, the said mortgage shall be the first charge thereon.

80 Pursuant to said section a mortgage was duly executed, and, at all times material to this action, was in full force and effect, and in my opinion comprised the goods in question before us. A release of the mortgage could be obtained only from the trustee mortgagee with the concurrence of the Government — as set forth in the provisions of the mortgage.

81 It is admitted that no application for a release was made, or release given, and was apparently neither mentioned nor thought of when the transaction took place.

82 The law seems to be clear that all persons dealing with a company are presumed to have notice of any Acts of Parliament affecting the company, and of its regulations and, therefore, to have notice of any restrictions upon the authority of directors and any formalities prescribed for the exercise of their powers.

83 (See *Hamilton & Parker Company Law* and authorities there noted.)

84 It must be assumed then that the plaintiff company had at least constructive notice of the affairs of the defendant company with respect to dealing in and disposing of any of its assets with respect to said mortgage thereon, and it seems to me that this ground alone would be a sufficient defence to the action rebutting, as I think it does, the implied warranty.

85 But apart from constructive notice it must, I think, be conceded that in view of the close relationship between the two companies the plaintiff company must be held to have been aware of the mortgage and its effect.

86 The J. D. McArthur Company was the contractor for the construction of the whole line of railway and during construction operated such portions of it as were fit for use. The transaction involved millions of dollars. The president of both concerns was Mr. J. D. McArthur and some of the directors in one occupied similar posts in the other. It would appear that the president participated actively in the business and affairs of each. Is it possible to conceive, in view of this, that the directors who, of course, are the agents of these companies, could possibly be ignorant of the state of the defendant's title? I am bound to say that in my humble opinion the plaintiff company through the agency of its directors must have known, and did know, of the existence of the mortgage in question and therefore must have purchased subject to that mortgage whatever its effect might be.

87 In view of the ground upon which I have arrived at the above conclusion it is unnecessary to consider whether or not in any event the release heretofore set forth operated as a complete release of all claims including the present one.

88 I would therefore allow the appeal with costs, and dismiss the action with costs.

***Clarke, J.A.* (dissenting):**

89 In my opinion the sale by the defendant to the plaintiff was not a void transaction as between the parties to it although it was necessary under the terms of the mortgage to obtain certain consents in order to give title free from the mortgage.

90 I think the provisions of sec. 6 of *The Sale of Goods Act*, R.S.A., 1922, ch. 146, were sufficiently complied with.

91 In the action of *Rex v. A. & G.W. Ry.* in which the present plaintiffs were defendants it was decided that the rails, etc. in question in this action were subject to the trust mortgage which cannot be controverted while the judgment in that action stands (see [1923] 3 W.W.R. 41). Apart from the judgment I am of the same opinion, the property mortgaged includes the equipment acquired for the purpose of the railway "and all real and personal property now or hereafter held or acquired for the purposes of the said lines." I think the letting of the rails for use in a spur line to serve as a feeder for the railway is one of the purposes of the railway within the meaning of the mortgage. I do not think, however, that strictly the defendant or the Government in its capacity of guarantor of the bonds was authorized to take or keep possession of the rails. I see nothing in the mortgage giving such a right, the Government as guarantor may, under certain cir cumstances, put the trustee in motion, which seems to me quite a different thing from the taking of possession by either the railway company or the Government as guarantors. Therefore the claim of the plaintiff to possession as between the parties hereto is well founded and the first paragraph of the formal judgment should not be disturbed. This relief is probably of little benefit to the plaintiff so long as the rails remain subject to the mortgage.

92 It does not appear that the plaintiff has suffered any damage by reason of being deprived of possession. The substantial question in the action is the right of the plaintiff to a rescission of the sale for want of title and to have a credit restored for the purchase-price of $43,615.50 and payment thereof as a debt owing by the defendant or to damages for breach of warranty.

93 By virtue of sec. 14 of *The Sale of Goods Act*, there was upon the sale of the rails by the defendant to the plaintiff an implied condition that the defendant had the right to sell the goods and an implied warranty that the plaintiff should have and enjoy quiet possession *unless the circumstances of the contract were such as to show a different intention*.

94 The difficulty of construing the words of exception is pointed out in *Niblett Ltd. v. Confectioners' Materials Co.*, [1921] 3 K.B. 387, 90 L.J.K.B. 984, 125 L.T. 552, 37 T.L.R. 653.

95 I am inclined to think that the circumstances were such as to negative any implied condition of the right to sell, which I think means, the right to give a perfect title. Both parties must have been aware of the mortgage which prevented the giving of a good title, and to say there was a condition would be to defeat the sale and render the transaction void from the beginning, which surely was not the intention of the parties.

96 I do not think, however, that the circumstances were such as to negative the implied warranty for quiet possession, which is frequently enjoyed, although the title may be imperfect. The price was for, at least, the full value of the goods and I see nothing to indicate any intention that the purchaser should assume any obligation in respect of the mortgage or that the sale was of the interest of the vendor only.

97 If I am wrong in respect of the condition and the proper view is that of the trial Judge ([1923] 3 W.W.R. 46) then there was a liability upon the defendant to restore to the plaintiff a credit for the price of the goods, viz., $43,615.50.

98 And, according to my view of the warranty for quiet possession, there was a liability upon the defendant for damages for breach of that warranty, the measure of which would be the value of the goods at the time of the disturbance of the plaintiff's possession.

99 In either case there was a liability upon the defendant in favour of the plaintiff.

100 By the release of July 23, 1920, the plaintiff released the defendant "from all its present liabilities to the said J. D. McArthur Company, Limited, under construction contracts or otherwise."

101 Why does this not include the liability in respect of the implied condition or warranty, as the case may be?

102 In *In re Cumming Mfg. Co.*, 6 O.W.R. 578 at p. 583, the Master in ordinary quotes the following from *Sweet's Law Dictionary*, p. 486:

> 'This term "liability" has a broader meaning than the term "debt" and has been interpreted as "the condition of being actually or potentially subject to an obligation, or, in a more special sense, as denoting inchoate, future, unascertained, or imperfect obligations as opposed to 'debts' — the essense of which is that they are generally ascertained and certain." '

103 See also *Words and Phrases*, 2nd series, vol. 3, p. 98, under the heading "Liability," and at p. 814, under the heading "Other liabilities"; *Stroud's Judicial Dictionary*, 2nd ed., vol. 2, p. 1090; *Wolmershausen v. Gullick*, [1893] 2 Ch. 514, 3 R. 610, 68 L.T. 753.

104 In an ordinary transaction where a release is given of so great a liability as the one in question, one would expect there would be some discussion or negotiation about the item, but this is not an ordinary transaction. The plaintiff releases an indebtedness of more than a million dollars and Mr. McArthur, the holder of most of the issued capital stock of the company, assumes a further indebtedness of the railway company to the Union Bank of $710,000. There was no inventory of the assets or of the railway company's liabilities. The apparent object of the transaction was that the Government should take the railway free from all liabilities to the plaintiff without regard to their amount or the nature of them.

105 The agreement of July 23, 1920, between McArthur and the Government recites an indebtedness by the railway company to the McArthur Company in a large amount in connection with the construction of its line of railway and also recites that the Government has decided to take over the railway "but has insisted on doing so free from all liability of the railway company to J. D. McArthur Company, Limited."

106 The owner McArthur agrees to procure the absolute release of the railway company from all its said liabilities to the McArthur Company and to release all his claims of every nature or kind.

107 It is fairly open to argument that the release agreed to be obtained from the McArthur Company was only of the indebtedness in connection with the construction of the railway line and perhaps for moneys advanced, but I think the release itself by the words "or otherwise" makes it evident that the release was not confined to the construction indebtedness, but was to cover liability of any kind, that being within the contemplation of the parties, which is quite reasonable when considering the close relationship of the plaintiff and defendant companies up to that time and the

absence of knowledge by the Government of the transactions of the railway company under the McArthur management. I think effect cannot be given to the words "or otherwise" in the release without including the liability sought to be enforced in this action and if that is the correct conclusion it follows that the plaintiff's action fails so far as it seeks to recover the purchase-price of the rails.

108 I would, therefore, allow the appeal with costs and vary the judgment by striking out pars. 2 and 3 and in lieu thereof that there be an order that except as ordered in par. 1 of the judgment the action be dismissed and as both parties have succeeded in part there should be no costs of the action.

Appeal dismissed with costs, Hyndman and Clarke, JJ.A. dissenting.

Solicitors of record:
Woods, Sherry, Collisson & Field, solicitors for plaintiffs, respondents.
Parlee, Freeman, MacKay & Howson, solicitors for defendants, appellants.

5.

Most Negative Treatment: Not followed
Most Recent Not followed: Pringle v. Fraser | 1971 CarswellOnt 699, 19 D.L.R. (3d) 129, [1971] 2 O.R. 749 | (Ont. C.A., Mar 4, 1971)

1944 CarswellBC 87
Supreme Court of British Columbia

Nanaimo Community Hotel Ltd. v. British Columbia (Board of Referees appointed under Excess Profits Tax Act, 1940)

1944 CarswellBC 87, [1944] 4 D.L.R. 638, [1944] C.T.C. 102, [1944] B.C.J. No. 91, 60 B.C.R. 558

IN THE MATTER OF AN APPLICATION BY NANAIMO COMMUNITY HOTEL LIMITED FOR A WRIT OF CERTIORARI DIRECTED TO THE BOARD OF REFEREES

Macfarlane, J.

Judgment: June 21 and July 26, 1944

Proceedings: on a motion for a writ of Certiorari

Counsel: *J. B. Clearihue*, K.C., for the Board.
F. S. Cunliffe, for Nanaimo Community Hotel Limited.

Subject: Tax — Miscellaneous
Related Abridgment Classifications
Administrative law
II Prerequisites to judicial review
  II.1 Jurisdiction of court to review
    II.1.b Exchequer Court and Federal Court
      II.1.b.i "Federal board, commission or other tribunal"
        II.1.b.i.A General principles
Constitutional law
III Historical background
  III.3 Supremacy of Imperial Parliament
Constitutional law
VII Distribution of legislative powers
  VII.3 Nature of general provincial powers
    VII.3.e Matters of local and private nature within province
Constitutional law
VII Distribution of legislative powers
  VII.4 Areas of legislation
    VII.4.l Judicature
      VII.4.l.iii Provincial jurisdiction
Judges and courts
I Constitutional issues
  I.4 Provincial jurisdiction over administration of justice (Constitution Act, 1867, s. 92(14))
Tax

II Income tax
II.23 Administration and enforcement
II.23.n Practice and procedure on appeals
II.23.n.xii Striking out pleadings
Tax
IV Other federal taxes
IV.5 Excess profits tax

Headnote

Taxation --- Other federal taxes — Excess profits tax

Excess Profits Tax — Excess Profits Tax Act, 1940, Ch. 32, Statutes of 1940, as amended — Section 5 — Section 13 — Section 14 — Income War Tax Act, Ch. 97, R.S.C. 1927 — Sections 65 to 67 — Assessment on basis of standard profits ascertained by Board of Referees — Whether all facts presented — Whether Board was complete at time of hearing — Appeal to Exchequer Court — Application for Writ of Certiorari to remove decision of Board into Supreme Court of British Columbia — Question of jurisdiction.

The applicant, having expressed its desire to have its standard profits ascertained by the Board of Referees pursuant to section five of The Excess Profits Tax Act, 1940, appeared before the Board in Vancouver on April 27, 1943. The Chairman of the Board was not present at the hearing, leaving only two members to hear the applicants' representations. The Board's decision, signed by three members and approved by the Minister of National Revenue was made known to the applicant and an assessment for Excess Profits Tax was raised against the applicant upon excess profits computed in relation to the Standard Profits so fixed by the Board. An appeal was accordingly lodged by the applicant with the Minister. Subsequent to this action the applicant made a motion for a Writ of Certiorari to remove the decision of the Board of Referees into the Supreme Court of British Columbia and urged that the decision be quashed. In support of the motion it was set forth, *inter alia*, that the proceedings were taken before an incomplete Board and without due hearing of the applicant's representations.

HELD:

(i) That Section 66 of the Income War Tax Act is sufficient to oust the jurisdiction of this Court to deal with a decision of the Board of Referees on which an assessment is subsequently made.

(ii) That the motion be dismissed with costs.

Annotation

This decision is the first by a Canadian court relating to a determination with regard to Standard Profits by the Board of Referees. While the judgment itself is of interest in its clear cut interpretation of Section 66 of the Income War Tax Act there are a number of related questions which the court found itself not required to consider but which constitute a rich field for legal research.

The Board of Referees was appointed by the Minister of National Revenue in accordance with Section 13 of the Excess Profits Tax Act, 1940, on November 1, 1940. The Order-in-Council appointing the Board was dated November 16th, 1940 and was published in the Canada Gazette of December 14, 1940 at page 2138. The Order-in-Council reads as follows:

"Whereas the Excess Profits Tax Act, 1940 (4 Geo. VI, c. 32), provides, by s. 13 thereof, that 'the Minister may appoint a Board of Referees to advise and aid him in exercising the powers conferred upon him under this Act, and such Board shall exercise the powers conferred on the Board by this Act and such other powers and duties as are assigned to it by the Governor in Council':

And Whereas the Minister of National Revenue reports:

That, on the first day of November, 1940, he duly appointed a Board of Referees for the purposes aforesaid, the said Board being composed of:

The Honourable Mr. Justice William Henry Harrison, of the Supreme Court of New Brunswick, Chairman;

Mr. Kenneth W. Dalglish, C.A., of Montreal; and

Mr. Charles P. Fell, of Toronto.

