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UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF NEW YORK

In re:	Chapter 11
MOTORS LIQUIDATION COMPANY, *et al.*, f/k/a General Motors Corporation, *et al.*,	Case No.: 09-50026 (REG)
	(Jointly Administered)
Debtors.	

MOTORS LIQUIDATION COMPANY GUC TRUST,	
Plaintiff,	Adversary Proceeding Case No.: 12-09802
v.	
APPALOOSA INVESTMENT LIMITED PARTNERSHIP I, *et al.*,	
Defendants.	

GUC TRUST'S OMNIBUS POST-TRIAL REPLY BRIEF IN CONNECTION WITH (I) OFFICIAL COMMITTEE OF UNSECURED CREDITORS' FIRST AMENDED OBJECTION TO CLAIMS FILED BY GREEN HUNT WEDLAKE, INC. AND NOTEHOLDERS OF GENERAL MOTORS NOVA SCOTIA FINANCE COMPANY AND MOTION FOR OTHER RELIEF (BANKR. DKT. NO. 7859) AND (II) MOTORS LIQUIDATION CO. GUC TRUST V. APPALOOSA INVESTMENT LTD. PARTNERSHIP I, *ET AL.*

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18.	*Bankruptcy and Insolvency Act*, RSC 1985, c. B-3, s. 65.11

The GUC Trust[1] respectfully submits this post-trial reply brief in response to the opening post-trial briefs and Joint Statement of Facts filed by Wedlake, Paulson,[2] the Noteholders (collectively, the "**Defendants**") and New GM.[3]

PRELIMINARY STATEMENT

While the many lawyers involved in presenting this dispute to the Court have introduced degrees of complexity, when all is said and done, this case turns on the most basic, and most important, principle of bankruptcy law: "equality of distribution." *Bailey v. Glover*, 88 U.S. 342, 346 (1874). If the Disputed Claims are allowed, that bedrock principle of bankruptcy law will have been egregiously violated.

Manufactured complexity serves the interests of the Noteholders because it is only with the aid of smoke and mirrors that one can suspend disbelief long enough to take seriously the notion that $1 billion of Notes issued by an Old GM subsidiary could possibly give rise to $2.7 billion of claims against Old GM. Once the smoke clears and the mirrors are removed, however, it becomes clear that the Bankruptcy Code cannot possibly countenance such an outcome.

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[1] Capitalized terms used but not otherwise defined herein shall have the meanings ascribed to them in the *GUC Trust's Post-Trial Brief In Connection With (I) Official Committee Of Unsecured Creditors' First Amended Objection To Claims Filed By Green Hunt Wedlake, Inc. And Noteholders Of General Motors Nova Scotia Finance Company And Motion For Other Relief (Bankr. Dkt. No. 7859) And (II) Motors Liquidation Co. GUC Trust v. Appaloosa Investment Ltd. Partnership I, et al.* (Bankr. Dkt. No. 12438; Adv. Pro. Dkt. No. 225) ("**GUC Brief**"). The following parties filed post-trial opening briefs: (1) Wedlake (Bankr. Dkt. No. 12449; Adv. Pro. Dkt. No. 222) ("**GHW Brief**"), (2) Paulson (Adv. Pro. Dkt. No. 220) ("**Paulson Brief**"), (3) Noteholders (Bankr. Dkt. No. 12436; Adv. Pro. Dkt. No. 223) ("**NH Brief**") and (4) New GM (Bankr. Dkt. No. 12435; Adv. Pro. Dkt. No. 221) ("**NG Brief**"). The Defendants and New GM also filed a joint statement of facts (Bankr. Dkt. No. 12437; Adv. Pro. Dkt. No. 224) ("**Joint Statement of Facts**" or "**JSF**").

[2] "**Paulson**" refers to: (1) dbX – Risk Arbitrage 1 Fund, (2) Lyxor/Paulson International Fund Limited, (3) Paulson Enhanced Ltd., (4) Paulson International Ltd., (5) Paulson Partners Enhanced, L.P. and (6) Paulson Partners L.P., all of which are investment funds or accounts managed by Paulson & Co. Inc.

[3] To avoid excessive repetition, not every point made in the GUC Brief will be reiterated in this reply. Points raised in the GUC Brief, but not reiterated here, are not waived and are expressly preserved.

Had the claimants here not already been paid an avoidable transfer of $367 million – a percentage recovery in and of itself greater than the recovery of any other unsecured creditor in this bankruptcy case – and had the claimants not engaged in inequitable conduct, then they would have been entitled to a guarantee claim against Old GM for any amounts not paid by GM Nova Scotia with respect to the $1 billion due on account of the Notes issued by GM Nova Scotia. That situation, commonplace in chapter 11 cases, would have been fair to the Noteholders and also fair to other unsecured creditors of Old GM.

Because the Noteholders have retained the benefit of the $367 million avoidable transfer, however, under section 502(d), the claims asserted on their behalf must be disallowed in their entirety. Alternatively, if the Court does not disallow the claims, then at least the claims of those creditors who behaved inequitably should be subordinated to the claims of innocent creditors. And finally, if the Court does not disallow or subordinate the claims (as is warranted based on the trial record), then, at the very least, the claim against Old GM should only be allowed once and in its proper amount, which would require the Court to reduce the claim by the 36% paydown on the Notes already received by the Noteholders.

Besides equality of distribution, another vitally important principle at stake here is court supervision of Old GM's estate. The record amply demonstrates that the Lock-Up Agreement was a postpetition agreement requiring this Court's approval and, perhaps even more importantly, the record establishes that the $367 million Consent Fee was paid with Old GM's cash without this Court's approval. The parties' utter disregard for the Court's role in supervising the Old GM bankruptcy proceedings is shocking.

Indeed, even if this Court were to credit the demonstrably incredible version of the facts advanced jointly by the Noteholders and New GM, they do not come out looking much better.

In their telling, there was no need to apprise the Court of this matter because the agreement to make a $367 million postpetition payment from a trust account funded by Old GM, and as to which Old GM continued to have an interest, was reached at 7:35 a.m., approximately twenty two minutes before the Old GM bankruptcy petition was filed. Even if that were true, clearly, this Court and Old GM's creditors should have been provided with an opportunity to at least carefully consider this matter before the Sale Order was entered.

By returning to the overarching principles of equality of distribution and court supervision, we do not mean to oversimplify, but only to situate this case in its proper context. We well understand that the Noteholders and their allies have emptied many toner cartridges mounting numerous, complex defenses to this claims objection. In its opening brief and below, the GUC Trust addresses each of those arguments in turn. Now that this case has reached its conclusion, however, we respectfully submit that careful application of the key legal principles to the factual record compels the relief requested by the GUC Trust – relief that will serve the interests of fairness to *all* creditors and protect core values of our system of bankruptcy law.

ARGUMENT

I. SECTION 502(d) REQUIRES DISALLOWANCE OF THE DISPUTED CLAIMS

A. Section 502(d) Is A Complete Defense To The Disputed Claims

Section 502(d) provides for disallowance of "any claim of any entity from which property is recoverable" as an avoidable transfer "unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable. . . ."[4] Section 502(d) does not condition disallowance on the filing of an avoidance action or even on the possibility that such an action against the transferee can or will be filed. The majority of the

[4] 11 U.S.C. § 502(d).

cases addressing the issue recognize that an avoidance action need not be filed to prevail on a section 502(d) objection.

Without support in the text of section 502(d) and against the weight of the case law, the Noteholders contend that section 502(d) is "only triggered after a trustee or debtor in possession successfully prosecutes an avoidance action and obtains a judgment requiring the turnover of property to the estate."[5] This is not so. Courts have recognized that a claim may be defeated by the defensive assertion of section 502(d) without the filing of an avoidance action.[6] Courts have further held that section 502(d) may be asserted defensively to disallow a claim even when the objecting party is barred from bringing an avoidance action, such as where the applicable statute of limitations has expired.[7] There is no prohibition against "asserting section 502(d) as an affirmative defense to a claim of a creditor even if the trustee's claim is time-barred or otherwise nonrecoverable."[8]

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5 NH Brief at 35.

6 *See In re Eye Contact, Inc.*, 97 B.R. 990, 992 (Bankr. W.D. Wis. 1989) (disallowing claim under section 502(d) even though no avoidance action was filed).

7 *See U.S. Lines, Inc. v. United States (In re McLean Indus., Inc.)*, 196 B.R. 670, 676 (S.D.N.Y. 1996); *In re Mid Atl. Fund, Inc.*, 60 B.R. 604, 610 (Bankr. S.D.N.Y. 1986); *see also El Paso v. Am. W. Airlines, Inc. (In re Am. W. Airlines, Inc.)*, 217 F.3d 1161, 1165-66 (9th Cir. 2000); *Comm. of Unsecured Creditors v. Commodity Credit Corp. (In re KF Dairies, Inc.)*, 143 B.R. 734 (B.A.P. 9th Cir. 1992); *In re Badger Lines*, *Inc.*, 199 B.R. 934, 939-40 (Bankr. E.D. Wis. 1996), *rev'd on other grounds*, 202 F.3d 945 (7th Cir. 2000); *In re Sierra-Cal*, 210 B.R. 168, 173 (Bankr. E.D. Cal. 1997); *see also In re McKenzie*, Nos. 11-cv-192, 11-cv-274, 12-cv-025, 2012 WL 4742708, at *8 (E.D. Tenn. Oct. 2, 2012) (stating majority of courts allow a trustee to use section 502(d) defensively); Arthur Steinberg, Bankruptcy Code Section 502(d): Back Door to Avoidance?, 28 UCC Law J. 73, 75-76 (1995) ("The clear majority of cases hold that a trustee may object to the allowance of a claim on the ground that the claimant received an avoidable transfer, notwithstanding that under Section 546(a), the two-year limit for commencing an avoidance action has expired.").

8 *Enron Corp. v. Ave. Special Situations Fund II, LP (In re Enron Corp.)*, 340 B.R. 180, 191 (Bankr. S.D.N.Y. 2006) (citations omitted), *vacated sub nom. on other grounds Enron Corp. v. Springfield Assoc., L.L.C. (In re Enron Corp.)*, 379 B.R. 425 (S.D.N.Y. 2007); *see also In re KF Dairies, Inc.*, 143 B.R. at 737-38 ("Application of the time-bar to objections based on section 502(d) would undercut the statutory language, the purpose of the bankruptcy code, and the general rule that statutory time-bars are inapplicable to matters of defense, where no affirmative relief is sought."); *In re McLean*

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The notion that an objection predicated upon section 502(d) is not dependent on the assertion of an avoidance action is consistent with the overarching purpose of the statute: to restore the "equality of a distribution disturbed by the illicit [transfer]."[9] "Claim objections and avoidance actions . . . are separate and distinct proceedings which use different rules and procedures to accomplish distinct and discrete portions of the administration of a bankruptcy estate."[10] The Noteholders' contention that the only purpose of section 502(d) is to "ensure the compliance with judicial orders"[11] conflates these two "distinct and discrete" proceedings, and disregards the core principle of equality of distribution among creditors.[12] The Noteholders have

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Indus., Inc., 196 B.R. at 676; *In re Am. W. Airlines, Inc.*, 217 F.3d at 1165-66 (holding transfer avoidable for 502(d) purposes even if the trustee is unable to recover such transfer from the transferee); *accord Brown v. I.R.S. (In re Larry's Marineland of Richmond, Inc.)*, 166 B.R. 871 (Bankr. E.D. Ky. 1993) (inability of trustee to obtain affirmative monetary recovery from IRS under section 106(b) of the Bankruptcy Code did not prevent trustee's use of 502(d)); *see generally Parker N. Am. Corp. v. Resolution Trust Corp. (In re Parker N. Am. Corp.)*, 24 F.3d 1145, 1155 (9th Cir. 1994) (noting that by invoking section 502(d) a party transforms an avoidance action into an affirmative defense to a proof of claim).

The cases cited by the Noteholders are inapposite. In *Holloway v. I.R.S. (In re Odom Antennas, Inc.)*, 340 F.3d 705, 708 (8th Cir. 2003), for example, individual creditors sought to avoid a lien under section 502(d), and the Eighth Circuit uncontroversially held that affirmative relief was not available to them. Here, of course, the GUC Trust has never sought affirmative relief against the Noteholders. Rather, the GUC Trust has always confined section 502(d) to its proper claims disallowance function. Additionally, *Seta Corp. of Boca, Inc. v. Atl. Computer Sys. (In re Atl. Computer Sys.)*, 173 B.R. 858, 862 (S.D.N.Y. 1994), unlike here, involved a situation where the transferee-claimant had asserted defenses to avoidance of recoupment and setoff. Defendants here have not asserted any such defenses.