That the said Board has been requested "to advise and aid" the Minister of National Revenue "in the exercise of the powers conferred upon him" under the said Act and related laws, in order that the Minister may, with greater certainty, be "satisfied" that the conditions referred to in s. 5(a) and (b) pertaining to depressed industries and business with low profits, are present, in such degree, that the taxpayers concerned should not have their standard profits determined solely under the provisions of s. 2(i);

Now, Therefore, His Excellency the Governor General in Council, on the recommendations of the Minister of National Revenue and under the authority of s. 13 of the Excess Profits Tax Act, 1940 is pleased to assign and doth hereby assign to the said Board of Referees the following powers and duties:

(a) To report to the Minister of National Revenue in furtherance of "the advice and aid" sought by him from it, when in the opinion of the Board an industry or a business as a class "was depressed" during the standard period as referred to in the said Act or when "the business of the taxpayer was for some reason peculiar to itself, abnormally depressed" during the said standard period "when compared with other businesses in the same class"

(b) To report to the Minister of National Revenue in furtherance of "the advice and aid" sought by him from time to time as to whether in any case or group of cases the taxpayer or taxpayers would not be justly and fairly dealt with if the standard profits as defined in s. 2(i) were adopted for assessment purposes; provided, always, that any such case or cases were within the descriptions set forth in s. 5 of the said Act; and

(c) To determine, within the provisions of the said Act, the Standard Profits of any taxpayer or group of taxpayers that may be referred to it for consideration by the Minister of National Revenue.

A. D. P. HEENEY,

Clerk of the Privy Council."

By Order-in-Council P.C. 90/8097, dated September 9, 1942, Dr. Courtland Elliott was added to the Board, his appointment being effective as from September 1, 1942. Prior to this date the Board had heard representations made to it *en banc*. With the addition of Dr. Elliott, and as a result of the greatly increased number of applications on the part of taxpayers for hearings, the Board occasionally heard representations when only two or three of its members were present. It will be noted that it is nowhere stated in the above Orders-in-Council or in the Act itself that the Board is required to hear a taxpayer or that the Board should as a body consider the taxpayer's problems with all the members present at the same time. It would seem therefore that any taxpayer who raised the question as to whether or not the Board could refrain from hearing his case or that his representations were received by only two members of the Board instead of three or four would have no grounds in law to press such a contention. Consequently, the further question as to whether two members of the Board can make a valid recommendation to the Minister when the Board is composed of three members as well as after its expansion to its present number of four, would appear to be disposed of by the language of the Orders-in-Council. It would seem that, so long as all the members of the Board concur in the recommendation to the Minister in the report required by paragraph (a) of the first Order-in-Council, the number of members who actually receive or hear the application is immaterial.

***MacFarlane, J.*:**

1 This is a Motion for a Writ of Certiorari to remove into this Court the decision of the Board of Referees, appointed by the Minister of National Revenue, pursuant to the provisions of the Excess Profits Tax Act, 1940, being Chapter 32 of the Statutes of Canada 1940, whereby the said Board purported to ascertain the standard profits of Nanaimo

Community Hotel Limited pursuant to the said Act, which said decision bears date the 15th day of May, 1943, with the purpose in view of quashing the said Order.

2 Counsel for the Board raises the preliminary objection that there is no jurisdiction in this Court to deal with the decision of the Board and refers to Sections 65 to 67 of the Income War Tax Act made applicable by Section 14 of the Excess Profits Tax Act 1940, "to matters arising under the provisions of this Act to the same extent and as fully and effectively as they (Sections 40 to 87), both inclusive) apply under the provisions of the Income War Tax Act".

3 The Board of Referees is appointed pursuant to Section 13 of the said Excess Profits Tax Act. The proceedings in respect of which the complaint herein is made were those envisaged by Section 5 of the said Act. The complaint is that the proceedings were taken before an incomplete Board and without due hearing of the representations of the Hotel Company. Following the alleged decision, which the applicant now asks this Court to quash, an assessment was made and from that assessment Notice of Appeal was filed. When the application was made the Board, according to the material filed, was sitting in Vancouver, British Columbia.

4 Section 66 of the Income War Tax Act reads in part as follows: —

> "66. Subject to the provisions of this Act the Exchequer Court shall have exclusive jurisdiction to hear and determine all questions that may arise in connection with any assessment made under this Act ..."

5 Mr. Cunliffe argues that that section presupposes that an assessment has been made, and that as I understand him, the words "in connection with" mean "Consequent upon". I do not think that is the correct construction to be put upon these words. One of the very generally accepted meanings of "connection" is "relation between things one of which is bound up with or involved in another"; or again "having to do with". The words include matters occurring prior to as well as subsequent to or consequent upon so long as they are related to the principal thing. The phrase "having to do with" perhaps gives as good a suggestion of the meaning as could be had.

6 I think Section 66 is sufficient to oust the jurisdiction of this Court to deal with a decision on which an assessment is subsequently made.

7 It is not necessary, therefore, for me to deal with the other phases of the very interesting and instructive argument presented on behalf of the Motion.

8 The Motion must be dismissed with costs.

End of Document

6.

2016 ONSC 5350
Ontario Superior Court of Justice

Ontario v. Turn-Key Construction Inc.

2016 CarswellOnt 14884, 2016 ONSC 5350, 272 A.C.W.S. (3d) 523, 61 C.L.R. (4th) 6, 61 B.L.R. (5th) 250

Her Majesty the Queen in Right of Ontario (Applicant) and Turn-Key Construction Inc. (Respondent)

F. Bruce Fitzpatrick J.

Heard: August 11, 2016
Judgment: August 24, 2016
Docket: Thunder Bay CV-16-0215

Counsel: Christopher P. Thompson, for Crown
Douglas Treilhard, for Respondent

Subject: Contracts
Related Abridgment Classifications
Contracts
VII Construction and interpretation
VII.5 Words and phrases
VII.5.e Miscellaneous
Headnote
Contracts --- Construction and interpretation — Words and phrases — Miscellaneous
Indemnity clause — Contractor supplied and installed underground fibre cable to property owned by province — Contract's indemnity clause created duty to defend on part of contractor in certain situations — Subcontractor hired by contractor accidentally severed major electrical power line to property — Province retained electrician to do emergency repairs — Contractor refused to pay electrician, so electrician commenced action against province and contractor for payment — Province brought application for declaration that contractor had duty to defend province — Application granted — Contractor was required to pay province's reasonable defence costs, along with any costs for related cross or third party claims, and province was entitled to separate counsel — It was plain and obvious from language of contract that matter underlying claim was precisely type of matter contemplated by indemnity — Words used in one part, "indemnify and hold harmless", indicated scope of indemnity was quite broad — Words used in another part clearly indicated province was indemnified against all liability arising from lawsuit — Words in third part, "based upon, occasioned by or attributable to anything done or omitted to be done by the Supplier, its subcontractors", applied to subcontractor cutting power line.
Table of Authorities
Cases considered by *F. Bruce Fitzpatrick J.*:

Creston Moly Corp. v. Sattva Capital Corp. (2014), 2014 SCC 53, 2014 CSC 53, 2014 CarswellBC 2267, 2014 CarswellBC 2268, 373 D.L.R. (4th) 393, 59 B.C.L.R. (5th) 1, [2014] 9 W.W.R. 427, 461 N.R. 335, 25 B.L.R. (5th) 1, 358 B.C.A.C. 1, 614 W.A.C. 1, (sub nom. *Sattva Capital Corp. v. Creston Moly Corp.)* [2014] 2 S.C.R. 633 (S.C.C.) — considered

Helfand v. Royal Canadian Art Pottery (1970), [1970] 2 O.R. 527, 11 D.L.R. (3d) 404, 1970 CarswellOnt 595 (Ont. C.A.) — considered

Hoang v. Nguyen (2013), 2013 ONSC 6242, 2013 CarswellOnt 13875, [2013] I.L.R. I-5499, 36 R.P.R. (5th) 256 (Ont. S.C.J.) — referred to

John Lee & Son (Grantham) Ltd. v. Railway Executive (1949), [1949] 2 All E.R. 581 (Eng. C.A.) — considered
Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada (2010), 2010 SCC 33, 2010 CarswellBC 2501, 2010 CarswellBC 2502, 92 C.L.R. (3d) 1, [2010] 10 W.W.R. 573, 9 B.C.L.R. (5th) 1, 89 C.C.L.I. (4th) 161, 73 B.L.R. (4th) 163, 323 D.L.R. (4th) 513, (sub nom. *Progressive Homes Ltd. v. Lombard General Insurance Co.*) [2010] I.L.R. I-5051, [2010] 2 S.C.R. 245, 406 N.R. 182, 293 B.C.A.C. 1, 496 W.A.C. 1 (S.C.C.) — considered
Stewart Title Guaranty Co. v. Zeppieri (2009), 2009 CarswellOnt 365, 70 C.C.L.I. (4th) 247, [2009] I.L.R. I-4784, 94 O.R. (3d) 196, 307 D.L.R. (4th) 539 (Ont. S.C.J.) — considered
UPS Supply Chain Solutions, Inc. v. Airon HVAC Service Ltd. (2015), 2015 ONSC 1734, 2015 CarswellOnt 3811, [2015] I.L.R. I-5715, 47 C.C.L.I. (5th) 139 (Ont. S.C.J.) — considered

APPLICATION by province for declaration that contractor had duty to defend province in action commenced by electrician.

***F. Bruce Fitzpatrick J.*:**

Reasons On Application

1 This is an application seeking a declaration that the respondent, Turn-Key Construction Inc. ("*Turn-Key*"), has a contractual duty to defend the applicant, Her Majesty the Queen in right of Ontario ("*Ontario*"), in an action (the "*Action*," Court File No. CV-15-0109) commenced by G. Prezio Electric Limited ("*Prezio*").

2 The contract at issue required Turn-Key to supply and install underground fibre cable to the Fort William Historical Park, a facility owned by Ontario and located in Thunder Bay (the "*Contract*").

3 The parties do not dispute that the Contract contains an indemnity clause that creates a duty to defend on the part of Turn-Key in certain situations (the "*Indemnity*"). The relevant provisions of the Contract respecting the Indemnity and the duty to defend are as follows:

ARTICLE 7 — INDEMNITY AND INSURANCE

7.01 **Supplier Indemnity**

The Supplier hereby agrees to indemnify and hold harmless the Indemnified Parties from and against any and all liability, loss, costs, damages and expenses (including legal, expert and consultant fees), causes of action, actions, claims, demands, lawsuits or other proceedings, (collectively, "Claims"), by whomever made, sustained, incurred, brought or prosecuted, including for third party bodily injury (including death), personal injury and property damage, in any way based upon, occasioned by or attributable to anything done or omitted to be done by the Supplier, its subcontractors or their respective directors, officers, agents, employees, partners, affiliates, volunteers or independent contractors in the course of performance of the Supplier's obligations under, or otherwise in connection with, the Contract. The Supplier further agrees to indemnify and hold harmless the Indemnified Parties for any incidental, indirect, special or consequential damages, or any loss of use, revenue or profit, by any person, entity or organisation, including, without limitation, the Ministry, claimed or resulting from such Claims. The obligations contained in this paragraph shall survive the termination or expiry of the Contract.

7.05 **Supplier Participation in Proceeding**

The Supplier shall, at its expense, to the extent requested by the Ministry, participate in or conduct the defence of any Proceeding against any Indemnified Parties referred to in this Article and any negotiations for their settlement. The Ministry may elect to participate in or conduct the defence of any such Proceeding by notifying the Supplier in writing of such election without prejudice to any other rights or remedies of the Ministry under the Contract, Agreement, at law or in equity. Each Party participating in the defence shall do so by actively participating with the other's counsel. No settlement shall be entered into by the Supplier unless it has obtained the prior written

> approval of the Ministry. If the Supplier is requested by the Ministry to participate in or conduct the defence of any such Proceeding, the Ministry agrees to co-operate with and assist the Supplier to the fullest extent possible in the Proceedings and any related settlement negotiations. If the Ministry conducts the defence of any such Proceedings, the Supplier agrees to co-operate with and assist the Ministry to the fullest extent possible in the Proceedings and any related settlement negotiations. This paragraph shall survive the termination or expiry of the Contract.

4 There is no dispute about the legal principles which are applicable to applications of this sort. Principles applicable to a duty defend in an insurance case are equally applicable to those cases involving a commercial contract (*Hoang v. Nguyen*, 2013 ONSC 6242 (Ont. S.C.J.) at paras. 74-75). The determination of a duty to defend application turns on the pleadings and the contract containing the duty to defend. As set out by Rothstein J. in the Supreme Court of Canada case of *Progressive Homes Ltd. v. Lombard General Insurance Co. of Canada*, 2010 SCC 33 (S.C.C.) at paras. 19-20:

> An insurer is required to defend a claim where the facts alleged in the pleadings, if proven to be true, would require the insurer to indemnify the insured for the claim . . . It is irrelevant whether the allegations in the pleadings can be proven in evidence. That is to say, the duty to defend is not dependent on the insured actually being liable and the insurer actually being required to indemnify. What is required is the mere possibility that a claim falls within the insurance policy. Where it is clear that the claim falls outside the policy, either because it does not come within the initial grant of coverage or is excluded by an exclusion clause, there will be no duty to defend . . .
>
> In examining the pleadings to determine whether the claims fall within the scope of coverage, the parties to the insurance contract are not bound by the labels selected by the plaintiff . . . The use or absence of a particular term will not determine whether the duty to defend arises. What is determinative is the true nature or the substance of the claim.

5 There is no dispute that a mere possibility of a claim falling within the terms of an indemnity will trigger a duty to defend.

6 There is no dispute that while providing work pursuant to the Contract, a subcontractor of Turn-Key accidently severed a major electrical power line to the Fort William Historical Park. This is specifically pleaded in the statement of claim to the Action (the "*Claim*") at paragraph 9. The accident happened at the beginning of November 2013. This created significant problems of freezing for the facilities of Fort William in Thunder Bay.

7 Ontario had to have the power restored quickly. This is pleaded in paragraph 12 of the Claim. Prezio did the work. This is pleaded at paragraphs 15 through 17 of the Claim. Turn-Key refused to pay Prezio. This is pleaded at paragraph 32 of the Claim. Prezio sued Ontario and Turn-Key in the Action.

8 Turn-Key resists the application arguing that Prezio's pleadings do not engage the Indemnity. Turn-Key argues there is no duty to defend in this case.

9 I disagree.

10 I am granting the application for the following reasons.

11 In my view, it is plain and obvious from the language of the Contract that the matter underlying the Claim is precisely the type of matter contemplated by the Indemnity. The weight of the jurisprudence provided by the parties directs the court to take a common sense approach, as opposed to a technical and hypothetical approach to the interpretation of commercial contracts. The true nature of the claim is determinative.

12 The authorities also indicate that the threshold is low when determining whether there is a duty to defend.

13 In this application, I am not called upon to determine whether or not Turn-Key must indemnify Ontario for any and all costs or losses arising from a judgment in the Action. I am determining if Turn-Key has a contractual duty to pay for Ontario's defence to the Action.

14 In this matter, Turn-Key characterizes the essential issue as follows: Whether Turn-Key is obliged to defend Ontario against a claim which, Turn-Key asserts, is based entirely on Ontario's voluntarily assumed liabilities to a third party, Prezio. I disagree with this characterization by Turn-Key.

15 Turn-Key has advanced five principles of contractual interpretation which, if applied, should lead the court to dismiss this application. Turn-Key argues:

1. General contractual terms are to be narrowly construed.

2. Contracts are to be interpreted in a commercially reasonable fashion.

3. Contracts are to provide commercial certainty.

4. Contracts of indemnity are presumed not to provide indemnity against one's own negligence.

5. *Contra proferentum* applies.

16 In general, these propositions are sound. However, in my view, their application does not lead to the result Turn-Key proposes for the following reasons.

The Narrow Construction Argument

17 I have underlined what I view as the key words in the Indemnity at issue in the Contract:

> 7.01 *Supplier Indemnity*
>
> The Supplier hereby agrees (1) to indemnify and hold harmless the Indemnified Parties from and against (2) any and all liability, loss, costs, damages and expenses (including legal, expert and consultant fees), causes of action, actions, claims, demands, lawsuits or other proceedings, (collectively, "Claims"), by whomever made, sustained, incurred, brought or prosecuted, including for third party bodily injury (including death), personal injury and property damage, in any way (3) based upon, occasioned by or attributable to anything done or omitted to be done by the Supplier, its subcontractors (numbers and emphasis added).

18 The portions of the Indemnity fall into three specific sections that I have numbered. The language is plain, clear, and easily understood. I do not find the words ambiguous.

19 In section (1), the words used indicate that the scope of the Indemnity is quite broad. This is because Turn-Key contracted to "indemnify and save harmless" Ontario. In *Stewart Title Guaranty Co. v. Zeppieri*, [2009] O.J. No. 322 (Ont. S.C.J.), D.M. Brown J. considered the meaning of the phrase "indemnify and save harmless." At paragraph 20, Brown J. concluded that "the language 'save harmless' imposes an additional obligation that goes beyond the obligation 'to indemnify.'"

20 In section (2), the words clearly indicate that Ontario is indemnified against all liability arising from a lawsuit. This is what Ontario seeks in the request for a declaration of a duty to defend. Of course, this obligation is modified and illuminated by the balance of the paragraph and, in particular, the words in section (3). In their arguments, counsel for both parties focused on the meaning of the words: "based upon, occasioned by or attributable to anything done or omitted to be done by the Supplier, its subcontractors."

21 Counsel for Turn-Key argued for a narrow interpretation of these words. Turn-Key's narrow interpretation would mean that because Ontario "voluntarily" engaged Prezio, the Action is not "based upon, occasioned by or attributable to anything done by Turn-Key or its subtrade." I cannot see the logic in such an interpretation. In my view, it is plain and obvious that the Action is completely based upon, occasioned by or attributable to the cutting of the power line by Turn-Key's subtrade. There was nothing voluntary in Ontario's action. In the absence of the subcontractor cutting the

power line, Ontario would not have engaged Prezio. I find that on the plain language of the Contract and a common sense approach to the true nature and substance of the Claim, there is more than a mere possibility that the Indemnity will ultimately be engaged.

22 Much of the argument made by Turn-Key relied on two older authorities which were used to put forward the proposition that the general words of the Indemnity should be narrowly construed. Turn-Key argued that a narrow interpretation leads to the conclusion that it is clear the Indemnity would never be triggered. While these older authorities may be still good law, I did not find them to stand for the propositions argued by Turn-Key. Also, I found more recent authorities to express more clearly and succinctly the manner by which I must interpret this commercial contract.

23 In *Creston Moly Corp. v. Sattva Capital Corp.*, 2014 SCC 53 (S.C.C.) at para. 47, the Supreme Court of Canada directed that courts are to interpret commercial contracts "as a whole, giving the words used their ordinary and grammatical meaning, consistent with the surrounding circumstances known to the parties at the time of formation of the contract." In the recent decision of *UPS Supply Chain Solutions, Inc. v. Airon HVAC Service Ltd.*, 2015 ONSC 1734 (Ont. S.C.J.), at para. 89, W. Matheson J. found that this requires a judge to take a practical, common sense approach not dominated by technical rules of construction when interpreting commercial contracts. I agree this accurately and succinctly sets out the most useful and applicable legal principles which bear on this application. These principles do not lead me to accept the narrow construction argument put forward by Turn-Key.

24 Counsel for Turn-Key pointed the court to the decision of the Ontario Court of Appeal in *Helfand v. Royal Canadian Art Pottery*, [1970] 2 O.R. 527 (Ont. C.A.). He argued that the principles set out therein should lead this court to a more restricted view of the scope of the Indemnity. He points to paragraphs 16 through 20 of *Helfand* to argue that the interpretation of general words in a contract cannot be determined by looking at their literal meaning alone. Instead, general words must be interpreted so as to restrict meaning to the nature of the agreement and the intentions of the parties. While *Helfand* may have held for a more restrictive interpretation of a commercial agreement, the wording at issue involved the meaning of a clause placed in an order form for teapots. The clause stated: "Seller agrees to *protect* purchaser against all claims, losses, damages, costs, and expenses . . . " (emphasis added). In my view, a clause requiring a party "to protect" is different and possibly of a more narrow scope than one that requires a party "to indemnify and save harmless." *Helfand* is limited to its particular facts and the particular language of the contract at issue. For that reason, the case is of no assistance here. Further, the *ratio* of the case was directed to the interpretation of an indemnity-like clause, and did not expressly deal with the duty to defend. Accordingly, I did not find *Helfand* particularly helpful, nor did I find Turn-Key's argument, that the words in the Indemnity should be narrowly construed, persuasive.

25 I also did not find the English Court of Appeal case from 1949, *John Lee & Son (Grantham) Ltd. v. Railway Executive*, [1949] 2 All E.R. 581 (Eng. C.A.), of assistance. The decision turned on the issue of the applicability of an indemnity rather than on the duty to defend. Also the court stated at page three that the decision turned on the nature of the landlord and tenant relationship as the context by which the particular indemnity provision should be construed. This is not the kind of relationship we have in this case.

The Commercially Reasonable and Commercially Certain Arguments

26 In my view, much of the argument put forward by Turn-Key focused on whether or not the Indemnity would apply rather than whether there was a mere possibility it would apply. Counsel for Turn-Key sought to buttress its position by referring to hypotheticals rather than dealing with the case as presented to the court. This was not of assistance to the court in determining the matter. There is enough in the facts of this case to allow the court to deal with both the commercial reasonability and commercial certainty of the contract without the need to resort to arguments based on hypotheticals.

27 I agree with Ontario that the essential fact in the Action is as follows: Without Turn-Key's subcontractor cutting the power line, Prezio would not have done anything for which it now seeks compensation from Ontario.

28 Work on an underground fibre cable line is what the Contract between Ontario and Turn-Key was all about. The Contract also contained an indemnification and a duty to defend clause as many commercial contracts do, particularly where sophisticated parties are involved. To my mind, the Indemnity is what the parties contemplated as necessary to determine who would pay for what in the event something went wrong while digging underground. As the result of something going wrong while digging underground, Ontario was sued. On these facts, an interpretation of the Contract wherein Turn-Key has a duty to defend Ontario in the Action is not a commercially unreasonable result nor something that would be considered uncertain or beyond the intentions of the parties.

The No Indemnity for One's Own Negligence Argument

29 It is clear from the Claim that the negligence at issue was not that of Ontario. I cannot see how a court could find Ontario negligent for retaining a contractor to do emergency repairs in the circumstances set out in the Claim. This argument does not support the proposition that it is clear the Claim will not engage the Indemnity.

The Contra Proferentem Argument

30 I do not find the terms of the Indemnity ambiguous. This argument was of no assistance.

Conclusion

31 In this case, the true nature or substance of the claim is that Ontario is being sued because of alleged negligence of a Turn-Key subcontractor. It is a lawsuit that has and will cost Ontario to defend that is based upon, occasioned by or attributable to the actions of a Turn-Key subcontractor. This creates a mere possibility that the Indemnity will be triggered in the case. Accordingly, Turn-Key has a duty to defend Ontario.

32 The application is granted.

33 The court therefore declares:

> 1. Turn-Key Construction Inc. has a contractual duty to defend Her Majesty the Queen in right of Ontario in the action bearing Court File No. CV-15-0109 and related actions;
>
> 2. Turn-Key Construction Inc. shall pay Her Majesty the Queen in right of Ontario's reasonable defence costs to date and going forward along with any costs for related cross or third party claims, and that Her Majesty the Queen in right of Ontario is entitled to separate counsel to represent Ontario from counsel representing Turn-Key at Turn-Key's expense, and that such counsel may be privately retained by Ontario, or be Crown counsel; and
>
> 3. In the event that the issue of the quantum of reasonable defence costs to date and going forward, cannot be resolved within 30 days of the release of these reasons, counsel may make an appointment to address that issue by way of a special date before Fitzpatrick J.

Costs

34 In my view, the disposition of this application calls for costs to be awarded to Ontario on a partial indemnity basis. At the commencement of the proceedings, I asked counsel for their best estimate of reasonable partial indemnity costs should they be successful. I found Turn-Key's estimate most reasonable. Given this observation, I would expect counsel to resolve the costs issue in that neighbourhood. If they cannot do so, they may make an appointment to address that issue before me. Such an appointment shall be requested within 30 days of the release of these reasons failing which the costs will be deemed to be settled such that Turn-Key will pay to Ontario the sum of $7,000.00, inclusive of disbursements and GST.

Application granted.

End of Document

7.

Most Negative Treatment: Distinguished
Most Recent Distinguished: Metro Ontario Inc. v. Cloverdale Mall Inc. | 2015 ONSC 4579, 2015 CarswellOnt 10875, 54 C.C.L.I. (5th) 167, 255 A.C.W.S. (3d) 815 | (Ont. Div. Ct., Jul 16, 2015)

2009 CarswellOnt 365
Ontario Superior Court of Justice

Stewart Title Guaranty Co. v. Zeppieri

2009 CarswellOnt 365, [2009] I.L.R. I-4784, [2009] O.J. No. 322, 174 A.C.W.S. (3d) 488, 307 D.L.R. (4th) 539, 70 C.C.L.I. (4th) 247, 94 O.R. (3d) 196

Stewart Title Guaranty Company v. Enio Zeppieri and Zeppieri & Associates

D.M. Brown J.

Heard: December 18, 2008
Judgment: January 27, 2009
Docket: 08-CV-00363826-0000

Counsel: S. Clements, M. Skuce for Applicant
G. Tighe, J. Cook for Respondents

Subject: Corporate and Commercial; Insurance; Civil Practice and Procedure; Property; Torts
Related Abridgment Classifications
Guarantee and indemnity
III Indemnity
  III.1 Bonds of indemnity
    III.1.a Scope of bond
Insurance
X Actions on policies
  X.1 Commencement of proceedings
    X.1.d Obligations of insurer
      X.1.d.ii To defend
        X.1.d.ii.F Miscellaneous

Headnote
Guarantee and indemnity --- Indemnity — Bonds of indemnity — Scope of bond
Company offering title insurance for real estate transactions (insurer) made agreement with provincial law society (society) to "indemnify and save harmless" law society's members from and against certain claims arising under title insurance policies — Purchasers in real estate transaction brought action against law society member and his firm (respondents) for negligence and failure to obtain good title — Respondents sought to have insurer honour indemnity agreement and cover their ongoing costs of defending purchasers' action — Insurer refused — Insurer brought application for various declarations regarding its obligations under indemnity agreement — Application dismissed — Contractual obligation to "save harmless" was broader than that of indemnification — Obligation to "save harmless" meant that member should never have to put his hand in his pocket in respect of claim covered by terms of indemnity agreement — Indemnity agreement required insurer to pay for member's ongoing costs of defending claim that falls within coverage of agreement — This interpretation was consistent with plain meaning of phrase "indemnify and save harmless" — Interpretation was also consistent with case law, business sense underpinning indemnity agreement, and reasonable expectations of parties.

Insurance --- Actions on policies — Commencement of proceedings — Obligations of insurer — To defend — General principles

Company offering title insurance for real estate transactions (insurer) made agreement with provincial law society (society) to "indemnify and save harmless" law society's members from and against certain claims arising under title insurance policies — Purchasers in real estate transaction brought action against law society member and his firm (respondents) for negligence and failing to obtain good title for purchasers due to Planning Act violation — Insurer took position that indemnity was not triggered and it had no duty to defend respondents — Respondents brought third party claim against insurer seeking declaration that insurer was under duty to indemnify respondents for costs of defending action — Insurer brought application for various declarations regarding its obligations under indemnity agreement — Application dismissed — Insurer was required to fund, on ongoing basis, reasonable costs incurred by respondents in defending purchasers' action — Court must decide insurer's duty to defend by looking at pleadings and insurance policy — Planning Act violation pleading against respondents alleged facts in respect of claim arising under title insurance policy — Claim against respondents fell within obligation to indemnify and save harmless in indemnity agreement and triggered insurer's duty to pay respondents' ongoing cost of defending claim — Since obligation to defend is broader than that to indemnify, mere possibility that claim within policy might succeed triggers obligation to defend.