9 *KF Dairies*, 143 B.R. at 736.

10 *In re Stoecker*, 143 B.R. 118, 133 (Bankr. N.D. Ill.), *aff'd in part and rev'd in part and remanded, on other grounds*, 143 B.R. 879 (N.D. Ill. 1992), *aff'd in part and vacated in part and remanded*, 5 F.3d 1022 (7th Cir. 1993). The claims objection process is a mechanism by which a creditor's allowed claim is fixed for purposes of distribution. An avoidance action, however, is a method used to return assets to a debtor's estate that were unlawfully diverted out of the estate, which can only occur through the commencement of an adversary proceeding. Thus, allowing the defensive use of section 502(d) is consistent with the longstanding "general rule that statutory time-bars are inapplicable to matters of defense, where no affirmative relief is sought." *In re KF Dairies, Inc.*, 143 B.R. at 737-38.

11 *See* NH Brief at 35; Paulson Brief at 6 ("statute seeks to 'coerce the return of assets obtained' by otherwise avoidable transfers.").

12 4 Collier on Bankruptcy, ¶ 502.05[2] [a], at 58 ("purpose of section 502(d) is to promote the pro-
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retained the benefits of the avoidable $367 million Consent Fee paid to them, and thus the Disputed Claims should be disallowed under section 502(d).

In an attempt to bolster their untenable position, the Noteholders misconstrue *U.S. Lines, (S.A.) Inc. v. United States (In re McLean Indus., Inc.)*, 30 F.3d 385 (2d Cir. 1994), *cert. denied*, 513 U.S. 1126 (1995), *remanded to* 184 B.R. 10 (Bankr. S.D.N.Y. 1995), *aff'd*, 196 B.R. 670 (S.D.N.Y. 1996). The Second Circuit's holding, however, as well as the subsequent history of that case, contradicts the Noteholders' argument that section 502(d) requires the filing of an avoidance action. In *United States Lines*, the Second Circuit explicitly stated that it was not addressing the issue of whether a section 502(d) objection could be maintained when the underlying avoidance action could no longer be asserted, and remanded the case to the bankruptcy court.[13] On remand, both the bankruptcy court and the district court permitted the defensive use of section 502(d), notwithstanding that the statute of limitations for the underlying avoidance action had expired.[14]

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rata sharing of the bankruptcy estate among all creditors . . . Creditors who have received voidable transfers to the detriment of the pool should not be entitled to make additional demands on the assets of the estate.") (footnote omitted) (citations omitted).

[13] *In re McLean Indus., Inc.*, 30 F.3d at 388 ("USL argues that the timeliness of its preference claim is irrelevant for the purposes of § 502(d), and that MARAD cannot benefit from its alleged preference and still make other claims against USL. . . . Because this issue has not been adequately briefed in this court and may require facts outside of the record, we express no opinion on this issue but remand to the bankruptcy court for the limited purpose of considering in the first instance USL's argument based upon § 502(d).").

[14] *U.S. Lines, Inc. v. United States (In re McLean Indus., Inc.)*, 184 B.R. 10 (Bankr. S.D.N.Y. 1995), *aff'd*, 196 B.R. 670 (S.D.N.Y. 1996). In the district court's decision, Judge Cote noted two contrary decisions from bankruptcy courts in other jurisdictions, but followed "the well-reasoned approach of Bankruptcy Judge Abram in *In re Mid Atlantic Fund, Inc.*, 60 B.R. 604 (Bankr. S.D.N.Y. 1986)," concluding that the plain meaning of section 502(d), its legislative history and its overarching purpose all pointed in the direction of permitting the defensive assertion of section 502(d), even where the underlying avoidance action could no longer be brought. *In re McLean, Indus., Inc.*, 196 B.R. at 676-77.

B. Payment Of The Consent Fee Was An Avoidable Postpetition Transfer Under Section 549

Disallowance under section 502(d) is required because payment of the Consent Fee was an unauthorized postpetition transfer of Old GM's property avoidable under section 549. The Noteholders and the Nova Scotia Trustee have failed to meet their burden of showing that this postpetition transfer of estate property was valid.[15]

1. The Proceeds Of The $450 Million Loan Were Property Of The Estate

The transfer of the $450 Million Loan that Old GM initiated prepetition to a GM Canada bank account for the purpose of paying the Consent Fee was subject to the Trust Agreement, the conditions of which were not satisfied as of the Petition Date. Specifically, as explained in Fact Section III(B)(1) of the GUC Brief and as conceded at trial by Mr. Buonomo, the Lock-Up Deadline and Amended Lock-Up Deadline were not met.[16] Thus, as of the filing of Old GM's bankruptcy petition, Old GM still had an interest in the $450 million held in trust, and all subsequent transfers of those proceeds were unauthorized postpetition transfers of Old GM's property.

Ignoring the failure to satisfy the trust conditions, the Noteholders argue that the funds used to pay the Consent Fee were not property of the estate because "[t]he proceeds of the $450

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[15] The Noteholders dispute that the transfer was a postpetition transfer. While the GUC Trust bears the initial burden of proving that the transfer occurred postpetition, once that burden is carried, then, under Rule 6001 of the Federal Rules of Bankruptcy Procedure, it is the Noteholders' burden to show the validity of the transfer. *See Manuel v. Allen (In re Allen)*, 217 B.R. 952, 955 (Bankr. M.D. Fla. 1998) ("If a transfer is established, the burden of proving the validity of the transfer rests with the defendants").

[16] Trial Tr. (8/9/2012), 80:13-81:9 (Buonomo). Indeed, New GM and the Noteholders concede that the Amended Lock-Up Deadline of 7:00 a.m. EDT was not met. *Compare* Trial Tr. (9/20/12), 85:16-20 (Truong) ("I held that signature until 7:00 a.m. after I received confirmation from Greg. . . . Only until then did I provide our signatures.") *with* Trial Tr. (9/20/12), 81:10-12 (Truong) (recalling that Mr. Gropper was the last to turn over his signature page). *See* Trial Tr. (8/9/2012), 236:6-9 (Buonomo) ("I was annoyed that we had gone over 7:30").

Million Loan were deposited in a GM Canada bank account"[17] prior to the filing of Old GM's petition. Property of the estate, however, is broadly construed and includes "all legal *or* equitable interests of the debtor in property as of the commencement of the case."[18] Under the Trust Agreement, Old GM had "a right to the funds and incidents of ownership until the conditions" of the Trust Agreement were satisfied.[19] As of the filing of the petition, those conditions were not, and could no longer be, satisfied. Since "the contingency of the escrow was not fulfilled prior to bankruptcy, the debtor holds an interest in the property," and this interest is therefore property of the estate.[20]

New GM's contention that the GM Canada account to which the $450 Million Loan was transferred was not "a trust or escrow account," but rather "a general account," is directly contradicted by the numerous record cites in the footnote immediately below.[21] An escrow is

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[17] NH Brief at 33.

[18] 11 U.S.C. § 541(a)(1) (emphasis added). Property in which a debtor holds "only legal title and not an equitable interest" becomes property of the estate when the bankruptcy case is commenced. *Id.* § 541(d).

[19] *Fisher v. N.Y.C. Dep't of Hous. Pres. & Dev. (In re Pan Trading Corp. S.A.)*, 125 B.R. 869, 878 (Bankr. S.D.N.Y. 1991); *see also In re Rosenshein*, 136 B.R. 368, 372 (Bankr. S.D.N.Y. 1992).

[20] *Wilson v. United Sav. of Tex (In re Missionary Baptist Found. of Am., Inc.)*, 792 F.2d 502, 506 (5th Cir. 1986). Defendants rely on cases that are easily distinguished. *See, e.g., Musso v. N.Y. State Higher Educ. Sevs. Corp. (In re Royal Bus. Sch., Inc.)*, 157 B.R. 932, 942 (Bankr. E.D.N.Y. 1993) (funds in the escrow account not property of the estate because escrow conditions to complete transfer from debtor were still capable of being satisfied as of the petition date); *Hooker Atlanta (7) Corp. v. Hocker (In re Hooker Invs., Inc.)*, 155 B.R. 332, 338-39 (Bankr. S.D.N.Y. 1993) (transfer out of an escrow account was not a transfer of property of the estate when all conditions of the escrow had been met). The conditions of the escrow at issue here were not, and could no longer be, met before Old GM's bankruptcy filing because the Notes were not exchanged for cash and the Lock-Up Agreement was not signed and delivered by either the Lock-Up Deadline or the Amended Lock-Up Deadline. Upon the failure to meet the escrow conditions, Old GM was vested with an immediate possessory interest in the $450 million. *See In re Missionary Baptist Found. of Am., Inc.*, 792 F.2d at 506.

[21] On May 28 and May 29, GM Canada sought consent from Export Development Canada ("**EDC**") on several occasions to a proposed transaction with the Noteholders. *See, e.g.*, Pl. Ex. 402 at NGM000021890; Pl. Ex. 238 at NGM000013385. GM Canada represented to EDC in each consent solicitation that the loan from Old GM to GM Canada to fund a payment to the Noteholders "would be conditional upon GM Canada holding the funds *in trust* until certain conditions are met," which "*trust*

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created when property is "delivered by the grantor, promisor, or obligor into the hands of a third person, to be held by the latter until the happening of a contingency or performance of a condition and then by him delivered to the grantee, promisee, or obligee."[22] Here, Old GM (the grantor) transferred $450 million into the hands of GM Canada to be held until the conditions in the Trust Agreement were satisfied, at which time GM Canada was to deliver the proceeds into an account for the benefit of the Noteholders. As described above, these conditions failed before Old GM filed for bankruptcy and could not be satisfied thereafter. Accordingly, the transfers leading to payment of the Consent Fee – from Old GM to GM Canada, from GM Canada to GM Nova Scotia, and from GM Nova Scotia to the Noteholders – are avoidable postpetition transfers of Old GM's property.[23]

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conditions" included the requirement that GM Nova Scotia "use the settlement proceeds from GM Canada to settle and extinguish the [Notes]." Pl. Ex. 238 at NGM000013385 (emphasis added). Further, in setting up the trust account, Mr. Lopez communicated with TD Bank to ensure that the funds would "be segregated into a USD stand-alone account" and that such account would not be linked in any way to GM Canada's "[g]eneral" USD account. Pl. Ex. 765; *see also* Pl. Exs. 766 and 767. On May 29, 2009, in determining the amount of what would become the $450 Million Loan, Ms. Sutedja expressed her desire to get "[the] *trust* agreement finalized and executed" and that "[i]f the consensus is to flow US$450M to [GM Canada's] *trust account*" then she would reflect that amount in the Trust Agreement and Promissory Note. Pl. Ex. 237 at NGM000013346 (emphasis added). In connection with the $450 Million Loan, the parties entered into the Trust Agreement on May 29, 2009. *See, e.g.*, Pl. Ex. 144, ¶ 2 (CC000133) (steps list). The first paragraph of the Trust Agreement, entitled "Creation of Trust," provides that GM Canada shall hold the proceeds of the $450 Million Loan "*in trust*, separate and apart from all other" GM Canada funds. Pl. Ex. 134 at NGM0000603 (emphasis added). The second paragraph of the Trust Agreement, entitled "Release from Trust and Use of Proceeds," provides that GM Canada "shall be entitled to release the [p]roceeds *from trust*" after a successful vote to pass the "proposed amendment" (which is defined as an amendment to the Notes "to provide that such Notes will become mandatorily exchangeable into cash"). Pl. Ex. 134 at NGM0000602 (¶ C) and 603 (¶ 2) (emphasis added). On May 29, once Old GM initiated the transfer of the $450 million, Ms. Sutedja reported that the wire to GM Canada's "*trust account* has gone out." Pl. Ex. 238 at NGM000013383 (emphasis added).

[22] *In re Pan Trading*, 125 B.R. at 878 (citations omitted).

[23] The Defendants and New GM mischaracterize Mr. Mayer's testimony when they contend that "any funds used to pay the Consent Fee would never have gone to unsecured creditors." JSF, ¶ 70. Because they were hypothetical, Mr. Mayer was unable to answer the Noteholders' questions about what would have happened if "there had been an additional $450 million in cash in Old GM at time it filed" for bankruptcy. Trial Tr. (10/3/2012), 20:1-21:1 (Mayer).

2. The Transfers Of The Consent Fee Proceeds Should Be Collapsed

Even if it is assumed, *arguendo*, that the Trust Agreement conditions had been satisfied, the transactions that resulted in payment of the Consent Fee should be collapsed and deemed a single, integrated transaction. Old GM's payment of the proceeds of the $450 Million Loan to GM Canada was the first step in a single, integrated transaction that directly resulted in payment of the Consent Fee.[24] The entire transaction should be recognized for what it is: an unauthorized postpetition transfer of Old GM's property to pay the Consent Fee to the Noteholders.