Table of Authorities

Cases considered by *D.M. Brown J.*:

Alie v. Bertrand & Frère Construction Co. (2002), 62 O.R. (3d) 345, 167 O.A.C. 20, 2002 CarswellOnt 4255, 222 D.L.R. (4th) 687, 1 C.C.L.I. (4th) 166, 26 C.L.R. (3d) 5, [2003] I.L.R. I-4146 (Ont. C.A.) — considered

Halifax Insurance Co. of Canada v. Innopex Ltd. (2004), 2004 CarswellOnt 4158, [2004] I.L.R. I-4338, 72 O.R. (3d) 522, 15 C.C.L.I. (4th) 159, 190 O.A.C. 356 (Ont. C.A.) — referred to

Hanis v. University of Western Ontario (2008), 69 C.C.E.L. (3d) 86, (sub nom. *Guardian Insurance Company of Canada v. University of Western Ontario*) [2008] I.L.R. I-4748, 241 O.A.C. 303, 2008 ONCA 678, 2008 CarswellOnt 5867, 67 C.C.L.I. (4th) 196 (Ont. C.A.) — followed

Kelly v. Eldridge (2006), 2006 CarswellNB 701, 59 C.L.R. (3d) 116, 2006 NBQB 426, 44 C.C.L.I. (4th) 258, 26 B.L.R. (4th) 66, 315 N.B.R. (2d) 32, 815 A.P.R. 32 (N.B. Q.B.) — referred to

Mewburn v. MacKelcan (1892), 19 O.A.R. 729 (Ont. C.A.) — followed

Monenco Ltd. v. Commonwealth Insurance Co. (2001), 2001 SCC 49, 2001 CarswellBC 1871, 2001 CarswellBC 1872, [2001] I.L.R. I-3993, 155 B.C.A.C. 161, 254 W.A.C. 161, 204 D.L.R. (4th) 14, 274 N.R. 84, 32 C.C.L.I. (3d) 165, [2002] 2 W.W.R. 438, 97 B.C.L.R. (3d) 191, [2001] 2 S.C.R. 699 (S.C.C.) — referred to

Nichols v. American Home Assurance Co. (1990), [1990] I.L.R. 1-2583, 45 C.C.L.I. 153, 39 O.A.C. 63, 107 N.R. 321, 68 D.L.R. (4th) 321, [1990] 1 S.C.R. 801, 1990 CarswellOnt 619, 72 O.R. (2d) 799 (note), [1990] R.R.A. 516, 1990 CarswellOnt 994 (S.C.C.) — referred to

Northwest Territories (Commissioner) v. 851791 N.W.T. Ltd. (1999), 1999 CarswellNWT 3 (N.W.T. S.C.) — distinguished

Opron Maritimes Construction Ltd. v. Canadian Indemnity Co. (1986), 21 C.L.R. 113, 19 C.C.L.I. 168, 73 N.B.R. (2d) 389, 184 A.P.R. 389, [1986] I.L.R. 1-2108, 1986 CarswellNB 59 (N.B. C.A.) — referred to

Thames Steel Construction Ltd. v. Northern Assurance Co. (1988), [1989] I.L.R. 1-2399, 67 O.R. (2d) 158, 55 D.L.R. (4th) 639, 1988 CarswellOnt 731, 32 O.A.C. 330, 34 C.C.L.I. 320 (Ont. C.A.) — referred to

Warwick v. C. Richardson (1842), 152 E.R. 477, 10 M. & W. 284 (Eng. Exch.) — referred to

3869130 Canada Inc. v. I.C.B. Distribution Inc. (2008), 45 B.L.R. (4th) 1, 2008 CarswellOnt 2802, 2008 ONCA 396, 66 C.C.E.L. (3d) 89, 239 O.A.C. 137 (Ont. C.A.) — followed

Statutes considered:

Planning Act, R.S.O. 1990, c. P.13

Generally — referred to

Rules considered:

Rules of Civil Procedure, R.R.O. 1990, Reg. 194

R. 14 — referred to

Words and phrases considered

indemnify and save harmless

The language "save harmless" imposes an additional obligation that goes beyond the obligation to "indemnify". To make a person whole after the fact may satisfy an obligation to indemnify in the proper case. But, to require a person protected by a promise to save him harmless first to pay out monies in respect of a claim, before he can call on his counter-party to honour his promise, hardly saves him harmless.

APPLICATION by insurer for declarations regarding its obligations under indemnity agreement.

***D.M. Brown J.*:**

I. Overview

1 In March, 2005, the applicant, Stewart Title Guaranty Company, an insurer offering title insurance products for Ontario real estate transactions, agreed with the Law Society of Upper Canada to "indemnify and save harmless" a LSUC member "from and against any claims arising under the title insurance policy(ies), except for the member's gross negligence or willful misconduct." Later that year Shlomo and Zvia Ziv sued their lawyer, the respondent Enio Zeppieri, and his firm, for negligence regarding a real estate purchase. In 2007 they amended their claim against the respondents to include an allegation that the respondents had failed to obtain good title to the property for them. The respondents called upon Stewart Title to honour the 2005 Indemnity Agreement and cover their on-going costs of defending the Zivs' action. Stewart Title refused.

2 At the heart of this application lies the following question: does the 2005 Indemnity Agreement require Stewart Title to pay, on an on-going basis, the legal defence costs of a LSUC member against whom a claim is made arising under a title insurance policy issued by it? Stewart Title contends that it does not. The respondents argue that it does, and they complain that Stewart Title stands alone amongst title insurers in Ontario in the position it takes.

II. Relief sought by applicant

3 In its Notice of Application Stewart Title sought three different declarations:

> (i) A declaration the words "claims arising under the title insurance policy" in the 2005 Indemnity Agreement mean that Stewart Title is only required to indemnify a LSUC member for damages awarded against the member and defence costs in respect of claims to which the title insurance policy would respond, if the insured had claimed under the title insurance policy rather than commencing an action against the LSUC member;
>
> (ii) A declaration that Stewart Title does not owe the respondents a duty to defend them in the Ziv action because the claims asserted against the respondents are not "claims arising under the title insurance policy"; and,
>
> (iii) A declaration that Stewart Title does not owe any duty to pay on behalf of, or to indemnify, the respondents in respect of any damages, interest or costs awarded against them in the Ziv action because the asserted claims are not ones "arising under the title insurance policy".

4 Notwithstanding these requests for declarations, as I understood the submissions made by Stewart Title in its factum and in its oral argument, the issues for determination on this application boil down to the following two:

> (a) Under the 2005 Indemnity Agreement is Stewart Title only required to indemnify and save harmless a LSUC member for the costs of defending a claim regarding title after a final adjudication of that claim has been made, or does the 2005 Indemnity Agreement require Stewart Title to indemnify the member for such costs on an on-going basis if the claim involves a matter arising under the policy?

(b) If the 2005 Indemnity Agreement requires Stewart Title to pay a member's on-going defence costs, is such an obligation triggered in the Zivs' action against the respondents?

5 Before turning to my analysis, let me deal with one procedural issue raised by both parties at the hearing. Although there was some debate about the propriety of determining these questions on this application, by the end of the hearing I understood the parties to acknowledge that, in essence, this application raises issues analogous to those in duty to defend applications. Rule 14 applications are used commonly in this province to determine duty to defend questions. Their use is proper as long as a court takes care not to make findings that would compromise or affect the underlying litigation: *Halifax Insurance Co. of Canada v. Innopex Ltd.* (2004), 72 O.R. (3d) 522 (Ont. C.A.), para. 37.

III. First Issue: Under the 2005 Indemnity Agreement Is Stewart Title only required to indemnify and save harmless a LSUC member for the costs of defending a claim regarding title after a final adjudication of that claim has been made, or does the 2005 Indemnity Agreement require Stewart Title to indemnify the member for such costs on an on-going basis if the claim involves a matter arising under the policy?

A. The agreement between Stewart Title and the LSUC

6 Let me sketch briefly the history of the dealings between the LSUC and private title insurance companies in order to set the stage for understanding the issues on this application. Over the years a high risk has attached to the practice of real estate conveyancing in Ontario. In the mid-1990s real estate claims accounted for close to 50% of the claims costs experienced by the insurance arm of the LSUC, the Lawyer's Professional Indemnity Company (once known as LPIC, now called LAWPRO). [1] Although that number declined to about 30% by 2002, LAWPRO still regards real estate practice as a high risk area.

7 In addition to providing professional liability insurance to its members, LAWPRO offers title insurance for real estate transactions. Its product is called TitlePLUS. Private insurance companies, such as Stewart Title, offer competing title insurance products for Ontario real estate transactions.

8 In the mid-1990s LAWPRO introduced a real estate transaction levy surcharge payable by a LSUC member for each real estate transaction in which the member provided legal services. According to LAWPRO, "the transaction levy surcharge ensures that the total premiums paid by real estate lawyers matches the risk (and losses) they represent to the insurance program." At present the levy surcharge amounts to $50.00 per transaction.

9 In 1998 LAWPRO introduced an exemption from the levy surcharge. Contained in Endorsement No. 2 to LAWPRO's professional liability insurance policy it reads:

C. Exclusions

No levy surcharge is payable by a member under this endorsement in respect of a real estate transaction if:

. . . . .

(v) the real estate transaction closes on or after January 1, 1998, and a title insurance policy(ies) is(are) issued in favor of all of the transferees and chargees obtaining an interest in or charge against the land which is the subject of the real estate transaction, provided that:

. . . . .

(b) the title insurer(s) issuing the title insurance policy(ies) has(have) in all cases (except for the member's gross negligence or willful misconduct):

(i) agreed to indemnify and save harmless from and against any claims arising under the title insurance policy(ies); and

(ii) waived its right to maintain a negligence claim against;

the member(s) acting as solicitor(s) for the transferee(s), chargee(s) and/or the title insurer(s)...

10 On October 18, 2004, the LSUC required title insurers to enter into a Release and Indemnity Agreement with it, otherwise solicitors using that title insurer's product would not qualify for the exemption from the $50 levy surcharge. Business necessity required private title insurers to enter into some form of agreement with the LSUC so that their products could match the $50 exemption offered by LAWPRO's TitlePLUS product.

11 Stewart Title objected to the form of agreement proposed by the LSUC. It was offended by the suggestion that the LSUC possessed the authority to regulate the title insurance industry, and also took the view that the proposed release and indemnity would broaden the scope of that already contained in Endorsement No. 2.

12 Nevertheless, negotiations ensued with the LSUC. In the result, by letter dated March 9, 2005, Stewart Title provided an indemnity in favor of all members of the LSUC which reads, in part:

> Pursuant to the requirement of the Endorsement(s) to the Law Society Professional Liability Insurance Policy (herein "Policy") that deal with the Real Estate Transaction Levy Surcharge, please accept this letter as evidence of our agreement with you, the members of the Law Society of Upper Canada, that where a title insurance policy(ies) is(are) issued in favor of all of the transferees and chargees obtaining an interest in or a charge against the land which is the subject of a real estate transaction, we agree to:
>
> (i) indemnify and save harmless the member of the Law Society of Upper Canada and the member's law firm ("the member") acting as solicitor(s) for the transferee(s), chargee(s) and/or the title insurer(s) from and against any claims arising under the title insurance policy(ies), except for the member's gross negligence or wilful misconduct; and
>
> (ii) release our right to maintain a negligence claim against the member(s) acting as solicitor(s) for the transferee(s) chargee(s), and/or the title insurer(s), except for the member's gross negligence or wilful misconduct.

13 This agreement was in place at the time of the real estate transaction underlying this application.

B. Analysis

(i) The parties' interpretations of the 2005 Indemnity Agreement

14 In his oral submissions applicant's counsel acknowledged that under the 2005 Indemnity Agreement Stewart Title must indemnify a LSUC member for costs of defending a claim, but such an obligation, he contended, is triggered only at the end of an action when a court has found that a claim was made out under the title insurance policy or when an action is settled.[2] For their part the respondents argued that the obligation to indemnify and save harmless for legal costs is triggered by the making of a claim against a member which, by application of the "pleadings rule", constitutes a "claim arising under the title insurance policy" as stipulated by the 2005 Indemnity Agreement.

(ii) The governing principles of interpretation

15 This is a commercial contract which must be interpreted in accordance with the principles most recently summarized by the Court of Appeal in *3869130 Canada Inc. v. I.C.B. Distribution Inc.*, 2008 ONCA 396 (Ont. C.A.), at paragraph 31:

> In *Ventas, Inc. v. Sunrise Senior Living Real Estate Investment Trust* (2007), 85 O.R. (3d) 254 at para. 24, this Court summarized the principles applying to the interpretation of commercial contracts as follows:

> Broadly stated ... a commercial contract is to be interpreted,
>
> > (a) as a whole, in a manner that gives meaning to all of its terms and avoids an interpretation that would render one or more of its terms ineffective;
> >
> > (b) by determining the intention of the parties in accordance with the language they have used in the written document and based upon the "cardinal presumption" that they have intended what they have said;
> >
> > (c) with regard to objective evidence of the factual matrix underlying the negotiation of the contract, but without reference to the subjective intention of the parties; and (to the extent there is any ambiguity in the contract),
> >
> > (d) in a fashion that accords with sound commercial principles and good business sense, and that avoids a commercial absurdity.

The Court went on to note that where the language of a written contract is unambiguous, extrinsic evidence is not admissible to alter, vary, interpret, or contradict the words used in the contract. Nevertheless, regardless of any ambiguity, the courts may always have regard to the context and to the objective evidence of the surrounding circumstances underlying the negotiation of the contract: *I.C.B. Distribution, supra.*, para. 32.

(iii) Giving effect to the language used

16 The 2005 Indemnity Agreement does not contain the standard duty to defend language ordinarily seen in liability insurance policies: see, for example, *Nichols v. American Home Assurance Co.*, [1990] 1 S.C.R. 801 (S.C.C.), at para. 8; Barbara Billingsley, *General Principles of Canadian Insurance Law*, p. 233. Instead, in the 2005 Indemnity Agreement Stewart Title agreed with the LSUC that for a real estate transaction where it issued a title insurance policy, it would "indemnify and save harmless" the lawyer and his firm who acted for the transferee, chargee and/or the title insurer "from and against any claims arising under the title insurance policy(ies), except for the member's gross negligence or wilful misconduct".