The Noteholders do not dispute that payment of the Consent Fee was part of an integrated transaction. Instead, they argue in error that the standard for collapsing has not been satisfied. Here, the appropriate test to determine whether the series of transactions leading to payment of the Consent Fee should be collapsed is found in *Silverman v. K.E.R.U. Realty Corp. (In re Allou Distributors, Inc.)*:[25]

> where the transactions, taken as a whole, diminish the value of the debtor's estate and are marked by either a transfer made by the debtor for less than fair consideration or a transfer made by the debtor with actual fraudulent intent, and the party from whom recovery is sought had actual or constructive knowledge of the entire scheme that renders the transfer fraudulent.[26]

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[24] *See, e.g.*, Trial Tr. (3/6/2013), 32:5-33:15 (Lopez) (noting that the proceeds from the $450 Million Loan "were earmarked for a specific purpose" which was to pay the Noteholders).

[25] 379 B.R. 5, 22 (Bankr. E.D.N.Y. 2007).

[26] *Id*. *See also Orr v. Kinderhill Corp.*, 991 F.2d 31, 36 (2d Cir. 1993); *In re Best Prods. Co.*, 157 B.R. 222, 229 (Bankr. S.D.N.Y. 1993) ("The ability of a court to collapse a series of steps into one transaction depends upon the facts and circumstances of each case. In reality, collapsing transactions is little more than an effort on the part of the court to focus not on the formal structure of a transaction, but rather on the knowledge or intent of the parties involved in the transaction."); *Official Comm. of Unsecured Creditors of Nat'l Forge Co. v. Clark (In re Nat'l Forge Co.)*, 344 B.R. 340, 348 (W.D. Pa. 2006) ("Among other things, courts consider whether all of the defendants were aware of the multiple steps of the transaction . . . [and] whether each step would have occurred on its own or, alternatively, whether each step depended upon the occurrence of the additional steps in order to fulfill the parties' intent."); *Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co. (In re Sunbeam Corp.)*, 284 B.R. 355, 370 (Bankr. S.D.N.Y. 2002) ("Although the concept of 'collapsing' a series of transactions and treating them as a single integrated transaction has been applied primarily . . . in

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In articulating this standard, the bankruptcy court in *Allou* built upon the Second Circuit's decision in *HBE Leasing Corp. v. Frank*, 48 F.3d 623, 635 (2d Cir. 1995), adapting that standard to a situation where the debtor is the transferor (and not the sham transferee as was the case in *HBE Leasing*).[27]

Here, collapsing is warranted because (1) the series of transactions diminished Old GM's estate for less than fair consideration, and (2) the transferees had, at the very least, constructive knowledge of the entire scheme. The Noteholders contend, incorrectly, that the GUC Trust cannot "satisfy the *Allou* test as the Promissory Note was fair consideration for the loan and there is no evidence of fraudulent intent by the Debtor (or any other party)."[28] In fact, the Promissory Note had no value to Old GM because, at the time of the $450 Million Loan, Old GM knew that the right to be repaid under the Promissory Note would be conveyed to New GM. The only putative consideration received by Old GM was the worthless release from the Oppression Action.[29] Moreover, the trial record shows that the Consent Fee, in an amount of approximately 36% of the face amount of the Notes, was far in excess of what any Noteholder had ever received as a consent fee.[30]

Also, contrary to the Noteholders' argument, actual fraudulent intent is not required

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the context of a failed leveraged buy-out ('LBO'), it has also been utilized in other contexts."), *appeal dismissed*, 287 B.R. 861 (S.D.N.Y. 2003); *see also Voest–Alpine Trading Corp. v. Vantage Steel Corp.*, 919 F.2d 206, 211–12 (3d Cir. 1990) (collapsing series of transactions as "sham").

[27] *See In re Allou Distributors, Inc.*, 379 B.R. at 21-22 ("More generally, the first condition [under *HBE Leasing*] for collapsing a series of transactions is that the transactions, taken as a whole, diminish the value of the debtor's estate and are marked by either a transfer made by the debtor for less than fair consideration or a transfer made by the debtor with actual fraudulent intent.").

[28] NH Brief at 40 n.16.

[29] *See* GUC Brief at 12 n.56 (demonstrating Noteholders received a disproportionately rich deal under the Lock-Up Agreement).

[30] *See* Trial Tr. (9/6/2012), 16:18-22, 126:19-23 (Cederholm).

under *Allou*. The Noteholders had, at a minimum, constructive knowledge that the Consent Fee, and the related transfers that ultimately resulted in payment of the Consent Fee to them, were potentially avoidable. Indeed, the Noteholders were active participants in structuring the transactions in an attempt to evade Court scrutiny and shelter the Consent Fee from avoidance.[31] As just one example, the Noteholders agreed to revise the escrow agreement to designate the account to which the Consent Fee would be paid as a GM Nova Scotia account because "otherwise, the repayment of the intercompany loan [between GM Canada and GM Nova Scotia] is at risk – which is the sole reason why we need the funds to momentarily land in Escrow Account #2."[32]

Accordingly, the series of transfers that began with Old GM and ended with payment of the Consent Fee to the Noteholders should be collapsed. The transfer of the $450 million to GM Canada was the first step in a single, integrated transaction designed to put $367 million of Old GM's property into the hands of the Noteholders.[33] The payment of the Consent Fee to the Noteholders, as well as the transfers leading up to that payment, were unauthorized postpetition transfers that are avoidable under section 549, and the Disputed Claims should therefore be disallowed under section 502(d).

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[31] *See* Pl. Exs. 66 and 67 (emails attaching Consent Fee escrow agreement copied to, and negotiated by, the Lock-Up Noteholders); Pl. Ex. 3 at AUR_GM021457 (Prieto notebook) ("the money is in a trust account in Canada where it is being held for this deal. [D]oes not think that money will be attackable where it is now . . . the rights to this preference will be assumed by [New GM] in the 363 [Sale]. [T]hey will show us the trust document."). Mr. Gropper interpreted Mr. Prieto's notebook entry to mean that "if the payment from GM U.S. to GM Canada is a preference, that the rights to that preference would be assumed by [New GM] in the 363 [S]ale." Trial Tr. (9/28/2012), 65:6-13 (Gropper).

[32] Pl. Ex. 67 at ELL_GM001701 (email from V. Graham, dated June 3, 2009).

[33] *See* New GM SJ Hr'g Tr. (7/19/2012), 84:16-21 ("The GUC Trust has put forward evidence . . . to establish that GM Canada was merely a conduit and not the quote 'initial transferee of such transfer or the entity for whose benefit such transfer was made,' quote, as that expression is used in Section 550 of the Code.").

3. The $450 Million Loan Was Not Authorized

The transfer of the Consent Fee was not an ordinary course transaction and therefore its payment required prior Court approval. New GM argues that the Cash Management Order (defined below) authorized GM Canada to transfer Old GM's property to fund the Consent Fee because "[t]here was no 'ordinary course' limitation set forth in the applicable provision of the Cash Management Order."[34] This argument is outrageous. Old GM's cash management motion sought Court authorization only for ordinary course transactions, and thus the Cash Management Order by its terms only approved ordinary course transfers (eliminating the need for a purported "ordinary course" limitation in the order itself).[35] But in any event, the transfer of the Consent Fee was not an "ordinary" or customary transfer, in either amount or purpose, and would under no circumstance be able to qualify as an authorized ordinary course transfer.[36]

4. Avoidance Claims Related To Payment Of The Consent Fee Were Not Sold to New GM

As already explained above, to prevail on its section 502(d) objection, the GUC Trust need not file, or even be able to file, an avoidance action to recover the Consent Fee. Nonetheless, for the sake of completeness, the GUC Trust will respond to arguments advanced by the Noteholders and New GM that the avoidance actions related to payment of the Consent

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[34] NG Brief at 31.

[35] Pl. Ex. 750 at 12 (Bankr. Dkt. No. 30, cash management motion) (seeking order authorizing "the continued transfers of funds among the Debtors and their affiliates in the ordinary course of business"); Pl. Ex. 751 at 3 (Bankr. Dkt. No. 2542, order granting cash management motion "**Cash Management Order**").

[36] *See* New GM SJ Hr'g Tr. (7/19/2012), 85:25-86:6 ("I'm surprised that New GM would even suggest . . . that a transaction of this character could have been authorized under my first day cash management order when its effect, if not also [sic] purpose, was to use GM Canada as the conduit for the $367 million in Old GM funds that found their way into the hands of certain noteholders."); *see also infra* note 48 (demonstrating extraordinary size of Consent Fee).

Fee, including claims under section 549, were sold to New GM. For the following reasons, these arguments lack merit.

Under the MSPA, Old GM sold to New GM only the avoidance actions "arising from, relating to or in connection with, any payments by or to . . . any Purchased Subsidiary."[37] As explained above, the series of transfers that put the Consent Fee into the Noteholders' hands should be collapsed and properly recognized as a transfer from Old GM to the Noteholders. Transfers from Old GM to the Noteholders were not sold to New GM – and no one argues that they were. Further, to the extent that the transfers are considered transfers to GM Nova Scotia, those transfers also were not sold to GM Nova Scotia because it was not a "Purchased Subsidiary" – and no one argues that it was. The fact that Old GM's payment to the Noteholders was funneled through GM Canada does not transform the avoidance action into a claim purchased by New GM.[38]

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[37] MSPA § 2.2(b)(xi); *Notice Of Filing Of The Amended Master Sale And Purchase Agreement And Certain Exhibits And Sections Of The Disclosure Schedule Thereto* at Disclosure Sch. 2.2(b)(xi) (Bankr. Dkt. No. 2649).

[38] The Noteholders argue in error that the GUC Trust must first obtain a judgment against GM Canada establishing that the transfer is avoidable before seeking recovery from the Noteholders. This argument misses the mark for a number of reasons. First, as explained above, to prevail on its section 502(d) objection, the GUC Trust need not pursue an avoidance action at all. Second, even if such an action were necessary, this is a blatant misstatement of the law on avoidable transfers because the trustee "may seek to recover against any transferee, initial or immediate, or an entity for whose benefit the transfer is made." *Kendall v. Sorani (In re Richmond Produce Co.)*, 195 B.R. 455, 463 (N.D. Cal. 1996); *see also IBT Int'l, Inc. v. Northern (In re Int'l Admin. Servs., Inc.)*, 408 F.3d 689, 704 (11th Cir. 2005) (same); *Durkin v. Shields (In re Imperial Corp. of Am.)*, No. 92-1003-IEG (LSP), 1997 WL 808628, at *3 (S.D. Cal. Aug. 20, 1997) (same); *Advanced Telecomm. Network, Inc. v. Allen (In re Advanced Telecomm. Network, Inc.)*, 321 B.R. 308, 328 (Bankr. M.D. Fla. 2005), *rev'd on other grounds*, 490 F.3d 1325 (11th Cir. 2007) (same). Finally, because GM Canada served as a mere conduit for the transfer to GM Nova Scotia and then to the Noteholders, there would not be any reason to seek recovery of the transfer from GM Canada. *See In re Int'l Admin. Servs., Inc.*, 408 F.3d at 705 (courts have "created a more malleable approach to § 550(a), recognizing that such a 'mere conduit' cannot be considered an 'initial recipient' for purposes of avoidance action.").

C. Alternatively, To The Extent The $450 Million Loan Is Deemed A Prepetition Transfer, The Consent Fee Is Nonetheless Avoidable Under Sections 547 And 548 Of The Bankruptcy Code

As already explained above, the Consent Fee is avoidable under section 549 as an unauthorized postpetition transfer. Nonetheless, if for some reason payment of the Consent Fee is deemed a prepetition transfer, as the Noteholders argue, it is still avoidable as either a fraudulent transfer or a preference.

The Consent Fee is avoidable as a constructively fraudulent transfer under section 548(a)(1)(B) of the Bankruptcy Code, because Old GM, while insolvent, received less than reasonably equivalent value for its transfer of the proceeds of the $450 Million Loan.[39] As demonstrated at trial, Old GM's own internal analysis confirmed that the Consent Fee was disproportionate to any benefit Old GM received.[40]

The Noteholders argue, without basis, that the Indifference Analysis, which was prepared by Old GM in consultation with its financial advisor, Morgan Stanley, is not reliable. This argument should be rejected. The Indifference Analysis was a contemporaneous analysis performed by Old GM and was the basis for Old GM's and Mr. Ammann's communications with U.S. Treasury about the Lock-Up Agreement. It is the only reasoned analysis prepared by any party that addresses the economics of a potential settlement with the Noteholders from Old GM's perspective.[41] There is no credible evidence on the topic except for the Indifference Analysis, which shows that a settlement with the Noteholders did not make economic sense at levels

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[39] 11 U.S.C. § 548(a)(1)(B).