17 This language imposes two obligations on Stewart Title with respect to a member of the LSUC — to "indemnify" that member, and to "save harmless" that member from claims arising under a title insurance policy. The contractual obligation to save harmless, in my view, is broader than that of indemnification. I accept the respondents' submission that the obligation to "save harmless" means that a LSUC member should never have to put his hand in his pocket in respect of a claim covered by the terms of the 2005 Indemnity Agreement. Accordingly, the 2005 Indemnity Agreement requires Stewart Title to pay for the member's on-going costs of defending a claim that falls within the coverage of agreement. This interpretation not only is consistent with the plain meaning of the phrase "indemnify and save harmless", it also is consistent with the case law, the business sense underpinning the 2005 Indemnity Agreement, and the reasonable expectations of the parties.

(iv) The case law

18 The decision of the Ontario Court of Appeal in *Mewburn v. MacKelcan* (1892), 19 O.A.R. 729 (Ont. C.A.) offers assistance in interpreting the language at issue. In that MacKelcan, a former law partner of Mewburn, agreed to "indemnify and save [him] harmless... *from payment*" of all liabilities of the parties' former partnership. A third party obtained a judgment against Mewburn for such a liability. Mewburn called on MacKelcan to make good on his promise. MacKelcan refused, arguing that his indemnity obligation did not arise until Mewburn first paid the judgment.

19 The Court of Appeal rejected MacKelcan's argument. Hagarty C.J.O. concluded that the obligation to indemnify and save harmless from payment of a liability meant "a saving harmless from the liability to pay with all its serious consequences": *Mewburn*, para. 29. MacLennan J.A. thought the word "indemnify" could either mean to make reimbursement after the loss had occurred or to prevent the loss from occurring.

20 MacLennan J.A. then went on to consider the language "save harmless". He reasoned that "to restore a party to his former state after suffering him to receive harm is not to save him harmless." [3] I find that reasoning persuasive. It makes common and business sense. The language "save harmless" imposes an additional obligation that goes beyond the obligation to "indemnify". To make a person whole after the fact may satisfy an obligation to indemnify in the proper case. But, to require a person protected by a promise to save him harmless first to pay out monies in respect of a claim, before he can call on his counter-party to honour his promise, hardly saves him harmless. He must bear the burden of incurring the expense related to the claim and then hope his counter-party promptly reimburses him. Under the 2005 Indemnity Agreement Stewart Title agreed to save LSUC members harmless from "any claims arising under the title insurance policy". In my view, that would include not only paying any damages for which a member might become liable, but also covering the on-going costs incurred in defending such claims.

21 I recognize that in the *Mewburn* case the contract provided that MacKelcan would save Mewburn harmless "from payment". That feature of the contract does not, in my view, make the reasoning in *Mewburn* inapplicable to the interpretation of the present contract. In interpreting a contract a court must give meaning to all contractual terms. If, as Stewart Title submitted, the obligation to indemnify means to compensate after the fact (a matter which I do not have to decide), then the obligation to "save harmless" must bear some additional meaning. Otherwise, those words would be superfluous.

22 This interpretation of the phrase "indemnify and save harmless" finds support in the recent New Brunswick decision in *Kelly v. Eldridge*, 2006 NBQB 426 (N.B. Q.B.). In a construction contract between a home owner and his building contractor, the latter agreed to "protect itself and indemnify and save the Owner harmless from any and all claims which may arise from the Contractor's operations causing property damage." The home owner's neighbours sued him and the contractor for damages, alleging that surface drainage had been affected by the construction. The homeowner sought an order that his contractor was required, by the terms of the construction contract, to pay his defence costs. McLellan J. accepted the homeowner's argument, holding that under the language of the contract the contractor had assumed the duty of bearing the homeowner's defence costs: *Kelly*, para. 11.

23 The only other decision to consider the language "indemnify and save harmless" to which counsel referred me was that of the Northwest Territories Supreme Court in *Northwest Territories (Commissioner) v. 851791 N.W.T. Ltd.*, [1999] N.W.T.J. No. 2 (N.W.T. S.C.). That case involved a passenger on a motorcycle who suffered injuries when the bike hit a pile of dirt on the road in a construction zone. She sued multiple parties, including the territorial government. The court dismissed an application by the territorial government to require a contractor to pay its on-going costs of defending the lawsuit. Under the construction contract the contractor had agreed to "indemnify and save the G.N.W.T. harmless from and against all claims...actions, suits or proceedings...arising out of...activities of the Contractor...in performing the work..."

24 With respect, I am not prepared to follow the reasoning in that case. First, the primary concern expressed by the court was a procedural one — it thought that applications before trial should not be used to determine whether a duty to defend exists. That simply is not the case in Ontario where courts regard a Rule 14 application as the appropriate method by which to consider such an issue: *Halifax Insurance, supra.* Second, the court's apparent reluctance to apply the "pleadings rule" in a case with multiple defendants does not reflect Ontario law. Finally, the court distinguished the Court of Appeal decision in *Mewburn*. I do not; I find persuasive the Court of Appeal's reasoning in the *Mewburn* case, notwithstanding the age of the decision.

(v) The business sense underpinning the 2005 Indemnity Agreement

25 Stewart Title contends that to interpret the 2005 Indemnity Agreement as containing a duty to pay on-going legal costs would be inconsistent with the rationale underpinning the duty of an insurer to defend. It points to the decision of the Court of Appeal in *Alie v. Bertrand & Frère Construction Co.* (2002), 62 O.R. (3d) 345 (Ont. C.A.), where, at paragraph 182, the Court stated:

> A duty to defend determined only after the trial of the claim may come much too late to assist an insured who paid through its premium for that defence, but is unable to fund the litigation itself. The prospective determination of a duty to defend also facilitates the expeditious resolution of claims made against the insured through the early involvement of the insurer who may eventually have to indemnify the insured.

See also: Billingsley, *supra.*, at p. 234.

26 Stewart Title argues that neither rationale applies in the case of 2005 Indemnity Agreement. First, it contends that because a lawyer has recourse to the benefit of a defence provided by his LAWPRO professional liability policy, subject to a $5,000.00 deductible, Stewart Title's agreement to "indemnify and save harmless" a member does not require it to fund on-going defence costs. I do not find this argument persuasive. While it is true that a LSUC member receives the protection of his professional liability insurance, albeit subject to a significant deductible, the factual matrix underlying the genesis of the 2005 Indemnity Agreement shows that it was the high proportion of LAWPRO's claims costs represented by real estate transactions that led to the imposition of the $50 levy surcharge. The surcharge was designed to fund the increased risks faced by LAWPRO in defending claims against real estate lawyers. To gain exemption for their products from the surcharge, title insurers were required to promise to "indemnify and save harmless" a LSUC member — the clause passed on the risk of the costs of defending claims, as well as indemnifying against potential settlements or judgments in title-insured transactions. That was the "quid pro quo" for securing an exemption from the levy surcharge, thereby enhancing the competitiveness in the marketplace of products offered by title insurers such as Stewart Title.

27 Stewart Title also argued that it would be inconsistent to require it to fund a member's defence costs while LAWPRO retains control over the conduct of the defence. Stewart Title is a sophisticated insurer. It could have raised that issue in its negotiations with the LSUC; there is no evidence before me that it did. Nor is there any evidence in the record which would permit me to assess the relative business risks and benefits of such an arrangement, and whether it could be characterized as a commercial absurdity.

(vi) The reasonable expectations of the parties

28 While I recognize that when considering the factual matrix underlying the negotiation of a commercial contract a court must not take into account the subjective intention of the parties, a court should give some regard to a party's admitted understanding of the contract. In the present case, during his cross-examination, Mr. Marco Polsonelli, a representative of Stewart Title, admitted that under the 2005 Indemnity Agreement Stewart Title is required to pay the on-going defence costs of a LSUC member as they arise where the suit against the member contains claims arising under the title policy:

> Q. 83: ...As I understand your testimony, we have agreed that the indemnity has two parts and two separate obligations. One, to indemnify as against damages awarded, to use your term there, which we have included all of the costs and interest and whatnot, and two, to indemnity as against defence costs, right?
>
> A. That is correct.
>
> Q. 84: And by necessity, we have agreed...and you have testified that the defence cost obligation will necessarily be incurred before the damages awarded obligation, because the defence costs come first?
>
> A. I guess unless the lawyer involved did not render an account throughout the proceedings, but I can't imagine that to be the case. *So generally, yes, those defence costs would become payable and due as the lawyer renders an account.* (emphasis added)

See also: QQ. 59-67; 73-75; 83-84.

29 Those are telling admissions.

C. Conclusion

30 I conclude that the terms of the 2005 Indemnity Agreement, in particular the phrase "indemnify and save harmless", require Stewart Title to fund, on an on-going basis, the reasonable defence costs of a LSUC member against whom a claim is made arising under a title insurance policy issued by Stewart Title, except in cases of the member's gross negligence or wilful misconduct.

IV. Second Issue: If the 2005 Indemnity Agreement requires Stewart Title to pay a member's on-going defence costs, is such an obligation triggered in the Zivs' action against the respondents?

A. The lawsuit against the respondent LSUC member

31 Enio Zeppieri, a lawyer and member of the law firm, Zeppieri & Associates, acted for Shlomo and Zvia Ziv on their purchase of a property in Thornhill, Ontario. The Zivs entered into an agreement of purchase and sale in April, 2005.

32 Mr. Zeppieri sent his requisition letter to the vendors' solicitor on June 15, 2005. It included a requisition of satisfactory compliance with the *Planning Act*, as well as the correction of certain misdescriptions on registered title documents which suggested possible violations of the *Planning Act*. The lawyer also requested the conversion of the Property from Land Registry to Land Titles.

33 On July 28, 2005 Mr. Zeppieri wrote vendors' counsel to advise that the Zivs would accept registration of a proposed Correcting Deed and the undertaking of the vendors' counsel that after closing there would be "rectification of the Planning Act on this property, and that you will attend to making certain that this property is converted to the Land Titles system by the Newmarket Registry office within sixty days of registration of the Transfer herein, and that your client will pay all costs associated therewith."

34 The purchase of the Property closed on August 2, 2005. The Correcting Deed was registered that day.

35 On August 2, 2005 Stewart Title issued a Gold Comprehensive Production Owner's Policy, naming the Zivs as the insureds, in respect of their purchase of the Property. The title insurance Policy provided coverage in the event that:

> 16. There is a violation of the subdivision and part lot control provisions of the *Planning Act*.

The Policy contained the following exclusion:

> You are not insured against loss, costs, legal fees, and expenses resulting from...
>
> 3. Title Risks...that result in no loss to you.

Schedule B to the Policy also excluded from coverage any loss or damage which arose by reason of:

> An easement registered as Registration/Instrument No(s) 474860 and an easement registered as Registration/Instrument No(s) VA71391.

36 About three months after the closing, on November 23, 2005, the Zivs started an action against their real estate agent and the respondents claiming damages for breach of contract and negligence. Although the original pleading by the Zivs referred only to the claim regarding the easements, from a December 22, 2006 letter sent by the Zivs' counsel, Stewart Title knew that they were thinking of amending their claim to assert a *Planning Act* violation. In that letter the Zivs' counsel went on to write:

> We are writing this letter on behalf of the Zivs to advise you of a claim or possible claim under the Policy.

37 The Zivs amended their Claim on April 2, 2007 to assert the following claims against Mr. Zeppieri and his firm:

> 12. The Lawyer (Zeppieri) acted for the plaintiffs in connection with their purchase of the Property. The Lawyer's requisition letter dated June 15, 2005 to Robertson, Munro the solicitors for the vendor Ninetta Panetta, include requisition number 14, which raised a concern that the title search disclosed a breach of the subdivision control provisions of the Planning Act R.S.O. 1990, c. P.13 ("Planning Act Violation"). The Lawyer informed the plaintiffs that they had an option not to close the transaction because of a technical problem, but he advised them to close, and without explaining the implications of doing so described in paragraph 13 below. They accepted this advice.
>
> 13. The Lawyer then proceeded to close the transaction on the basis of an undertaking given by Robertson Munro to rectify the Planning Act Violation, and on the basis of a correcting deed from the vendor to herself. As a result, the plaintiffs did not attain good title to the Property on closing. As of the date of this amended pleading, the Planning Act Violation has not been rectified. The plaintiffs will not have good title to the Property until and unless the Planning Act Violation is rectified.
>
> 14. At no time prior to closing did the Lawyer advise the plaintiffs of the existence of the Easements or how the Easements could restrict the ways in which the Property could be severed or developed. Had the Lawyer done so, the plaintiffs would have had the opportunity to negotiate a better price, or elect not to close the transaction as they were entitled to do given the Planning Act Violation.
>
> . . . . .
>
> 21. The Lawyer breached the duties he owed to the plaintiffs in various ways, including the following:
>
> > (f) by failing to obtain for the plaintiffs good title to the Property.
>
> 22. The Lawyer and the Law Firm are jointly and severally liable for the plaintiffs' damages resulting from these breaches.
>
> 23. As a result of the breaches outlined above, the plaintiffs have suffered damages for which all of the defendants are liable...

38 On April 12, 2007, the respondents' counsel wrote Stewart Title enclosing a copy of the Zivs' amended statement of claim. He sought to engage the indemnity:

> Although we understand that steps may have recently been taken by you to address your insureds' allegations against our client, you have a duty to defend our client in connection with a claim arising under the policy. The allegations in the Amended Statement of Claim clearly fall within the ambit of your title insurance policy and indemnity agreement with the Law Society of Upper Canada and therefore, the indemnity has been triggered.

39 Stewart Title's response of April 20, 2007, took the position that the obligation to indemnify under the 2005 Indemnity Agreement, if it existed in the circumstances of the Ziv case, did "not require Stewart to defend your client, rather to indemnify for loss as noted." After observing that the Amended Statement of Claim raised allegations in addition to the *Planning Act* Violation which were not covered by the Policy and for which Stewart would not pay "any legal fees and other costs associated with defending Mr. Zeppieri against those issues", Stewart Title went on to write:

> As to the Planning Act issue, when first apprized of the allegation, we contacted the lawyer who had undertaken to remedy the violation. She advised us that based on the recommendations of the Land Registrar; a correcting deed was obtained and registered prior to Stewart's Insured obtaining title to the Property. She also indicated that on closing she had taken steps to have the Property converted to a Land Titles Conversion Qualified. At this writing, we have been advised that the conversion has been approved and is in process. Accordingly, there is no Planning Act issue as it was cured on closing. There is no claim arising under the Policy.
>
> Although the Planning Act issue appears to have been resolved, if we assume that it remains unresolved and in need of repair, a fact which we deny, then the member would ostensibly be entitled to the indemnity. However, we note

that Exclusion item 3 in the Policy indicates that there is no coverage if there is no loss incurred. We note that the plaintiffs have not claimed any loss related to the Planning Act issue and have not indicated any causal connection between loss and the Planning Act issue. The member is, as a result, not entitled to the indemnity as the action against the lawyer in this latter instance is excluded by the Policy terms from coverage at the present time.

40 On April 23, 2007, respondents' counsel wrote to the Zivs' lawyer requesting confirmation that the Zivs agreed with Stewart Title that any *Planning Act* issue had been cured. The Zivs did not provide the requested confirmation.

41 On May 16, 2007 Stewart Title wrote to the Zivs' lawyer, enclosing a copy of the new Land Title Abstract for the Property, which had been converted to Land Titles as a qualified conversion. Stewart Title took the position that this conversion satisfied the vendor's counsel undertaking on closing and cured any prior *Planning Act* Violation related to severance.

42 On June 1, 2007 the respondents commenced a Third Party Claim against Stewart Title seeking a declaration that it was under a duty to indemnify the respondents for the cost of defending the Zivs' action, and a related cross-claim, and to indemnify them for any amounts for which the respondents might be found liable to the Zivs. In addition, Zeppieri sought a declaration that the refusal by Stewart Title to indemnify them for the costs of defending the Ziv action and for any amounts for which they might be found liable to the Zivs was contrary to, and in breach of, the 2005 Indemnity Agreement. Zeppieri sought contribution and indemnity for all costs incurred in defending the Ziv action and cross-claim.

43 Stewart Title filed a Defence to the Third Party Claim on July 23, 2007. Stewart Title denied that any of the allegations in the Amended Statement of Claim had triggered the 2005 Indemnity Agreement.

44 The Ziv action has been set down for trial on all issues. Stewart Title did not defend the main action. As a result, it has not moved to dismiss the Zivs' *Planning Act* Violation claim.

B. Analysis

45 Did the Zivs' action against the respondent member trigger an obligation on Stewart Title under the 2005 Indemnity Agreement to pay the respondent's on-going costs of defending the action? Stewart Title submitted that it did not for two reasons: (i) there was, in fact, no *Planning Act* problem on the conveyance to the Zivs because any problem was remedied on closing by the registration of the Correction Deed; and, (ii) if there was a *Planning Act* problem, it did not result in any loss to the Zivs, and so was an excluded claim under the Policy.

46 I see no merit in either submission. It is well accepted that a court must decide an insurer's duty to defend by looking at the pleadings and the insurance policy: *Halifax Insurance, supra.*, at para. 32. If the pleadings allege facts which, if true, would require the insurer to indemnify the insured for the claim, then the insurer is obliged to provide a defence, even though the actual facts may differ from the allegations pleaded: *Monenco Ltd. v. Commonwealth Insurance Co.*, [2001] 2 S.C.R. 699 (S.C.C.), at para. 28; *Alie v. Bertrand & Frère Construction Co.* (2002), 62 O.R. (3d) 345 (Ont. C.A.), at para. 182. Any doubt as to whether the pleadings bring the incident within the coverage of the policy should be resolved in favour of the insured: *Opron Maritimes Construction Ltd. v. Canadian Indemnity Co.* [1986 CarswellNB 59 (N.B. C.A.)] (1986), at para. 15. Nonetheless, there is no duty to defend an action if, on a review of the pleadings, no obligation to indemnify clearly exists: *Thames Steel Construction Ltd. v. Northern Assurance Co.* (1988), 67 O.R. (2d) 158 (Ont. C.A.), para. 4.

47 Paragraph 21(f) of the Zivs' Amended Statement of Claim pleads that Mr. Zeppieri breached his duties to the Zivs "by failing to obtain for the plaintiffs good title to the Property." Paragraphs 12, 13 and 14 plead the *Planning Act* Violation as the basis for that claim. The Zivs have set their action down for trial based on that pleading. The Policy provided the Zivs coverage for a "violation of the subdivision and part lot control provisions of the *Planning Act*." It is clear, in my view, that the Zivs' *Planning Act* Violation pleading against the respondents alleges facts in respect of a claim "arising under the title insurance policy". By application of the "pleadings rule", their claim against the respondents falls

within the obligation to indemnify and save harmless contained in the 2005 Indemnity Agreement and triggers Stewart Title's duty to pay the respondents their on-going costs of defending the claim.

48 That it may be determined at trial, after hearing all the evidence, that no *Planning Act* Violation existed at closing or, if one did, the Zivs did not suffer any loss, is neither here nor there for the purposes of applying the "pleadings rule" to the Zivs' action, the Policy and the 2005 Indemnity Agreement. An obligation to defend may well arise in cases where it eventually turns out that an insured is not entitled to indemnification: *Opron Maritimes, supra.*, at para. 6. Since the obligation to defend is broader than that to indemnify, it is the mere possibility that a claim within the policy may succeed that suffices to trigger the obligation to defend: *Nichols*, *supra*., at para. 17.

49 Stewart Title argued that since the Zivs' action includes both covered and uncovered allegations against the respondents, an allocation should be made of the defence costs relating to each group of claims. No evidence of actual defence costs incurred to date was filed on this motion, so I cannot make any specific comment on any possible issue of allocating costs between covered and uncovered claims made by the Zivs. However, the general principles which must guide the parties are quite clear. They are set out in the recent decision of the Court of Appeal in *Hanis v. University of Western Ontario*, [2008] O.J. No. 3909 (Ont. C.A.), where Doherty J.A. wrote, at paragraph 25:

> In the context of defending covered and uncovered claims in the same suit, a distinction must be drawn between cases where defence costs are related exclusively to the defence of either covered or uncovered claims, and cases where the same costs are incurred in the defence of both covered and uncovered claims. In the former circumstance, an allocation of costs would be required, barring a policy which provided for payment of defence costs relating to uncovered claims. In the latter case, allocation would not be necessary unless the policy provided for allocation where the costs related to both covered and uncovered claims.

V. Order

50 For the reasons given above, I do not grant the declarations requested by Stewart Title in its Notice of Application but, instead, I grant declarations that:

> (i) the terms of the 2005 Indemnity Agreement, in particular the phrase "indemnify and save harmless", require Stewart Title to fund, on an on-going basis, the reasonable defence costs of a LSUC member against whom a claim is made arising under a title insurance policy issued by Stewart Title, except in cases of the member's gross negligence or wilful misconduct; and,
>
> (ii) Stewart Title is required to fund, on an on-going basis, the reasonable costs incurred by the respondents, Enio Zeppieri and Zeppieri & Associates, in defending the action brought against them by Shlomo Ziv and Zvia Ziv, Court File No. 05-CV-300976 PD1, and the cross-claim in that action.

51 If any issue arises regarding the allocation of defence costs for the Ziv action, I would encourage the parties to use their reasonable efforts to negotiate an allocation agreement. If no agreement can be reached, then Stewart Title shall fund all defence costs incurred by the respondents, subject to retroactive adjustment upon the settlement or final disposition of the Third Party Claim.

VI. Costs

52 I would encourage the parties to try to settle the costs of this motion. If they cannot, the respondents may serve and file with my office written cost submissions, together with a Bill of Costs, by February 6, 2009. Stewart Title may serve and file with my office responding written cost submissions by February 18, 2009. The costs submissions shall not exceed three pages in length, excluding the Bill of Costs.

53 I thank counsel for the quality of their written and oral arguments; they were of great assistance.

Application dismissed.

Footnotes

1 The LSUC is the majority shareholder of LAWPRO.

2 On its cross-examination Stewart Title explained that if an award of damages was made in an action against a LSUC member in respect of a claim covered by the Policy, Stewart Title would indemnify the member both for the damages awarded against him and for costs incurred by the member in defending the claim. If no damages were awarded against the member, Stewart Title would only indemnify the member for his defence costs: Cross-examination of Marco Polsonelli, QQ. 46-48.

3 MacLennan J.A. adopted the language from the case of *Warwick v. C. Richardson* (1842), 10 M. & W. 284, 152 E.R. 477 (Eng. Exch.).

8.

2016 ABCA 265
Alberta Court of Appeal

Suncor Energy Inc. v. Mining Assn. of Canada

2016 CarswellAlta 1702, 2016 ABCA 265, [2016] A.W.L.D. 4145, [2016] A.W.L.D. 4147, 1 C.P.C. (8th) 393, 270 A.C.W.S. (3d) 460, 44 Alta. L.R. (6th) 43

Suncor Energy Inc. (Respondent) and Unifor Local 707A (Respondent) and Mining Association of Canada, Construction Labour Relations - an Alberta Association, Electrical Contractors Association of Alberta, Enform Canada, and Construction Owners Association of Canada (Applicants)

Marina Paperny J.A.

Heard: September 6, 2016
Judgment: September 15, 2016
Docket: Calgary Appeal 1601-0146-AC

Counsel: H.J.D. McPhail, Q.C., for Applicant
B.B. Johnston, Q.C., A. Costen, for Respondent, Suncor Energy Inc.
D.T. Williams, for Respondent, Unifor Local 707A

Subject: Civil Practice and Procedure; Public; Labour

Related Abridgment Classifications

Civil practice and procedure
III Parties
  III.8 Intervenors
    III.8.d Miscellaneous
Civil practice and procedure
XXIII Practice on appeal
  XXIII.9 Parties
    XXIII.9.a Adding parties
      XXIII.9.a.i Intervenors on appeal

Headnote

Civil practice and procedure --- Parties — Intervenors — Miscellaneous

Respondent Suncor decided to institute random drug and alcohol testing policy — Under Random Alcohol and Drug Testing Policy Grievance Arbitration, Union alleged proposed policy was contrary to collective agreement provisions, common law and applicable legislation — Majority arbitration decision concluded random drug testing policy was unreasonable and business interest being served was insufficient to override employee's right to privacy — Reviewing judge determined arbitration decision was unreasonable, quashed decision and sent it back for rehearing — Union appealed — Applicants were employer organizations involved in promoting work site safety in industrial construction, mining, electrical and upstream oil and gas industries, where dangerous and safety sensitive work environments existed — In earlier decision, two employer organizations were granted intervenor status on basis their concerns and mandates were directly implicated and had direct and unique interest in balancing test applied in determining whether random testing could be allowed in their workplaces — Court concluded issue was quasi-constitutional since it considered nature and importance of privacy rights of person — Employer organizations applied for leave to intervene — Application granted — Participation was limited to one joint factum and to specified issues — Appeal would likely engage larger policy issues that might usefully be informed by perspective offered by employer organization representatives and resolution of which might directly affect their members — Intervenor status granted earlier was factor in determining application to intervene — Interests of and assistance by employer organizations in appeal remained substantially same as in earlier decision.

Civil practice and procedure --- Practice on appeal — Parties — Adding parties — Intervenors on appeal

Respondent Suncor decided to institute random drug and alcohol testing policy — Under Random Alcohol and Drug Testing Policy Grievance Arbitration, Union alleged proposed policy was contrary to collective agreement provisions, common law and applicable legislation — Majority arbitration decision concluded random drug testing policy was unreasonable and business interest being served was insufficient to override employee's right to privacy — Reviewing judge determined arbitration decision was unreasonable, quashed decision and sent it back for rehearing — Union appealed — Applicants were employer organizations involved in promoting work site safety in industrial construction, mining, electrical and upstream oil and gas industries, where dangerous and safety sensitive work environments existed — In earlier decision, two employer organizations were granted intervenor status on basis their concerns and mandates were directly implicated and had direct and unique interest in balancing test applied in determining whether random testing could be allowed in their workplaces — Court concluded issue was quasi-constitutional since it considered nature and importance of privacy rights of person — Employer organizations applied for leave to intervene — Application granted — Participation was limited to one joint factum and to specified issues — Appeal would likely engage larger policy issues that might usefully be informed by perspective offered by employer organization representatives and resolution of which might directly affect their members — Intervenor status granted earlier was factor in determining application to intervene — Interests of and assistance by employer organizations in appeal remained substantially same as in earlier decision.

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Pedersen v. Van Thournout (2008), 2008 ABCA 192, 2008 CarswellAlta 648, (sub nom. *Pedersen v. Thournout*) 432 A.R. 219, (sub nom. *Pedersen v. Thournout*) 424 W.A.C. 219 (Alta. C.A.) — followed

Ross River Dena Council v. Yukon (2012), 2012 YKCA 14, 2012 CarswellYukon 122, [2013] 2 C.N.L.R. 355, 358 D.L.R. (4th) 100, 331 B.C.A.C. 234, 565 W.A.C. 234 (Y.T. C.A.) — considered

Rules considered:

Alberta Rules of Court, Alta. Reg. 124/2010

R. 14.37(2)(e) — considered

R. 14.58 — considered

R. 14.58(2) — referred to

APPLICATION by employer organizations for leave to intervene on appeal.

***Marina Paperny J.A.*:**

Background

1 Permission to intervene was granted to the applicants during the hearing of the application, with reasons to follow. These are those reasons.

2 The applicants, Mining Association of Canada (MAC), Construction Labour Relations (CLR), Electrical Contractors Association of Alberta (ECAA), Enform Canada and the Construction Owners Association of Alberta, all sought leave to intervene in this appeal. They collectively submitted that they will be directly and significantly affected by the outcome of the appeal, and that they can provide the court with important and unique assistance in its deliberations. The applicants are all employer organizations involved in promoting work site safety in the industrial construction, mining, electrical and upstream oil and gas industries, in which dangerous and safety sensitive work environments exist.