[40] Trial Tr. (9/27/2012), 96:18-21 (Ammann). A $285 million payment represented a 178% premium to market on the Notes. *See, e.g.*, Pl. Ex. 211 at 2 (email from D. Ammann, dated May 18, 2009).

[41] Trial Tr. (8/10/2012), 108:25-109:7 (Buonomo); Trial Tr. (9/27/2012), 76:1-77:19, 79:25-80:5, 80:13-15, 83:22-84:1, 102:5-8 (Ammann).

beyond a $285 million payment in exchange for extinguishing the Notes. Here, the Noteholders were paid $367 million, retained their Notes without any reduction of principal, and are the potential beneficiaries of approximately $2.7 billion in claims against Old GM.[42] Old GM therefore did not receive reasonably equivalent value, and payment of the Consent Fee is avoidable as a constructively fraudulent transfer.[43]

D. The Defenses Raised By The Noteholders As To The Avoidability Of The Transfers Are Without Merit

1. The Noteholders Did Not Take The Transfer "In Good Faith"

The evidence at trial showed that the Noteholders' receipt of the $367 million Consent Fee was not "in good faith" within the meaning of section 550(b). Section 550(b) provides a defense to "(1) a transferee that takes . . . in good faith, and without knowledge of the voidability of the transfer avoided; or (2) any immediate or mediate good faith transferee of such transferee." 11 U.S.C. § 550(b).[44] A transferee has "knowledge" of a transfer's voidabililty

[42] The Noteholders contend, incorrectly, that the Indifference Analysis is a range in which the Consent Fee falls. NH Brief at 41; JSF, ¶ 29. In fact, the Indifference Analysis was always expressed internally and to U.S. Treasury as a point, not a range. Pl. Ex. 126 ("point of indifference"); Pl. Ex. 130 ("point of indifference analysis"); Pl. Ex. 211 ("the indifference point is quite high"). As Mr. Buonomo testified, the indifference point refers to the number that "above this is too much, below this is favorable." Trial Tr. (8/9/2012), 22:13-23 (Buonomo). He also testified that the phrase "walk away" is the "*point* at which we should just . . . say no and file a bankruptcy in Canada." *Id.* at 29:2-7 (emphasis added). Regardless, every version of the Indifference Analysis was premised on an "all in" settlement with the Noteholders. *Id.* at 32:11-16. Mr. Buonomo concedes that the assumption in every draft of the Indifference Analysis was "payment for cancellation of the [N]otes, so all in colloquially." *Id.* at 108:17-24. Pl. Ex. 133 (seeking approval from UST for an "all-in offer" to the Noteholders). Finally, the parties argue that the Indifference Analysis "changed over time." JSF, ¶ 29. The evidence shows, however, that the indifference point changed only once and never exceeded $285 million. *See, e.g.*, Pl. Exs. 211 ($285 million), 126 ($234 million) and 130 ($285 million).

[43] For the reasons already set forth in the GUC Brief, the Consent Fee is also avoidable as a preference under section 547 and as an actual fraudulent transfer under section 548(a)(1)(A).

[44] Cases have reached different conclusions on the issue of whether the plaintiff carries the burden of proof to show the absence of a defense under section 550(b), or whether it is the defendant's burden to affirmatively establish the defense. *Compare In re Hooker Invs., Inc.*, 155 B.R. at 337 (stating that the party seeking to preclude trustee from recovering voidable transfer has burden of proof under section 550(b)) *with Lustig v. Hickey (In re Hickey)*, 168 B.R. 840, 850 (Bankr. W.D.N.Y. 1994) ("The trustee

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when the transferee is aware of the potential grounds for avoidance of the transfer; a complete understanding of the facts is not required.[45] There is no question that the Noteholders were aware of the potential grounds for avoidance. Among other evidence, Dennis Prieto's notebook entry demonstrates his understanding that the $450 Million Loan was potentially "attackable" as a "preference."[46] Additionally, the Noteholders were involved in structuring the Lock-Up Agreement, including payment of the Consent Fee, in a manner designed to evade this Court's scrutiny.[47] The Noteholders were also well aware that the amount of the Consent Fee was many orders of magnitude greater than any other consent fee with which they had ever been involved.[48] Because the Noteholders did not receive payment of the Consent Fee in good faith, their section 550(b) defense is without merit.

2. The Section 546(e) Safe Harbor Does Not Apply

The Noteholders further argue that the Consent Fee is shielded from avoidance under the section 546(e) safe harbor for certain transfers made "in connection with a securities contract." This defense does not apply because, by its express terms, section 546(e) only applies to certain transfers made in connection with a securities contract that are "made before the commencement

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has the burden of proving that the defendant should not have the benefit of the shelter provided by Section 550(b)(1)"). The Court need not decide this issue, however, because the GUC Trust has nonetheless proven that the Noteholders lacked good faith by a preponderance of the evidence.

[45] *Bruno Mach. Corp., v. Troy Die Cutting Co. (In re Bruno Mach. Corp.)*, 435 B.R. 819, 849 (Bankr. N.D.N.Y. 2010).

[46] Pl. Ex. 3 at AUR_GM021457 (Prieto notebook).

[47] *See supra* note 31.

[48] Prior to this deal, the largest consent fee with which Mr. Cederholm ever had experience was 8% of the face value of the notes and in this case the Noteholders received approximately 35% of the face value. Trial Tr. (9/6/2012), 31:9-14; 126:19-23 (Cederholm); *see* Gropper Decl., ¶ 52; Pl. Ex. 607 at FOR_GM002643 (email from L. Cowen to B. Truong, dated May 30, 2009).

of the case."[49] Section 546(e) is therefore not a defense to a postpetition transfer avoidable under section 549, such as the Consent Fee here.[50]

3. <u>The Lock-Up Agreement Was Not Assumed and Assigned</u>

The Noteholders also argue that transfers made pursuant to the Lock-Up Agreement are not subject to challenge because the Lock-Up Agreement was assumed and assigned under section 365 of the Bankruptcy Code. To prevail on this argument, the Noteholders bear the burden of proving by a preponderance of the evidence that the Lock-Up Agreement was validly assumed and assigned.[51] For the reasons set forth in the GUC Brief *(see* GUC Brief at 26 n.129), the Noteholders cannot satisfy this burden. The evidence shows that the Lock-Up Agreement was not, and could not have been, assumed by Old GM under the MSPA because (1) the Lock-Up Agreement is void as an unauthorized postpetition agreement; (2) even if the Lock-Up Agreement was a prepetition agreement, it was not assumed because Old GM failed to comply with the assumption procedures mandated by the Sale Order;[52] and (3) the Lock-Up Agreement is an "Excluded Contract" which was not sold to New GM.[53]

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[49] As discussed in Section V below, it is telling that the Noteholders themselves characterize the Consent Fee as a payment in connection with a securities contract – namely, the Notes. NH Brief at 42-43. This only further demonstrates that, in substance, the Consent Fee was a payment on the Notes.

[50] Alternatively, if the Consent Fee is considered a prepetition payment, the section 546(e) safe harbor still would not apply, because the Consent Fee was a principal payment on the Notes and did not involve a "securities contract" within the meaning of the Bankruptcy Code. *See* 11 U.S.C. § 741(7) (defining "securities contract" as a "contract for the purchase, sale or loan of a security").

[51] *See Friede Goldman Halter, Inc. v. Aircomfort, Inc. (In re Consol. FGH Liquidating Trust)*, 392 B.R. 648, 665 (Bankr. S.D. Miss. 2008) (defendant failed to meet burden of proving assumption and was therefore precluded from arguing that avoidance of preferential transfers is barred by assumption under section 365); *see also Weinman v. Allison Payment Sys., LLC (In re Centrix Fin., LLC)*, 434 B.R. 880, 888 (Bankr. D. Colo. 2010) (recognizing contract assumption as an affirmative defense).

[52] To the extent the Court finds that Old GM's only obligation under the Lock-Up Agreement was the "cooperation" obligation as argued by New GM, then even if the Lock-Up agreement was a prepetition agreement, it was not assumed because it was not executory. *See Memorandum Of Law In Support of Motion By General Motors LLC For Summary Judgment* (Bankr. Dkt. No. 11849) at 37 ("Old GM's only continuing obligation after the Petition Date with respect to the Lock-Up Agreement was the

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E. The $450 Million Loan Was Not Repaid

The Noteholders, relying on New GM, contend that the $450 Million Loan was repaid in full. The evidence does not support this contention and, in fact, strongly supports the conclusion that it was *not* repaid. On three different occasions, New GM tried and failed to prove that the $450 Million Loan was repaid.[54] After New GM failed to prove repayment the first two times, the Court gave New GM one last chance, adjourning the trial and permitting testimony from a previously unidentified witness. On its final attempt to prove repayment of the $450 Million Loan, New GM's hand-picked witness, Tyrone Lopez, proved to be incompetent to testify about the issue.

First, the evidence shows that Mr. Lopez was away at the time of the repayment transaction. Although he claims to have been "personally involved in the drafting, review and arranging for the execution of the D&A Memo," which is dated as of July 7, 2009, Mr. Lopez was out of the office from July 6 through July 10, 2009.[55] On Wednesday July 1, Mr. Lopez emailed a list of special transactions for the preceding month to his colleagues in the accounting department "just in case there are any issues as I will be away next week."[56] Consistent with his

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Cooperation Provision."). However, the GUC Trust disputes New GM's contention because, as described more fully in the GUC Brief and herein, Old GM had numerous obligations under the Lock-Up Agreement.

53 MSPA § 2.2(v)(ii).

54 New GM attempted to prove repayment with Mr. Buonomo on August 9, 2012, and again with Mr. Ammann on September 27, 2012. As the Court noted, "[i]t was obvious to anybody sitting in this courtroom" that Mr. Buonomo "could not of his own knowledge say what actually happened." Further, it was foreseeable that an objection to Mr. Ammann "testifying about stuff that he didn't know except by hearsay would likewise be sustained." Trial Tr. (11/26/2012), 10:10-18 (Iacobucci).

55 Lopez Decl., ¶ 5.

56 Pl. Ex. 733 (email from T. Lopez to J. Ogle and P. Gupta, dated July 1, 2009).

being away, Mr. Lopez did not send a *single* email during the week of July 6.[57]

Second, Mr. Lopez was entirely unfamiliar with critical facts required to prove New GM's convoluted repayment theory. A key piece of New GM's argument involves the transfer of CAD $1 billion into an escrow account with CIBC (the "**CIBC Escrow Account**"), pursuant to an escrow agreement between, among others, Old GM and CIBC (the "**CIBC Escrow Agreement**"). New GM contends, and the GUC Trust disputes, that the CIBC Escrow Account was an Old GM account. While Mr. Lopez was aware that the CIBC Escrow Account was set up for General Motors Company (*i.e.*, New GM), he did not know who owned the CIBC Escrow Account because that was not part of his job.[58] Mr. Lopez was not involved in establishing the account and did not know if the account was for Old GM or New GM.[59]

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[57] As shown by the emails admitted at trial, Tyrone Lopez did not send a single email from July 6, 2009 through July 10, 2009. *See* Pl. Ex. 643 (July 6, 2009 from J. Halbridge); Pl. Ex. 711 (July 6, 2009 from A. Raj); Pl. Ex. 712 (July 6, 2009 from A. Hartog); Pl. Ex. 713 (July 6, 2009 from J. McCabe); Pl. Ex. 714 (July 6, 2009 from S. Subramanian); Pl. Ex. 734 (July 6, 2009 from C. Albino); Pl. Ex. 735 (July 6, 2009 from N. Soori); Pl. Ex. 764 (July 6, 2009 from A. Hartog); Pl. Ex. 774 (July 6, 2009 from A. Sundaram); Pl. Ex. 181 (July 7, 2009 from J. Goldrath); Pl. Ex. 646 (July 7, 2009 from B. Truong); Pl. Ex. 693 (July 7, 2009 from V. Fiege); Pl. Ex. 694 (July 7, 2009 from A. Sundaram); Pl. Ex. 715 (July 7, 2009 from S. Subramanian); Pl. Ex. 717 (July 7, 2009 from A. Hartog); Pl. Ex. 757 (July 7, 2009 from D. Crawley); Pl. Ex. 775 (July 7, 2009 from D. Crawley); Pl. Ex. 776 (July 7, 2009 from D. Crawley); Pl. Ex. 439 (July 8, 2009 from L. Buonomo); Pl. Ex. 718 (July 8, 2009 from A. Hartog); Pl. Ex. 747 (July 8, 2009 from B. Neuman); Pl. Ex. 758 (July 8, 2009 from R. Burshtine); Pl. Ex. 647 (July 9, 2009 from A. Fratila); Pl. Ex. 719 (July 9, 2009 from J. McCabe); Pl. Ex. 720 (July 9, 2009 from S. Di Cresce); Pl. Ex. 759 (July 9, 2009 from A. Hartog); Pl. Ex. 20 (July 10, 2009 from D. Prieto); *see also* Def. Ex. 431 (July 6, 2009 from S. Subramanian); Def. Ex. 435 (July 6, 2009 from S. Subramanian); Def. Ex. 472 (July 6, 2009 from E. Xiong); Def. Ex. 473 (July 6, 2009 from N. Lall); Def. Ex. 514 (July 6, 2009 from C. Albino); Def. Ex. 515 (July 6, 2009 from S. Subramanian); Def. Ex. 516 (July 6, 2009 from C. Timbrell); Def. Ex. 517 (July 6, 2009 from M. Sutedja); Def. Ex. 518 (July 6, 2009 from M. Schein); Def. Ex. 477 (July 7, 2009 from N. Soori); Def. Ex. 478 (July 7, 2009 from D. Crawley); Def. Ex. 479 (July 7, 2009 from D. McCarroll); Def. Ex. 480 (July 7, 2009 from V. Fiege); Def. Ex. 481 (July 7, 2009 from A. Sundaram); Def. Ex. 482 (July 7, 2009 from N. Soori); Def. Ex. 483 (July 7, 2009 from D. Crawley); Def. Ex. 484 (July 7, 2009 from D. McCarroll); Def. Ex. 521 (July 7, 2009 from R. Burshtine); Def. Ex. 522 (July 7, 2009 from A. Sundaram); Def. Ex. 523 (July 7, 2009 from A. Sundaram); Def. Ex. 524 (July 7, 2009 from C. Timbrell); Def. Ex. 485 (July 9, 2009 from S. Di Cresce).