3 The appeal is from a judicial review of the Random Alcohol and Drug Testing Policy Grievance Arbitration. That arbitration focused on the respondent Suncor's decision to institute a random drug and alcohol testing policy. The appellant Union alleged the proposed policy was contrary to provisions of the collective agreement, the common law and the applicable legislation. The random testing is proposed to occur in the context of a dangerous workplace. The reviewing judge in the court below identified that the issue before him involved privacy and safety concerns and the inherent tension between the two.

4 Specifically, the arbitration involved oil sands operations carried out north of Fort McMurray and at Mackay River and Firebag. It is agreed that the operations are dangerous by their nature. Suncor was concerned about safety hazards posed by alcohol and drug use within the workplace and adopted measures that included the random testing standard.

5 The majority arbitration decision concluded that the random drug testing policy was unreasonable, lacked clarity, and was not unequivocal. The majority concluded that the employer's business interest that was being served by random testing was insufficient to override the employee's right to privacy. The dissent would have dismissed the grievance and found the implementation of the random testing standard to be a reasonable exercise of Suncor's management rights.

6 The reviewing judge in the court below determined that the majority decision was unreasonable, that the disposition of the arbitration could not stand. He quashed the decision and sent the matter back for rehearing before a fresh arbitration panel.

What are the issues on the appeal?

7 The applicants argue that the appeal raises substantive questions of legal policy concerning the ability of employers operating in inherently dangerous industries to implement random alcohol and drug testing. They say that this Court's determination will have a direct and material impact on them and the employers they represent. They submit that the outcome of this appeal will have a significant effect on the ability of their respective industries to implement random testing plans at their workplaces, which implicate the safety and security of those workplaces. They submit further that the appeal extends beyond the implications regarding this particular employer's policy.

8 In the court below two of the applicants applied for and received intervenor status on the basis that their concerns and mandates are directly implicated in the within case and that they have a direct and unique interest in the balancing test that should be or will be applied to determine whether random alcohol and drug testing can be allowed in the applicants' workplaces. In allowing the intervenor application, the court below concluded that the issue is quasi-constitutional in that it considers the nature and importance of the privacy rights of an individual. Thus, the issue is important from both a constitutional and public interest dimension.

Test for leave to intervene

9 Rules 14.37(2)(e) and 14.58 of the *Alberta Rules of Court*, AR 124/2010, authorize an appeal judge to grant permission to any person to intervene in an appeal and impose terms and conditions on the intervention.

10 When faced with an intervenor application, the court must, first, consider the subject matter of the appeal and, second, determine whether the proposed intervenor's interest warrants granting intervenor status: *Papaschase Indian Band No. 136 v. Canada (Attorney General)*, 2005 ABCA 320, 380 A.R. 301 (Alta. C.A.), at para 5.

11 In addition to establishing an interest, a proposed intervenor must demonstrate an ability to provide "special expertise or fresh perspective", which brings some benefit to the proceedings, especially where the number of potential interveners is significant. Further, an applicant should articulate where the difference lies in either oral or written submissions: *Pedersen v. Van Thournout*, 2008 ABCA 192, 432 A.R. 219 (Alta. C.A.), at paras 10-11.

12 The court in *Pedersen* summarized the relevant factors in a determination of whether to grant intervenor status, at para 3:

1. Will the intervener be directly affected by the appeal;

2. Is the presence of the intervener necessary for the court to properly decide the matter;

3. Might the intervener's interest in the proceedings not be fully protected by the parties;

4. Will the intervener's submission be useful and different or bring particular expertise to the subject matter of the appeal;

5. Will the intervention unduly delay the proceedings;

6. Will there possibly be prejudice to the parties if intervention is granted;

7. Will intervention widen the *lis* between the parties; and

8. Will the intervention transform the court into a political arena?

13 The appellant Union (respondent on the application) opposes the granting of intervenor status, submitting that the appeal is from a relatively straight forward judicial review application involving the reasonableness of an arbitrator's decision. The appellant asserts that the scope of the appeal is limited to the reasonableness of random testing under a particular collective agreement at a particular worksite, and that the law is already set out in *Irving Pulp & Paper Ltd. v. CEP, Local 30*, 2013 SCC 34, [2013] 2 S.C.R. 458 (S.C.C.). The appellant also submits that the proposed intervenors do not have any special expertise or fresh perspective to provide, and their materials offer only a bare assertion of such perspective.

14 These are compelling submissions. The appeal is arguably narrow insofar as it is a review of a decision of a reviewing judge with respect to a particular collective agreement and a specific workplace. Nevertheless, the appeal will likely engage larger policy issues that may usefully be informed by the perspective offered by the applicant industry representatives and the resolution of which may directly affect their members.

15 In my view, there is an additional factor that militates in favour of the application to intervene, and that is the fact that two of the applicants were granted intervenor status in the court below. This factor has received little judicial consideration, and is not listed in the relevant factors set out by this Court in *Pedersen*. It is, in my view, deserving of comment.

16 It is clear that, in Alberta, applicants who have been granted intervenor status in the court below are not automatically parties, nor intervenors, on appeal. They must apply again to obtain intervenor status on appeal: see rule 14.58 (2). In other words, being granted intervenor status in the court below does not amount to intervenor status by right on appeal.

17 In *Ross River Dena Council v. Yukon*, 2012 YKCA 14, 358 D.L.R. (4th) 100 (Y.T. C.A.), the court commented that the Yukon Court of Appeal, as part of its jurisdiction to control its own process, is entitled to determine whether and to what extent an intervention will be allowed on appeal. The court held that a decision by the court below to allow a person to intervene before it does not serve to give that person rights on appeal: para 11.

18 A somewhat different view was taken by the Federal Court of Appeal in *Canada (Attorney General) v. Friends of the Canadian Wheat Board*, 2012 FCA 114, 432 N.R. 383 (F.C.A.). Mainville J explicitly found that some deference was owed to the decision of the court below to grant intervenor status there. He said, at para 9:

> ...Where leave to intervene has already been granted in the Federal Court, barring a fundamental error in the decision granting leave, some material change in the issues on appeal, or important new facts bearing on the intervention, I do not see why this Court should not rely on the findings of the Federal Court with respect to the intervention or exercise its discretion to grant leave differently from the Federal Court. I rely for this proposition on the considered opinion of my colleague Stratas J.A. in *Global[ive] Wireless Management Corp. v. Public Mobile Inc.*, 2011 FCA 119.

19 The relevant statements in *Globalive Wireless Management Corp. v. Public Mobile Inc.* [2011 CarswellNat 882 (F.C.A.)] are at para 5:

> I grant the motion for leave to intervene in the appeal in this Court for the following reasons:
>
> a. In my view, absent fundamental error in the decision in the Federal Court to grant the moving parties leave to intervene, some material change in the issues on appeal, or important new facts bearing on the issue, this Court has no reason to exercise its discretion differently from the Federal Court. No one has submitted that there is fundamental error, material change or important new facts.
>
> b. It is evident from the reasons of the Federal Court that the moving parties' submissions were relevant to the issues and useful to the Court in its determination.

20 I would not say that an appellate court is required to grant permission to intervene in the absence of demonstrable error in the court below in having done so. This Court retains its jurisdiction to control its own procedure and to determine whether to allow an intervention on appeal, regardless of whether intervention was permitted in the court below. However, that intervenor status was granted in the court below is, in my view, a factor to consider in determining an application to intervene on appeal. I would add to the list of factors set out in *Pedersen* the following considerations where the applicants were granted intervenor status below:

(a) the role taken by the intervenors in the court below;

(b) whether the submissions of the intervenors were necessary or helpful in informing the decision being reviewed;

(c) whether the issues on appeal are the same as in the court below, or whether the issues as framed on appeal could continue to impact the applicants' interests;

(d) whether the particular perspective of the applicants can continue to inform the discussion as now framed on appeal.

21 In this case I am satisfied that the interests of the applicants and the assistance they can provide in the appeal remain substantially the same as in the court below. While the extent of the value of their participation is not apparent

from the reasons of the reviewing judge, it cannot be said that the issues on which they were given leave to intervene are no longer the subject of discussion or debate on appeal. The issues have not narrowed or been eliminated on appeal. Accordingly, I am exercising my discretion and granting permission to intervene to the applicants on the terms provided. Their participation is limited to one joint factum and to the following issues; the threshold required by the Supreme Court of Canada in *Irving Pulp & Paper Ltd* concerning the degree of evidence required to establish a workplace problem, and the group to be examined in assessing if there is a problem.

Conclusion

22 The applicants are granted intervenor status and have leave to file one joint factum limited to 20 pages. They are not granted leave to make oral submissions, unless the panel hearing the appeal determines otherwise.

Application granted.

1.

rescribed to be used upon partic-

ɛktəs/. In conflicts, the law of
this governs in choice of law

léks kəntrǽktəs/. In conflicts,
ɔlace where the contract was
he term today has undergone
time that substantive questions
d by the law of the place of the
cedural questions were decided
forum.

ıy/. The law of the forum, or
positive law of the state, coun-
ı of whose judicial system the
ːit is brought or remedy sought
. Substantive rights are deter-
of the place where the action
ʼhile the procedural rights are
w of the place of the form, "lex
contractus.

er-assisted legal research ser-
ead Data Central. LEXIS pro-
to a database of legal informa-
ral and state caselaw, statutes,
ə, regulatory, and secondary

say/. The law of the place.
ɛral descriptions but, in gener-
ɜed for *lex loci contractus (q.v.)*.
ırnishes the standard of con-
ɜ to all matters going to the
action itself. The substantive
action are governed by "lex
e where rights were acquired
ɛd. *Compare* Lex fori.

s lówsay ǽktəs/. The law of
act was done.

ıs /léks lówsay kəntrǽktəs/.
denote the law of the place
was made, and at other times
y which the contract is to be
of its performance), which
the same as that of the place
ɛ. The earlier cases do not
on.

ks lówsay dəlíktəs/. The law
he crime or wrong took place.
", or "place of the wrong", is
last event necessary to make
an alleged tort takes place.
l by the words *lex loci delicti*
place where a tort is commit-
ı more briefly as *lex loci de-*
simply *lex delicti*.

/léks lówsay dòməsíliyay/.
of domicile.

Lex naturale /léks nǽtyəréyliy/. Natural law. *See* Jus naturale.

Ley /léy/. L. Fr. (A corruption of *loi.*) Law; the law. For example, *Termes de la Ley*, Terms of the Law. In another, and an old technical, sense, ley signifies an oath, or the oath with compurgators; as, il tend sa *ley* aiu pleyntiffe. *See also* Lex.

In Spanish law, a law; the law; law in the abstract.

L.H.W.C.A. Longshore and Harbor Workers' Compensation Act.

Liability. The word is a broad legal term of the most comprehensive significance, including almost every character of hazard or responsibility, absolute, contingent, or likely. It has been defined to mean: all character of debts and obligations; amenability or responsibility; an obligation one is bound in law or justice to perform; an obligation which may or may not ripen into a debt; any kind of debt or liability, either absolute or contingent, express or implied; condition of being actually or potentially subject to an obligation; condition of being responsible for a possible or actual loss, penalty, evil, expense, or burden; condition which creates a duty to perform an act immediately or in the future; duty to pay money or perform some other service; that which one is under obligation to pay, or for which one is liable; the state of being bound or obliged in law or justice to do, pay, or make good something; the state of one who is bound in law and justice to do something which may be enforced by action.

All the claims against a corporation. Liabilities include accounts and wages and salaries payable, dividends declared payable, accrued taxes payable, fixed or long-term liabilities such as mortgage bonds, debentures and bank loans.

See also Current liabilities; Derivative liability; Employer's liability acts; Enterprise liability; Legal liability; Liable; Limitation of liability acts; Malpractice; Monetary liabilities; No fault; Parental liability; Personal liability; Product liability; Several liability; Strict liability; Vicarious liability.

Absolute liability. See Strict liability.

Accrued liability. Obligation which has been incurred but not yet paid; *e.g.* taxes, rent.

Children. See Parental liability.

Contingent liability. A liability not yet fixed but dependent on events to occur in the future (*e.g.* a pending law suit).

Fixed liability. One fixed as to time, amount, etc.; *e.g.* mortgage.

Joint and several liability. Responsible together and individually. The person who has been harmed can sue and recover from both wrongdoers or from either one of the wrongdoers (if he goes after both of them, he does not, however, receive double compensation). *See also* Joint and several liability; Joint tort-feasors.

Joint liability. Liability for which more than one person is responsible. *See also* Contribution; Joint liability; Joint tort-feasors.

Liability bond. See Bond.

Long term liabilities. Obligations expected to be paid after one year or the operating cycle, whichever is longer.

Primary liability. A liability for which a person is directly responsible as contrasted with one which is contingent or secondary.

Secondary liability. A liability in the nature of a contigent claim such as the liability of a guarantor as contrasted with that of a strict surety or comaker. A guarantor's liability does not arise until the principal debtor has failed to pay the creditor.

Liability created by statute. One depending for its existence on the enactment of a statute, and not on the contract of the parties. One which would not exist but for the statute.

Liability for damages. Liability for an amount to be ascertained by trial of the facts in particular cases.

Liability imposed by law. Liability imposed in a definite sum by a final judgment against assured. Total liability imposed by law upon a person.

Liability insurance. Contract by which one party promises on consideration to compensate or reimburse other if he shall suffer loss from specified cause or to guaranty or indemnify or secure him against loss from that cause. That type of insurance protection which indemnifies one from liability to third persons as contrasted with insurance coverage for losses sustained by the insured. *See also* Insurance.

Liability limits. The sum beyond which a liability insurance company does not protect the insured on a particular policy. Most policies covering liability for bodily injury have two limits, a limit of liability to any one person, and, subject to the personal limit, another and usually higher limit for any single accident, where more than one person is involved.

Liable. Bound or obliged in law or equity; responsible; chargeable; answerable; compellable to make satisfaction, compensation, or restitution. Obligated; accountable for or chargeable with. Condition of being bound to respond because a wrong has occurred. Condition out of which a legal liability might arise. Justly or legally responsible or answerable.