[58] Trial Tr. (3/6/2013), 40:20-22; 64:10-18; 65:9-13 (Lopez).

[59] *Id*. at 66:1-9.

Further, Mr. Lopez had no involvement with the CIBC Escrow Agreement.[60] He did not concern himself with agreements related to the GM U.S. parent company because, again, that was not his job.[61] He knows nothing about why or how Old GM came to be a party to the CIBC Escrow Agreement.[62] In fact, the obligations related to the CIBC Escrow Agreement are "completely foreign" to Mr. Lopez, and he had no idea if the obligations belonged to Old GM or New GM.[63] As Mr. Lopez testified, "[w]hat was happening in the U.S., what step they were in, that's completely out of my purview."[64]

Finally, even if Tyrone Lopez were competent to testify regarding the alleged repayment, which he was not, his testimony should nevertheless be afforded no weight because he is not a credible witness. In addition to having been away from the office at the time of the purported repayment transaction, Mr. Lopez was not honest about having altered an email that he sent to TD Bank and an email that he received from TD Bank, before forwarding both emails in their altered forms to his supervisors at GM Canada.[65] Mr. Lopez's explanation as to why his email to TD Bank, sent at 9:14 a.m., contains text that is different than the version of this email, also

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[60] *Id*. at 38:21-39:3.

[61] *Id*. at 45:4-10.

[62] *Id*. at 47:6-18.

[63] According to Mr. Lopez, "[w]hether it was Old GM, New GM, from my perspective I look at this, I see the parent company" and "it[']s not [sic] job to know" whether it was Old GM or New GM. *Id*. at 48:10-49:1.

[64] *Id*. at 58:23-24.

[65] *See* Trial Tr. (3/6/2013), 20:17-30:15 (Lopez). *Compare* Pl. Exs. 376, 699 (email from T. Lopez to D. McCarroll, dated June 1, 2009 at 9:14 a.m., "I was wondering if you could confirm receipt of the [$450 Million Loan]"); *with* Pl. Ex. 375 (T. Lopez forwarding email chain to his superiors containing purported email from T. Lopez to D. McCarroll, dated June 1, 2009 at 9:14 a.m., "Could you please confirm receipt of the [$450 Million Loan] . . . *on Friday afternoon*" and telling his superiors "We're good!") (emphasis added). *Compare* Pl. Exs. 376, 700 (email from D. McCarroll dated June 1, 2009 at 9:33 a.m., "Tyrone, do you have an idea of what day this week, funds will leave the account? Thanks"); *with* Pl. Ex. 375 (T. Lopez forwarding email chain to his superiors containing purported email from D. McCarroll dated June 1, 2009 at 9:33 a.m., "Tyrone, *As requested*, Thanks" and telling his superiors "We're good!") (emphasis added).

purportedly sent at 9:14 a.m. and that he forwarded to his superiors, is not credible. Here is Mr. Lopez's testimony:

> what likely happened, and I honestly don't have direct recollection, . . . I typed the email, sent it out, the computer froze, I did control alt delete, . . . basically retyped the email, and didn't say obviously the same words . . . and resent . . . What likely happened is that my original email was likely in the outbox when the process runs that actually sends out all the emails. Both emails went out.[66]

When asked how it is that TD Bank's responses, both purportedly sent at 9:33 a.m., also seem to have different texts, Mr. Lopez speculated that TD Bank could have separately replied to each of his purported 9:14 a.m. emails.[67] Mr. Lopez's testimony on this issue was simply not credible and calls into question the overall reliability of his testimony. But even if every word of Mr. Lopez's testimony were to be credited, the evidence simply does not support an inference that the $450 Million Loan was repaid.

As of early July 2009, the balance owed to Old GM on the $450 Million Loan was $372 million. The intercompany transaction through which the balance of the $450 Million Loan was purportedly repaid is described in the Direction & Acknowledgement. According to the Direction & Acknowledgement, in July 2009, Old GM and GM Canada entered into the FX Transaction pursuant to which GM Canada agreed to sell CAD $1 billion to Old GM in exchange for the U.S. dollar equivalent (approximately $860 million) from Old GM.[68] Figure 1, below, illustrates the FX Transaction:

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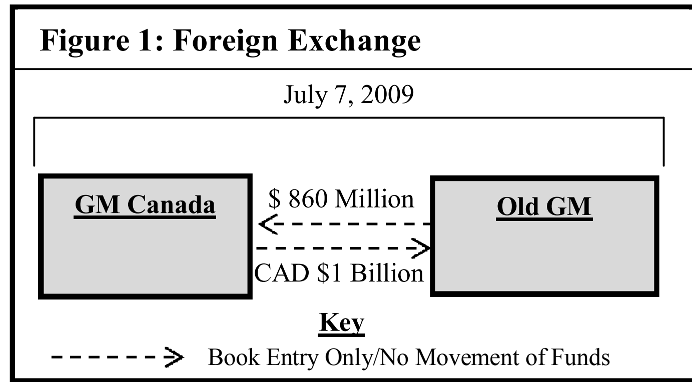
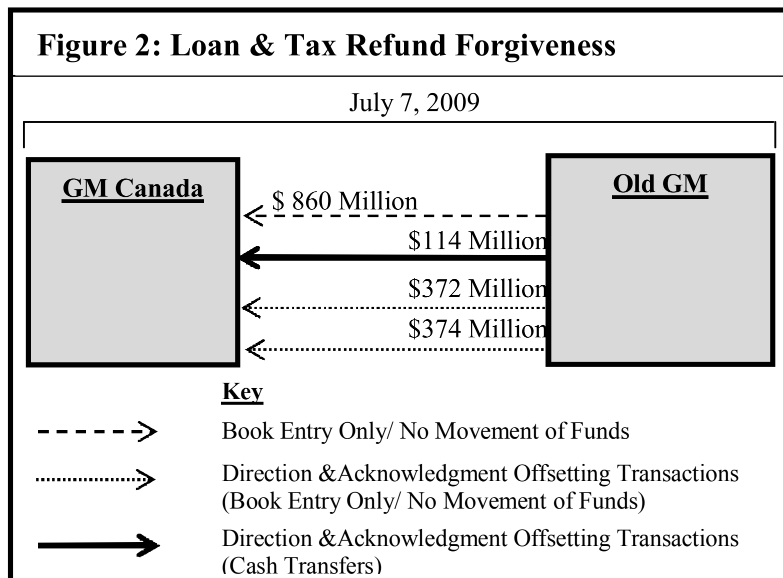
[66] Trial Tr. (3/6/2013), 23:23-25:3 (Lopez).

[67] Trial Tr. (3/6/2013), 80:9-14 (Lopez).

[68] Lopez Decl., ¶ 5; Def. Ex. 425 (Direction & Acknowledgement). As a threshold matter, Old GM was not authorized to enter into the FX Transaction because it was not an "ordinary course" transaction. As Mr. Lopez testified, it was the largest foreign exchange transaction between Old GM and GM Canada he is aware of, and the only such transaction where Old GM's JPMorgan London account was not utilized. Trial Tr. (3/6/2013), 61:13-23 (Lopez).



Old GM fulfilled its part of the FX Transaction. As shown in Figure 2 below, Old GM provided $860 million of value to GM Canada, consisting of (1) Old GM's forgiveness of the $374 million tax refund owed by GM Canada to Old GM, (2) Old GM's forgiveness of the $372 million balance owed by GM Canada to Old GM on the $450 Million Loan, and (3) a cash transfer from Old GM to GM Canada in the approximate amount of $114 million.[69] So far, so good.



[69] *Id*. at 57:17-19. To be precise, Old GM's forgiveness of the $450 Million Loan was in the amount of $372,589,733.33, its forgiveness of the tax refund was in the amount of $374,487,000.00 and its cash transfer to GM Canada was in the amount of $113,434,410.29. *See, e.g.*, Def. Ex. 425.

But, there is a problem with the repayment argument. In the end, the transaction turned out to be a one-legged swap, because GM Canada never transferred the CAD $1 billion due to Old GM or otherwise provided value in that amount to Old GM. Instead, at the direction of Old GM employees (who were soon to be New GM employees), the CAD $1 billion that should have been paid to Old GM was paid into the CIBC Escrow Account to provide funding support for GM Canada's pension. These funds were purportedly directed by Old GM into the CIBC Escrow Account for the benefit of GM Canada's pension, even though Old GM was not legally obligated to make that payment, and even though this Court never approved this purported CAD $1 billion postpetition obligation.[70] Right up until July 6, 2009, the draft CIBC Escrow Agreement showed that this CAD $1 billion pension support obligation was always intended to be a New GM obligation.[71] In fact, the CIBC account into which the CAD $1 billion was deposited was established by New GM.[72] Old GM never received any benefit on account of the

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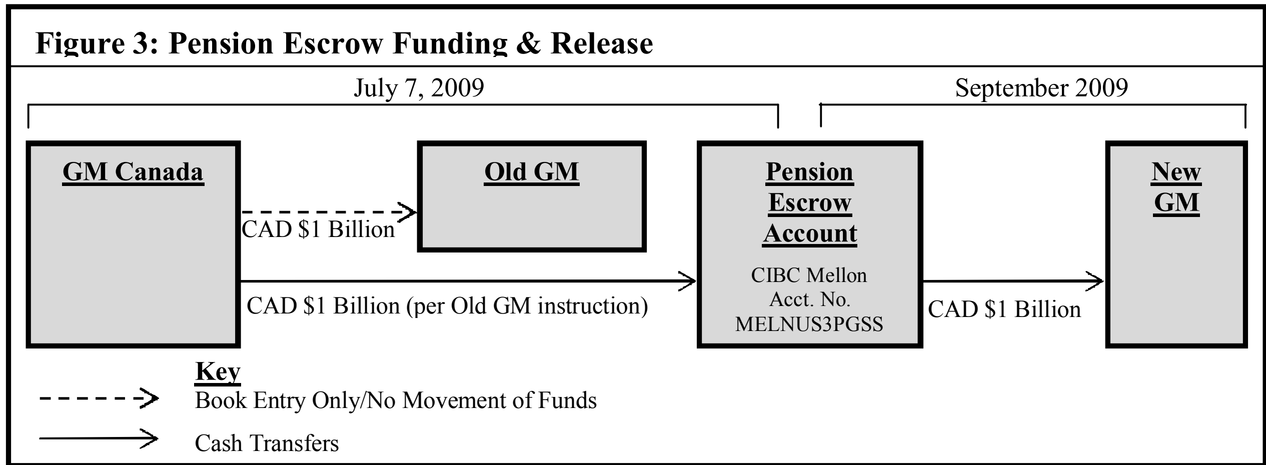
70 *See* Pl. Ex. 717 (email from A. Hartog to A. Sundaram, and others, dated July 7, 2009, attaching executed copy of the CIBC Escrow Agreement); Trial Tr. (3/6/2013), 40:12-15 (Lopez).

71 As reflected in the various drafts of the CIBC Escrow Agreement that were circulated prior to the Sale Order, New GM was the intended party to the CIBC Escrow Agreement. *See* Pl. Ex. 707 (email from A. Hartog to A. Sundaram, and others, dated July 2, 2009, attaching draft CIBC Escrow Agreement as of July 2, 2009 with General Motors Company as a party); Pl. Ex. 709 (email from A. Hartog to A. Sundaram, and others, dated July 3, 2009, attaching draft CIBC Escrow Agreement as of July 3, 2009 that references NGMCO., Inc.). Old GM was substituted at the last minute for New GM as the counterparty to the CIBC Escrow Agreement in an effort to get around this Court's five-day stay of the effective date of the Sale Order. *See* Sale Order, ¶ 70 (Bankr. Dkt. No. 2968); *see also* Pl. Ex. 712 (email from A. Hartog to A. Sundaram, and others, dated July 6, 2009, regarding substituting New GM for Old GM as a party and attaching revised CIBC Escrow Agreement); Pl. Ex. 764 (email from A. Sundaram to G. Krowles, dated July 6, 2009: "Due to the stay provision in the 363 Sale Order passed last night . . . we may need to have an escrow GM Old Co, which need to move to NewCo for the C$1B.").

72 *See* Pl. Ex. 708 at NGM000040485-86 (email from G. Krowles at CIBC, to A. Hartog, and others, dated July 3, 2009, sending wiring instructions for "GM Company" pension escrow account); Pl. Ex. 710 at NGM000043437 (email from A. Sundaram to T. Lopez, and others, dated July 4, 2009, discussing "CIBC preferences for C$1B NewCo escrow"); Pl. Ex. 764 at NGM000040841 (email from A. Sundaram to G. Krowles at CIBC, dated July 6, 2009, discussing timing of funding for "the C$1B escrow under GM New Co").

escrow funds, and, not surprisingly, upon release of the escrow funds, the CAD $1 billion went directly to New GM. *See* Figure 3.

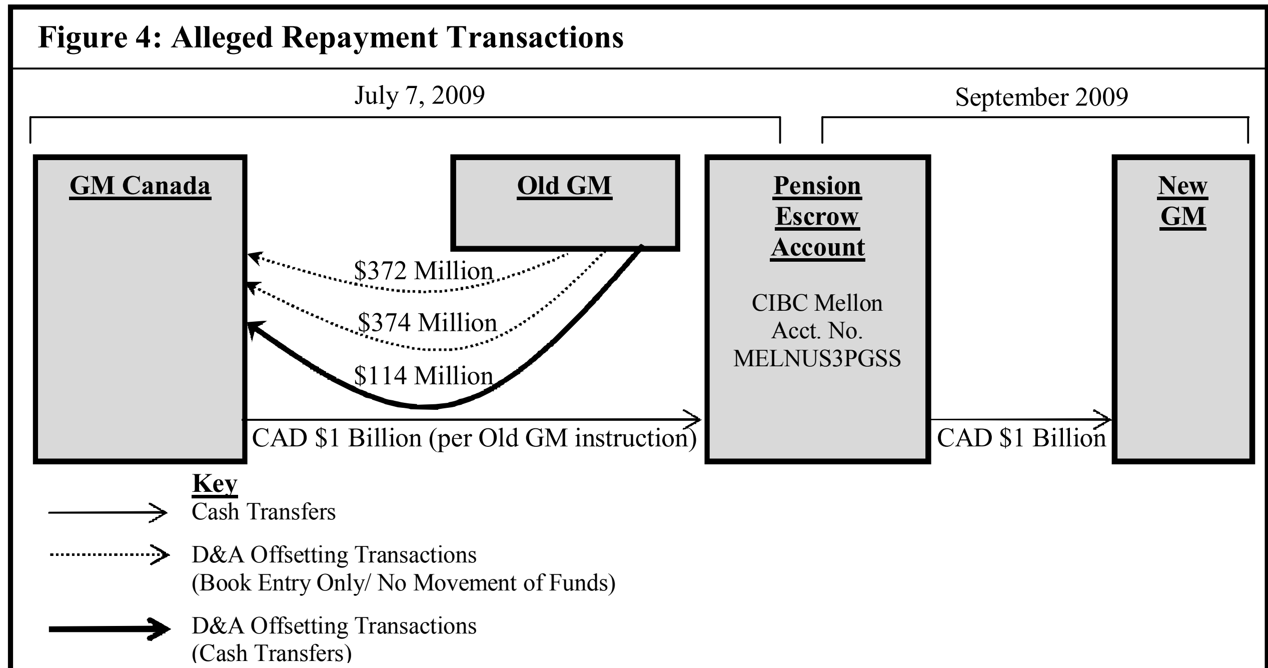
Figure 3: Pension Escrow Funding & Release



Thus, New GM – not Old GM – received the CAD $1 billion to which Old GM was entitled. Accordingly, the Old GM side of the FX Transaction was not fulfilled, and the $372 million balance on the $450 Million Loan was never repaid.

Finally, Figure 4 depicts the Direction & Acknowledgement transaction as a whole, clearly demonstrating that Old GM received no benefit in exchange for its payment of $860 million to GM Canada.[73]

[73] During Mr. Lopez's examination, New GM's counsel asked questions about various sections of the $33 billion secured super-priority debtor-in-possession credit agreement dated as of June 3, 2009 (the "**DIP Agreement**"), as approved by final order of this Court dated June 25, 2009 (the "**DIP Order**"). Trial Tr. (3/19/2013), 6:14-12:5 (Lopez); *see generally* Def. Ex. 213 (DIP Order and DIP Agreement). Mr. Lopez was not competent to testify about, and thus did not testify about, the DIP Agreement, which he had never seen. The GUC Trust anticipates that New GM will argue that section 4.3(b) of the DIP Agreement, and the related DIP Order, in some way authorized Old GM to enter into the CIBC Escrow Agreement and fund the CIBC Escrow Account. There is no evidence in the record on the topic. But, in any event, the argument does not make sense, because at the time of the DIP Order and up until July 6, 2009, the plan was for New GM – not Old GM – to be party to the CIBC Escrow Agreement. *See supra* note 71. It was only because of this Court's stay of its sale order that Old GM was purportedly substituted for New GM at the eleventh hour without this Court's approval. *Id.*



II. THE TAINTED CLAIMS AND THE NOVA SCOTIA TRUSTEE CLAIM SHOULD BE EQUITABLY SUBORDINATED

A. The GUC Trust Has Standing

Contrary to the arguments of the Noteholders, the GUC Trust, through Wilmington Trust Company, as GUC Trust Administrator ("**WTC**"), has standing to assert claims for equitable subordination or disallowance and recharacterization (the "**GUC Trust Claims**")[74] because the Confirmation Order,[75] Plan[76] and GUC Trust Agreement[77] preserved these claims for, and transferred them to, the GUC Trust.

Paragraph 31 of the Confirmation Order, entitled "Role of GUC Trust Administrator,"

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[74] The Noteholders do not contest the GUC Trust's standing with respect to any claims or objections asserted by the GUC Trust other than the GUC Trust Claims.

[75] "**Confirmation Order**" refers to *Findings Of Fact, Conclusions Of Law, And Order Pursuant To Sections 1129(a) And (b) Of The Bankruptcy Code And Rule 3020 Of The Federal Rules Of Bankruptcy Procedure Confirming Debtors' Second Amended Joint Chapter 11 Plan* (Bankr. Dkt. No. 9941).

[76] "**Plan**" refers to the *Debtors' Second Amended Joint Chapter 11 Plan* (Bankr. Dkt. No. 9836).

[77] "**GUC Trust Agreement**" refers to the Motors Liquidation Company GUC Trust Agreement, annexed as Exhibit D to the Plan.

provides that the "GUC Trust Administrator shall . . . (d) have the power and authority to prosecute and resolve (x) objections to [Disputed Claims[78]] and (y) subject to obtaining any applicable consent from [Old GM], and any necessary approval of the Bankruptcy Court, any claims for equitable subordination and recharacterization in connection with such objections."[79] Section 6.2(f) of the Plan contains language identical to paragraph 31 of the Confirmation Order.[80]

Similarly, section 8.1(b)(iv) of GUC Trust Agreement also preserves the GUC Trust Claims and transfers them to the GUC Trust. Section 8.1(b)(iv) authorizes WTC, in furtherance of the purpose of the GUC Trust, to "object to and/or withdraw objections to [Disputed Claims], and manage, control, prosecute and/or settle on behalf of the GUC Trust, (x) objections to

[78] The *Official Committee Of Unsecured Creditors' Objection To Claims Filed By Green Hunt Wedlake, Inc. And Noteholders Of General Motors Nova Scotia Finance Company And Motion For Other Relief* (Bankr. Dkt. No. 6248) (the "**Initial Objection**") contains, among other things, claims for equitable subordination and recharacterization as well as the defensive assertion of avoidance actions in the context of section 502(d) and has been pending since July 2, 2010, well before Plan confirmation. Section 4.3(g) of the Plan states that "[n]otwithstanding anything to the contrary in the Plan, the [Guarantee Claims] and the Nova Scotia [Trustee] Claim shall be treated as [Disputed Claims]." The Initial Objection was, without a doubt, preserved and transferred to the GUC Trust.

[79] Confirmation Order, ¶ 31. Paragraph 31 of the Confirmation Order goes on to say that "[a]s of the conclusion of the Confirmation Hearing, the GUC Trust Administrator shall have the power and authority to take such actions and perform such acts as may be necessary, desirable, or appropriate to comply with or implement the Plan or the GUC Trust Agreement and shall have the authority to take all actions as may be necessary, desirable, or appropriate to effect any transaction described in, approved by, contemplated by, or necessary to effectuate the Plan or the GUC Trust Agreement." *Id*.

[80] Section 6.2(f) of the Plan, entitled "Role of GUC Trust Administrator," provides "[i]n furtherance of and consistent with the purposes of the GUC Trust and the Plan, the GUC Trust Administrator shall . . . (iv) have the power and authority to prosecute and resolve (x) objections to [Disputed Claims] and (y) subject to obtaining any applicable consent from [Old GM], . . . and any necessary approval of the Bankruptcy Court, any claims for equitable subordination and recharacterization in connection with such objections." Plan, § 6.2(f). On March 29, 2011, the Plan was confirmed pursuant to this Court's Confirmation Order. The Defendants' contention that section 6.2(f)(iv)(y) of the Plan (which, among other things, preserved claims for equitable subordination) was added to the Plan on March 8, 2011 is unsupported by the record but nonetheless wholly irrelevant. Paragraph Z of the Confirmation Order is a finding by the Court that changes to the December 8, 2010 amended plan did not materially adversely affect the treatment of any claims, including the Disputed Claims. Thus, Defendants' argument is unfounded.

[Disputed Claims], and (y) subject to obtaining any applicable consent from [Old GM] and any necessary approval of the Bankruptcy Court, any claims for equitable subordination and recharacterization in connection with such objections."[81]

Finally, the Noteholders contend, incorrectly, that the assumption and assignment agreement entered into on December 15, 2011 between Old GM and the GUC Trust (the "**Assignment Agreement**") is a "flagrant violation" of the Plan and Confirmation Order.[82] The Assignment Agreement simply reflects what was already provided for in the Plan.

B. Defendants Have Failed To Prove Good Faith And Fairness

As insiders of Old GM, the Lock-Up Noteholders and the Nova Scotia Trustee (collectively, the "**Subordination Defendants**") bear the burden of proving that the Lock-Up Agreement was a good-faith and fair transaction.[83]

The Subordination Defendants cannot satisfy their burden here because, as explained above and in the GUC Brief, in exchange for an essentially worthless release from the Oppression Action, the Lock-Up Noteholders received $367 million, retained their Notes and

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[81] Pursuant to the Confirmation Order, Plan and GUC Trust Agreement, the GUC Trust was not required to seek Old GM's consent or Bankruptcy Court approval before asserting the GUC Trust Claims, unless such consent was required as a matter of law, which is why the words "any applicable" modify consent, and "any necessary" modify Bankruptcy Court approval in each of those three documents. Consequently, upon confirmation of the Plan, neither Old GM's consent nor Bankruptcy Court approval was a condition to the assertion of the GUC Trust Claims.

[82] NH Brief at 48.