Exposed or subject to a given contingency, risk, or casualty, which is more or less probable. Exposed, as to damage, penalty, expense, burden, or

Constitution, administered generally to certain public officers or officials, to members of the armed services, to attorneys on being admitted to the bar, to aliens applying for naturalization (8 U.S.C.A. § 1448), etc. Such oaths which are not overbroad have been upheld. As to oath of allegiance to the Constitution as required of President, members of Congress, and executive and judicial officers, see Art. II, Sec. 1, and Art. VI, U.S. Const. It is commonly provided that an affirmation may be given in lieu of an oath.

Obedience. Compliance with a command, prohibition, or known law and rule of duty prescribed. The performance of what is required or enjoined by authority, or the abstaining from what is prohibited, in compliance with the command or prohibition.

Obiter /ó(w)bətər/. Lat. By the way; in passing; incidentally; collaterally.

Obiter dictum /ó(w)bətər díktəm/. Words of an opinion entirely unnecessary for the decision of the case. A remark made, or opinion expressed, by a judge, in his decision upon a cause, "by the way," that is, incidentally or collaterally, and not directly upon the question before him, or upon a point not necessarily involved in the determination of the cause, or introduced by way of illustration, or analogy or argument. Such are not binding as precedent. *See* Dicta; Dictum.

Obit sine prole /ówbət sáyniy prówliy/. Lat. [He] died without issue.

Object, *v.* In legal proceedings, to object (*e.g.,* to the admission of evidence) is to interpose a declaration to the effect that the particular matter or thing under consideration is not done or admitted with the consent of the party objecting, but is by him considered improper or illegal, and referring the question of its propriety or legality to the court. *See also* Objection.

Object, *n.* End aimed at, the thing sought to be accomplished; the aim or purpose, the thing sought to be attained.

Anything which comes within the cognizance or scrutiny of the senses, especially anything tangible or visible. That which is perceived, known, thought of, or signified; that toward which a cognitive act is directed. The term includes whatever may be presented to the mind as well as to the senses; whatever, also, is acted upon or operated upon affirmatively, or intentionally influenced by anything done, moved, or applied thereto. It may be used as having the sense of effect.

See also Intent; Motive.

Objection. Act of objecting; that which is, or may be, presented in opposition; an adverse reason or argument; a reason for objecting or opposing; a feeling of disapproval.

The act of a party who objects to some matter or proceeding in the course of a trial, or an argument or reason urged by him in support of his contention that the matter or proceeding objected to is improper or illegal. Used to call the court's attention to improper evidence or procedure. Such objections in open court are important so that such will appear on the record for purposes of appeal. See Fed.Evid.R. 103(a)(1), Fed.R.Civil P. 46, and Fed.R.Crim.P. 51. *See also* Contemporaneous objection rule; Object *(v).*

Objection to jury. See Challenge.

Objective. In cost accounting, a desired quantifiable achievement for a period of time.

Objective intent. *See* Intent.

Objective symptom. Those which a surgeon or physician discovers from an examination of his patient; "subjective symptoms" being those which he learns from what his patient tells him.

Objectivity principle. A principle requiring that accounting information be free from bias and verifiable by an independent party, such as an external auditor.

Object of an action. Legal relief to prevent or redress the wrong. The thing sought to be obtained by the action; the remedy demanded or the relief or recovery sought or prayed for; not the same thing as the cause of action or the subject of the action.

Object of a statute. Aim, intent or purpose of its enactment. End or design which it is meant to accomplish, while the "subject" is the matter to which it relates and with which it deals. Matter or thing forming groundwork of statute.

Objects of a power. Those among whom donee is given power to appoint.

Obligate. To bind or constrain; to bind to the observance or performance of a duty; to place under an obligation. To bind one's self by an obligation or promise; to assume a duty; to execute a written promise or covenant; to make a writing obligatory.

Obligatio ex contractu /òbləgéysh(iy)ow èks kəntrǽkt(y)uw/. An obligation arising from contract, or an antecedent *jus in personam.*

Obligatio ex delicto, *or* **obligatio ex maleficio** /òbləgéysh(iy)ow èks dəlíktow/°mæ̀ləfish(iy)ow/. An obligation founded on wrong or tort, or arising from the invasion of a *jus in rem.*

Obligation. A generic word, derived from the Latin substantive "obligatio," having many, wide, and varied meanings, according to the context in which it is used. That which a person is bound to do or forbear; any duty imposed by law, promise, contract, relations of society, courtesy, kindness, etc. Law or duty binding parties to perform their

agreement. An undertaking
which constitutes a legal or mo
renders a person liable to co
ment for neglecting it; a word
and the particular meaning
gained by consideration of its
gation or debt may exist by re
as well as an express contract,
being a legal duty on the part
comply with the promise. Li
contract or law (*i.e.* judgmen
word originally meant a seale
extends to any certain writt
money or do a specific thin
binding agreement or acknowl
ty to pay a certain sum or
The binding power of a vow
contract, or of law, civil, politi
pendent of a promise; that wh
or moral duty.

See also Contract; Duty; Lial

Absolute obligation. One whi
tive to the obligor, but require
ing to the engagement.

Contractual obligation. One
contract or agreement. *See*
the obligation of contracts; Obli

Current obligation. See Curre

Divisible or indivisible oblig
obligation is one which, being
theless be lawfully divided, w
consent of the parties. An ir
is one which is not susceptible

Express or implied obligation.
tional obligations are those b
binds himself in express ter
obligation, while implied obli
are raised by the implication
law from the nature of the tr

Failure to meet obligations.
obligations.

Joint or several obligation.
one by which two or more
selves jointly for the perfor
gation. A several obligation
obligors promise, each for hi
engagement.

Moral obligation. A duty
binding in conscience and a
justice, but is not recognized
quate to set in motion the m
that is, one which rests upo
tions alone, and is not impo
positive law. A duty which w
by law, were it not for some
with a view to general benefit
in that particular instance
See also Love and affection.

:y who objects to some matter the course of a trial, or an n urged by him in support of the matter or proceeding ob- ɜr or illegal. Used to call the) improper evidence or proce- .ons in open court are impor- will appear on the record for l. See Fed.Evid.R. 103(a)(1), nd Fed.R.Crim.P. 51. *See also* bjection rule; Object *(v).*

See Challenge.

ıccounting, a desired quantifia- : a period of time.

See Intent.

ι. Those which a surgeon or from an examination of his symptoms" being those which ıt his patient tells him.

le. A principle requiring that tion be free from bias and veri- ndent party, such as an exter-

n. Legal relief to prevent or The thing sought to be ob- n; the remedy demanded or ry sought or prayed for; not the cause of action or the 1.

Aim, intent or purpose of its : design which it is meant to he "subject" is the matter to l with which it deals. Matter oundwork of statute.

Those among whom donee is oint.

or constrain; to bind to the ormance of a duty; to place 1. To bind one's self by an se; to assume a duty; to exe- nise or covenant; to make a

ıctu /òbləgéysh(iy)ow èks kən- ligation arising from contract, *s in personam.*

o, *or* **obligatio ex maleficio** ks dəlíktow/°mæ̀ləfísh(iy)ow/. ed on wrong or tort, or arising f a *jus in rem.*

.eric word, derived from the obligatio," having many, wide, s, according to the context in ıat which a person is bound to luty imposed by law, promise, of society, courtesy, kindness, nding parties to perform their

agreement. An undertaking to perform. That which constitutes a legal or moral duty and which renders a person liable to coercion and punishment for neglecting it; a word of broad meaning, and the particular meaning intended is to be gained by consideration of its context. An obligation or debt may exist by reason of a judgment as well as an express contract, in either case there being a legal duty on the part of the one bound to comply with the promise. Liabilities created by contract or law (*i.e.* judgments). As legal term word originally meant a sealed bond, but it now extends to any certain written promise to pay money or do a specific thing. A formal and binding agreement or acknowledgment of a liability to pay a certain sum or do a certain thing. The binding power of a vow, promise, oath, or contract, or of law, civil, political, or moral, independent of a promise; that which constitutes legal or moral duty.

See also Contract; Duty; Liability.

Absolute obligation. One which gives no alternative to the obligor, but requires fulfillment according to the engagement.

Contractual obligation. One which arises from a contract or agreement. *See* Contract; Impairing the obligation of contracts; Obligation of a contract.

Current obligation. See Current obligations.

Divisible or indivisible obligation. A divisible obligation is one which, being a unit, may nevertheless be lawfully divided, with or without the consent of the parties. An indivisible obligation is one which is not susceptible of division.

Express or implied obligation. Express or conventional obligations are those by which the obligor binds himself in express terms to perform his obligation, while implied obligations are such as are raised by the implication or inference of the law from the nature of the transaction.

Failure to meet obligations. See Failure to meet obligations.

Joint or several obligation. A joint obligation is one by which two or more obligors bind themselves jointly for the performance of the obligation. A several obligation is one where the obligors promise, each for himself, to fulfill the engagement.

Moral obligation. A duty which is valid and binding in conscience and according to natural justice, but is not recognized by the law as adequate to set in motion the machinery of justice; that is, one which rests upon ethical considerations alone, and is not imposed or enforced by positive law. A duty which would be enforceable by law, were it not for some positive rule, which, with a view to general benefit, exempts the party in that particular instance from legal liability. *See also* Love and affection.

Simple or conditional obligation. Simple obligations are such as are not dependent for their execution on any event provided for by the parties, and which are not agreed to become void on the happening of any such event. Conditional obligations are such as are made to depend on an uncertain event.

Obligation of a contract. That which the law in force when contract is made obliges parties to do or not to do, and the remedy and legal means to carry it into effect. The "obligation of a contract" is the duty of performance. The term includes everything within the obligatory scope of the contract, and it includes the means of enforcement. *See also* Contract; Impairing the obligation of contracts.

Obligatory writing. *See* Writing obligatory.

Obligee /òbləjíy/. A promisee. The person in favor of whom some obligation is contracted, whether such obligation be to pay money or to do or not to do something. The party to whom someone else is obligated under a contract. Thus, if C loans money to D, C is the obligee and D is the obligor under the loan. The party to whom a bond is given.

Obligor /óbləgər/òbləgór/. A promisor. The person who has engaged to perform some obligation. Person obligated under a contract or bond.

Obliteration. To destroy; wipe or rub out; erase. Erasure or blotting out of written words. A method of revoking a will or a clause therein if accompanied by the required intent to revoke. *See also* Alteration; Deface; Spoliation.

Oblivion. Act of forgetting, or fact of having forgotten; forgetfulness. Official ignoring of offenses. Amnesty, or general pardon, as, an act of oblivion. State or fact of being forgotten. *See* Amnesty; Pardon.

Obloquy /óbləkwiy/. Censure and reproach. Blame, reprehension, being under censure, a cause or object of reproach, a disgrace.

Obscene. Objectionable or offensive to accepted standards of decency. Basic guidelines for trier of fact in determining whether a work which depicts or describes sexual conduct is obscene is whether the average person, applying contemporary community standards would find that the work, taken as a whole, appeals to the prurient interest, whether the work depicts or describes, in a patently offensive way, sexual conduct specifically defined by the applicable state law, and whether the work, taken as a whole, lacks serious literary, artistic, political, or scientific value. A state may choose to define obscenity offense in terms of "contemporary community standards" without further specification or may choose to define standards in more precise geographic terms. *See also* Censor; Censorship; Contemporary community

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nd commercially realis-
ting accountants should
ract such as that under

nity' will depend on the
onsent (under a contrac-
not here concerned with
n irrespective of his con-
d by the principal debtor
antee, which is probably
al debtor.[80]

('the indemnified party')
ult of the performance of
e other party ('the indem-

emnity forms one species
ance are wholly concerned

lements) ('*Chitty*'), paras 14-015,
2002) 9 JIBFL 360; A Berg,
ski, 'The Nature of a Claim on
eds), *Sinclair on Warranties and*
Beswick, *Beswick and Wine on*
).

with insurers providing indemnities to hold persons harmless in respect of an adverse and uncertain event. The insuring clause is a type of indemnity clause, subject to the other clauses (exceptions, limitations, claims conditions, and excess clauses) of the policy. Insurance is heavily regulated and only a person authorized to carry on general insurance business under the Financial Services and Markets Act 2000 can lawfully carry on the business of offering indemnity insurance. Whilst our principal concern is with indemnity clauses outside of the insurance context, the insurance cases provide some valuable guidance on the approach of the courts to indemnities.

Indemnities and guarantees

The central characteristic of an indemnity clause is that the indemnifier assumes a primary responsibility for the adverse event covered by the clause and undertakes to hold the indemnified party harmless against the consequences of that event. It should therefore also be distinguished from the liability of a guarantor or surety, which is in its nature secondary or accessory to the liability of the principal debtor. If the surety pays the creditor he may still have recourse against the principal debtor by way of indemnity of subrogation. Conversely an indemnifying party bears the ultimate loss. The distinction is sometimes blurred in modern practice by the use of documents which are expressed to be both a guarantee and an indemnity. **20.53**

Non-insurance indemnity clauses

The phrase 'indemnity clause' in practice generally refers to a clause in a commercial contract (other than an insurance contract) which attempts to shift the responsibility for an adverse event from one party to the other. As such, indemnity clauses can effect a powerful change in the contractual allocation of risks. For this reason the courts have always approached indemnity clauses with caution. As a matter of construction, the courts have generally treated 'indemnity clauses' extremely strictly, and subjected them to 'specially exacting standards'.[81] Generally speaking where the indemnified party was guilty of negligence performing the contract the courts have been reluctant to award an indemnity unless clear words indicate that the clause should extend to incidents of negligence by the party seeking the indemnity. **20.54**

Unfair Contract Terms Act 1977

Parliament has intervened, with the Unfair Contract Terms Act 1977 providing a power to override 'unreasonable indemnity clauses'.[82] Critically this power in section 4 **20.55**

[81] *Ailsa Craig Fishing Co Ltd v Malvern Fishing Ltd* [1983] 1 WLR 964, HL. See Lord Fraser at 970 and Lord Wilberforce at 966.

[82] *Chitty*, paras 14-075 to 14-076.