[83] *See, e.g., Mishkin v. Siclari (In re Adler, Coleman Clearing Corp.)*, 277 B.R. 520, 564 (Bankr. S.D.N.Y. 2002). As explained in Argument Section II(B) of the GUC Brief, the Lock-Up Noteholders are insiders of Old GM due to the level of control they exercised over GM Nova Scotia and their access to non-public information about both Old GM and GM Nova Scotia. GUC Brief at 51-52 ns. 268-76. The Nova Scotia Trustee is an insider of Old GM because Wedlake is an insider of Old GM's affiliate – and wholly owned subsidiary – GM Nova Scotia. GUC Brief at 50 n.267. Even if the Court finds that the Subordination Defendants are not insiders, which they are, equitable subordination is nonetheless available with respect to claims asserted by non-insiders. *See, e.g.*, *In re Alder, Coleman Cleaning Corp*, 277 B.R. at 565-66 (even if claimant "were no more than an 'outsider' with special access and privileges, he would still be subject to equitable subordination.").

asserted approximately $2.7 billion in claims against Old GM. The Noteholders' contention that the Lock-Up Agreement was fair is contrary to the evidence.

C. <u>The Lock-Up Noteholders Behaved Inequitably</u>

Under the doctrine of equitable subordination, a court may subordinate a creditor's claim that, although "not lacking a lawful basis[,] nonetheless results from inequitable behavior on the part of that creditor."[84] Inequitable conduct "encompasses conduct that may be lawful but is nevertheless contrary to equity and good conscience."[85]

The Tainted Claims should be equitably subordinated because the Lock-Up Noteholders engaged in inequitable conduct that conferred an unfair advantage on them. As set forth in Argument Section II(C) of the GUC Brief, among other things, certain Lock-Up Noteholders:

- threatened to tie up Old GM's bankruptcy unless they received the commercially unreasonable Consent Fee, which they knew would be paid to them postpetition with funds that were property of Old GM's estate;[86]
- increased their holdings the day after they entered into the Lock-Up Agreement in order to receive a larger portion of the Consent Fee and solidify total control over the Nova Scotia Bankruptcy Case, before the pertinent facts were known to other creditors of Old GM;[87]
- commenced the meritless Oppression Action to extract the rich recovery ultimately reflected in the Lock-Up Agreement;[88]
- consistently misrepresented to the Court and the public that the Lock-Up Agreement was a prepetition agreement, even though they knew that the agreement was not completed until after Old GM's bankruptcy petition was filed;[89]
- failed to disclose their trading history of CDS referencing Old GM in the Rule

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[84] *Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.)*, 379 B.R. 425, 432-33 (S.D.N.Y. 2007), *motion to certify appeal denied*, Nos. 01-16034, 06 Civ. 7828, 07 Civ. 1957 (SAS), Adv Pro. No. 05-01025, 2007 WL 2780394 (S.D.N.Y. Sept. 24, 2007).

[85] *Nisselson v. Softbank AM Corp. (In re MarketXT Holdings Corp.)*, 361 B.R. 369, 386 (Bankr. S.D.N.Y. 2007) (citations omitted).

[86] GUC Brief at 12, 27 ns.55, 137.

[87] *Id*. at 9, 53 ns.35 through 40, 279.

[88] *Id*. at 53 n.282.

[89] *Id*. at 53 n.283.

2019 statements filed with the Court;[90] and

- manipulated the date and method by which GM Nova Scotia would be put into bankruptcy in order to insulate the Consent Fee and Lock-Up Agreement from challenge and ensure that a "winding up" event would trigger section 135 of the Companies Act.[91]

Thus, the Lock-Up Noteholders engaged in inequitable conduct warranting subordination of the Tainted Claims.

D. The Nova Scotia Trustee Behaved Inequitably

Likewise, Wedlake's conduct warrants equitable subordination of the Nova Scotia Trustee Claim.[92] As set forth in Fact Section II(D) of the GUC Brief, Wedlake acted inequitably in numerous respects including: (i) failing to adequately investigate possible "transfers at under value;"[93] (ii) failing to have inspectors appointed for the GM Nova Scotia estate, as is customary in such a proceeding and contrary to his own best judgment;[94] (iii) knowingly consenting to the Lock-Up Noteholders' manipulation of the timing of the Nova Scotia Bankruptcy Case;[95] (iv) submitting an inflated and false claim against Old GM in reliance upon calculations performed at the direction of the Lock-Up Noteholders and without undertaking any independent investigation;[96] and (v) failing to investigate the Statement of Affairs, despite Wedlake's

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[90] *Id*. at 9 ns.35 through 40.

[91] *Id*. at 29 ns.149 through 151.

[92] As stated in the GUC Brief, the inequitable conduct of those Lock-Up Noteholders who hand-picked and controlled Wedlake should be imputed to Wedlake. *See Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (In re 604 Columbus Ave. Realty Trust)*, 968 F.2d 1332, 1356 (1st Cir. 1992).

[93] Trial Tr. (8/7/2012), 95:13-21 (Wedlake).

[94] *Id*. at 106:5-20.

[95] *Id*. at 63:25-64:4; Pl. Ex. 202 (email from P. Huff to P. Wedlake, dated June 2, 2009); Wedlake Decl., ¶ 14; *see also* Wedlake Decl., ¶ 18; Trial Tr. (8/7/2012), 93:7-20 (Wedlake); Pl. Ex. 32 (email from P. Huff to P. Wedlake, dated Sept. 8, 2009).

[96] *See* GUC Brief at 32-37 ns.170 through 206; *see also In re Adler, Coleman Clearing Corp.*, 277 B.R. at 567.

awareness that it was riddled with irregularities.[97]

In particular, Wedlake performed no investigation and exercised no independent judgment over the Nova Scotia Bankruptcy Case. For example, Wedlake expected that the outstanding amount of the Notes to be reflected in the Statement of Affairs would not include interest.[98] But when the Noteholders directed the inclusion of interest, Wedlake did not ask any questions before including such interest in the Nova Scotia Trustee Claim. Moreover, Wedlake admits that it relied on a GM Nova Scotia December 31, 2008 financial statement that lists the outstanding amount of the Notes as $875 million but, inexplicably, Wedlake filed the claim for a much larger amount.[99]

Wedlake also improperly relied on New GM, the purported claimant under the Swaps, to identify New GM as the purported swap counterparty. On July 20, 2009, months before the New GM Swap Claim was filed, Wedlake's counsel received a list of creditors of GM Nova Scotia that identified Old GM as the claimant under the Swaps.[100] On October 29, 2009, Mr. Prieto of Aurelius revised the list of creditors of GM Nova Scotia which still showed Old GM as the proper swap counterparty.[101] On November 10, 2009, Wedlake received the New GM Swap Claim asserted by New GM. Although at that time, the documents available to Wedlake

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[97] *See* GUC Brief at 30-32 ns.156 through 169. New GM and the Defendants contend, incorrectly, that GM Nova Scotia and its representatives were the "ultimate" decision makers "[a]t all times" regarding the Statement of Affairs. JSF, ¶ 130. In fact, Wedlake knew that that Ms. Sutedja, who signed the Statement of Affairs on November 23, 2009, resigned before GM Nova Scotia was petitioned into bankruptcy in October of 2009 and worked for New GM at the time she signed the Statement of Affairs. Trial Tr. (8/7/2012), 20:3-21:5 (Wedlake). At that time, GM Nova Scotia had no officers, directors or employees. *Id*.

[98] Pl. Ex. 465 (email from P. Wedlake to P. Huff and R. Mackeigan, dated Oct. 28, 2009).

[99] JSF, ¶ 131. *See* Pl. Ex. 315, Attach. ¶ 5 ("Noteholders having an unsecured claim of [CAD] $1,088,542,512.01").

[100] Pl. Ex. 648 (email from N. Cheifetz to recipients, dated July 20, 2009).

[101] Pl. Exs. 466 and 467 (emails from D. Prieto to P. Wedlake and others, dated Oct. 29, 2009).

indicated that Old GM was the proper swap counterparty, Wedlake made no inquiry. Two days later, when New GM directed that Wedlake adjust the Statement of Affairs to conform it to the New GM Swap Claim, Wedlake complied.[102]

In connection with the Swaps, and with its activities as trustee of GM Nova Scotia in general, Wedlake claims to have relied on Ms. Sutedja, who admits she "didn't really do any related business activities with" GM Nova Scotia.[103] Ms. Sutedja admits that she knows nothing about the Swaps, other than that one existed.[104] And while Peter Wedlake claims to have spoken to Ms. Sutedja six times, Ms. Sutedja does not remember ever having spoken with him.[105]

E. The Subordination Defendants Injured Old GM's Creditors While Unfairly Advantaging Themselves

As a prerequisite to the equitable subordination of claims, courts require that the inequitable conduct either result in injury to creditors or confer an unfair advantage on the claimant. This element is satisfied where the general creditors are less likely to collect their debts as a result of the alleged inequitable conduct.[106] As a result of the inequitable conduct proven at trial, the Subordination Defendants have asserted unjustifiably inflated claims in Old GM's bankruptcy case which, if not disallowed or subordinated, will certainly diminish

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[102] Pl. Ex. 449 (email from M. Munro to P. Wedlake, dated November 12, 2009). Wedlake's claim that New GM must be the proper party because Old GM did not file a claim related to the Swaps does not make sense; neither does Wedlake's contention that it determined that New GM purchased the Swaps as executory contracts that were assumed and assigned after it read the NG Brief filed on May 24, 2013.

[103] M. Sutedja Depo. Tr. (5/31/2012), 15:5-13.

[104] *Id*. at 31:13-17.

[105] *Id*. at 159:25-160:7; 161:9-11.

[106] *80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.),* 169 B.R. 832, 840 (Bankr. S.D.N.Y. 1994) ("If the misconduct results in harm to the entire creditor body, the objecting party . . . need only show that the creditors were harmed in some general, concrete manner . . . [and] it is sufficient to allege that the general creditors are less likely to collect their debts") (citations omitted).

recoveries by other creditors.[107]

Without a doubt, the Noteholders' sweetheart deal has been a major cost to the estate, even over and above the cost of the deal itself. Both Wedlake and the Noteholders have been active litigants throughout Old GM's bankruptcy, including in connection with Plan confirmation, disclosure statement proceedings and other matters.[108] It should also not be forgotten that this litigation was always anticipated by New GM and the Lock-Up Noteholders, because they knew that they were engaged in inappropriately aggressive conduct (to say the least). As Mr. Buonomo testified, he "accurately predicted the future, and predicted" that the GUC Trust would be arguing against allowance of the Disputed Claims.[109] Mr. Prieto, a copious note taker during the Lock-Up Agreement negotiations, noted that that they "do not want to give GM US creditors more reasons to object."[110]

The deal with the Noteholders was financed by Old GM for the benefit of the Noteholders, GM Canada and GM Canada's creditors.[111] The Defendants' suggestion that Old GM's creditors somehow benefitted from the Lock-Up Agreement because it allegedly staved off a GM Canada bankruptcy is based on mere conjecture, and finds no support in the record. No evidence whatsoever was presented as to the "disruption, cost, risk, delay, and loss of value that

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[107] *In re Adler, Coleman Clearing Corp.*, 277 B.R. at 567 (inflation of claim where there is a limited pot from which to satisfy claims is prejudicial to other creditors).

[108] *See, e.g.*, Bankr. Dkt. Nos. 11369, 8526, 8974, 9272, 7325, 4412, 4484, 7314, 8528, 8535, 8794, 9020, 9207, 11370.

[109] Trial Tr. (8/10/2012), 114:3-6 (Buonomo).

[110] Pl. Ex. 3 at AUR_GM021453 (Prieto notebook).

[111] GM Canada would have been insolvent had it remained obligated to repay the billion-dollar Intercompany Loans due to GM Nova Scotia. Old GM, in effect, paid for and was saddled with the costs of the Lock-Up Agreement (*i.e.*, the Consent Fee). *See* Pl. Ex. 121 at 2 (shows 0% recovery to GM Canada's unsecured creditors in all scenarios).

would have resulted from a GM Canada bankruptcy filing."[112] Further, no evidence was introduced to show how Old GM benefitted from GM Canada's preservation of NOLs and tax refunds that supposedly "could have been lost" if GM Canada filed for bankruptcy.[113] The Defendants' hypothetical arguments deserve no consideration.

The Subordination Defendants were unquestionably given an unfair advantage over other unsecured creditors of Old GM. Among other things, no other unsecured creditor knew when the Consent Fee would be paid, or when the Nova Scotia Bankruptcy Case would be commenced, or that the Lock-Up Noteholders would be provided with a signed consent to bankruptcy of GM Nova Scotia, drafted by counsel to the Lock-Up Noteholders.[114] This unequal access to information allowed the Lock-Up Noteholders to purchase more Notes to ensure their control over the Nova Scotia Bankruptcy Case and Wedlake and, they hoped, to enlarge their ultimate recovery from Old GM's estate.[115] Further, certain Noteholders analyzed the Swap Documents before they were publicly available to value the Swaps for Wedlake.[116] Again, these Noteholders were in the know and therefore aware of, if not directly responsible for, the inflated claim under the Swaps. The Noteholders who received the Consent Fee also gained an unfair advantage over other creditors because they have already received a recovery greater than what other general unsecured creditors have recovered on account of their allowed claims in this case.

F. Equitable Subordination Is Consistent With Bankruptcy Law

The third prong of the equitable subordination test requires that subordination be

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[112] NH Brief at 16.

[113] *Id*.

[114] Pl. Ex. 524 at AUR_GM038120-R (05-2012) (Noteholders and Old GM reached a deal that "bankruptcy would follow the [extraordinary] resolution.").

[115] *See, e.g.*, Pl. Ex. 38 (Rule 2019 statement).

[116] GUC Brief at 35 n.188.

consistent with bankruptcy law. As this Court has recognized, "[i]f the misconduct results in harm to the entire creditor body, the [trustee] need not identify the injured creditors or quantify their injury, but need only show that the creditors were harmed in some general, concrete manner"[117] and "[i]t is hardly inconsistent with bankruptcy policy to deny creditors equal status as a response to actions taken on their behalf to give them an unfair advantage."[118]

The Subordination Defendants' contention that equitably subordinating the Tainted Claims and the Nova Scotia Trustee Claim would violate section 1123(a)(4) of the Bankruptcy Code is nonsensical. As an initial matter, this Court has already found that the "Plan provides for the same treatment by the Debtors for each Claim or Equity Interest in each respective Class."[119] More importantly, this Court has already explained, in response to objections to Plan confirmation raised by the Noteholders and Wedlake, that the requirement of section 1123(a)(4) that a plan provide the same treatment for each claim of a particular class "means, as [a] practical matter, that all *allowed* claims within a particular class should get the same treatment."[120]

The Noteholders' contention that the defense of *in pari delicto* bars the GUC Trust from equitably subordinating the Tainted Claims and the Nova Scotia Trustee Clam is equally misguided.[121] According to the Subordination Defendants, the defense of *in pari delicto* bars the

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[117] *In re Enron Corp.*, 379 B.R. at 434 (2d alteration in original).

[118] *In re Adler, Coleman Clearing Corp.*, 277 B.R. at 567.

[119] Confirmation Order, ¶ 4.

[120] *In re Motors Liquidation Co.*, 447 B.R. 198, 215 (Bankr. S.D.N.Y. 2011) (emphasis in original).

[121] It should be noted that avoidance action claims are not barred by *in pari delicto*. *See, e.g., Tese-Milner v. Beeler (In re Hampton Hotel Investors, L.P.)*, 289 B.R. 563, 580 (Bankr. S.D.N.Y. 2003) (noting, with respect to payments made in violation of section 549, "[i]t would be turning the Wagoner Rule and concepts of *in pari delicto* on their heads to hold that the Trustee lacks standing to recover such payments."); *Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (In re Verestar, Inc.)*, 343 B.R. 444, 480 n.19 (Bankr. S.D.N.Y. 2006) ("It should be noted that *in pari delicto* is not a defense to a fraudulent conveyance suit.") (citing *In re Mediators*, 105 F.3d 822, 825 (2d Cir. 1997)).

GUC Trust's equitable subordination claim because any misconduct by Old GM in connection with the Lock-Up Agreement should be imputed to the GUC Trust. The Subordination Defendants, however, cannot point to any authority barring actions by an estate representative against third parties based on an *in pari delicto* defense that seeks to impute postpetition misconduct of the debtor. That is because courts have consistently held that postpetition wrongful conduct by the debtor should not be imputed to the trustee or other estate representative.[122]

The *in pari delicto* defense also does not apply here because the Subordination Defendants are insiders.[123] But even if the *in pari delicto* defense is available to the Subordination Defendants, which it is not, the adverse interest exception precludes imputation of the conduct at issue. Under the adverse interest exception, wrongful conduct of a corporate

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122 *See, e.g., Grubin v. Rattet (In re Food Mgmt. Grp., LLC)*, 380 B.R. 677, 695 (Bankr. S.D.N.Y. 2008) (failing to impute postpetition acts of a debtor to the trustee where debtor's principals "lacked authority to sell estate assets outside the ordinary course of business" because "the 'fundamental principle of agency that the misconduct of managers *within the scope of their employment* will normally be imputed to the corporation'" would not apply to bar the trustee's suit) (emphasis added) (citation omitted); *see also Rosen v. Gemini Title & Escrow, LLC (In re Hoang)*, 449 B.R. 850, 856 (Bankr. D. Md. 2011) (holding that wrongful acts committed by the debtor postpetition while serving as a debtor-in-possession will not be imputed to a trustee so as to bar recovery under the doctrine of *in pari delicto* and noting "[t]he determinative factor here . . . is that the actions occurred after the filing of the petition."); *Giacometti v. Arton Bermuda Ltd.* (*In re Sia)*, 349 B.R. 640, 655 (Bankr. D. Haw. 2006) ("The debtor's pospetition unclean hands do not impair the ability of the trustee in bankruptcy to pursue the . . . debtor's co-conspirators. . . . timing—whether the trustee's claims are based upon prebankruptcy or postpetition activities of the conspirators—is critical."). Even if the Subordination Defendants could impute postpetition actions of Old GM to the GUC Trust, only such actions which occurred before the closing of the 363 Sale on July 10, 2009 could be imputed. After the closing, the individuals involved were employees of New GM.

123 "Otherwise, a trustee could never sue the debtor's insiders on account of their own wrongdoing . . . [and] only the trustee has standing to sue insiders . . . for injuries to a corporation or a limited partnership arising from their waste, mismanagement or breach of fiduciary duty." *In re Hampton Hotel Investors, LP*, 289 B.R. at 577 n.23; *see also Official Comm. of Unsecured Creditors v. Austin Fin. Servs., Inc. (In re KDI Holdings, Inc.)*, 277 B.R. 493, 518 (Bankr. S.D.N.Y. 1999) ("the *in pari delicto* doctrine is inapplicable where a cause of action is brought against an insider."); *Devon Mobile Commc'ns Liquidating Trust v. Adelphia Commc'ns Corp. (In re Adelphia Commc'ns Corp.)*, 322 B.R. 509, 529 n.18 (Bankr. S.D.N.Y. 2005) (same).

officer will not be imputed to the corporation if the officer's interests were adverse to the corporation and the conduct was not for the benefit of the corporation.[124] Here, the conduct of the conflicted Old GM employees and advisor (*i.e.*, Mr. Buonomo, Ms. Sutedja and Mr. Ammann) should not be imputed to Old GM because their interests were adverse to Old GM's creditors, to whom they owed fiduciary duties. They acted for the benefit of New GM, not Old GM.[125] As a result, even if the defense of *in pari delicto* applied, which it does not, the adverse interest exception precludes imputation of the conduct at issue to the GUC Trust.

III. THE LOCK-UP AGREEMENT IS A POSTPETITION AGREEMENT

A. The 10:37 Version Was Entered Into Postpetition

All parties agree that *the* Lock-Up Agreement to which they are bound is the 10:37 Version, which is identified as version 20 in Weil Gotshal's document management system.[126] Every draft of the Lock-Up Agreement conditions the effectiveness of the parties' rights and obligations on execution and delivery of signature pages to "*[t]his Agreement*."[127] Both forensic experts conclude that the 10:37 Version was created after 9:00 a.m. on June 1, 2009, more than

124 *See Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 64, 79 (S.D.N.Y. 2008), *adhered to on reconsideration*, Nos. 05 Civ. 9050 (LMM), 03 MDL 1529, 2008 WL 1959542 (S.D.NY. May 5, 2008).

125 Mr. Buonomo acknowledged that Old GM's analysis of what would have been a reasonable settlement with the Noteholders was thought of as analyzing what it would be worth to *New GM* to avoid a GM Canada bankruptcy. Trial Tr. (8/10/2012), 24:19-24 (Buonomo). Ms. Sutedja testified that they viewed the GM entities as an "enterprise" and did not differentiate their work among the various GM entities. M. Sutedja Depo. Tr. (5/31/2012), 112:4-13.

126 New GM and the Defendants claim that "all the witnesses with personal knowledge testified that the final executed Lock-Up Agreement that was circulated by Weil Gotshal by email at 10:37 a.m. was the same as the Lock-Up Agreement that they had agreed to and executed prior to the filing of Old GM's petition." JSF, ¶ 54. However, it is absolutely impossible, as established by the forensic evidence, that any party signed the 10:37 Version before Old GM's bankruptcy filing at 7:57 a.m. because such version did not exist until after 9:00 a.m. Moreover, no party has ever identified a prepetition version of the Lock-Up Agreement that is "the same as" the 10:37 Version because no such version has ever existed. *Id.*

127 GUC Brief at 56 n.294 (emphasis added).

one hour after Old GM filed its bankruptcy petition.[128] It is undisputed that, as of Old GM's bankruptcy filing at 7:57 a.m., version 18 was still being edited, and neither version 19 nor version 20 yet existed.[129] Thus, the forensic evidence conclusively establishes that the final, binding version of the Lock-Up Agreement was not even created, and certainly not completed, until after the filing of Old GM's bankruptcy petition, and that the Lock-Up Agreement was still being revised as of, and after, the bankruptcy filing.

B. The Lock-Up Agreement Was Still Being Revised When Old GM Filed For Bankruptcy

In an effort to explain away the forensic evidence, the Defendants assembled "revised demonstrative exhibit no. 4," by which they attempt to reverse engineer what they say the Lock-Up Agreement looked like at the time of the bankruptcy filing at 7:57 a.m. as compared to the 10:37 Version. Based on this demonstrative, the Noteholders contend that the changes made after Old GM's bankruptcy filing are "minor postpetition modifications" and "non-material wordsmithing" to the body of the Lock-Up Agreement, and "conforming" changes to the extraordinary resolution that is annexed as an exhibit to the Lock-Up Agreement.[130]

As an initial matter, the existence of even minor revisions belies the Noteholders' claim

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[128] Trial Tr. (11/27/2012), 114:13-18 (Racich). The Noteholders' concession that they executed the 10:37 Version is an admission that they signed the Lock-Up Agreement after Old GM's bankruptcy filing.

[129] At 8:43 a.m., Peter Godhard of Weil Gotshal circulated a draft of the Lock-Up Agreement that includes "track changes" made by Andrew Woodworth to version 18 from approximately 7:34 a.m. through 8:11 a.m. (the "**8:43 Version**"). Pl. Exs. 686 and 687. This fact is corroborated by the metadata which shows that Peter Godhard attached a copy of version 18 to an email at 8:43:33 a.m. *See* Pl. Ex. 688 at WGM00296327 (line corresponding to 8:43:33 that says COR: Mail-Attach Copy, an action that had previously been identified as "user defined" in Pl. Ex. 299); *see also* Trial Tr. (11/27/2012), 137:21-138:9 (Racich). As acknowledged by Racich, the 8:43 Version shows what changes were made by whom and when. *Id*. at 119:19-23. The contents of the 8:43 Version are also consistent with New GM's assertion that the version of the Lock-Up Agreement that existed "in the 7 a.m. range of June 1, 2009 was a form of version 18 of the Lock-Up Agreement." Trial Tr. (9/27/2012), 65:23-25 (Ammann).

[130] NH Brief at 29; JSF, ¶ 60.

that the supposed prepetition version of the Lock-Up Agreement purportedly signed and delivered before the bankruptcy was the same as the 10:37 Version. For a document to be final, all revisions to the document must be complete – even if minor.[131] As the Second Circuit recognized in *Winston v. Mediafare Entm't Corp.*, 777 F.2d 78, 82-83 (2d Cir. 1985), the parties' insistence on the continual redrafting of specific terms of a proposed agreement establishes that "the changes made must be deemed important enough to the parties to have delayed final execution and consummation of the agreement."[132] Even if only "correcting typos" or "documenting the noncontroversial details remains," the parties will not be bound until all such details have been completed.[133] Thus, revised demonstrative exhibit no. 4 further drives home the point that the Lock-Up Agreement was not finished when Old GM filed for bankruptcy.[134]

In addition to the forensic evidence, the parties' contemporaneous communications show

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[131] *See Bear Stearns Inv. Prods., Inc. v. Hitachi Auto. Prods. (USA), Inc.*, 401 B.R. 598, 619 (S.D.N.Y. 2009).

[132] As a result, the Noteholders' argument that Jones lacks knowledge of when the parties agreed to any particular Lock-Up Agreement terms or whether the postpetition edits had been agreed to earlier or existed elsewhere is not relevant. NH Brief at 26. Further, the Noteholders' contention that "when a Weil Gotshal typist may have created a copy of an agreement on a computer system is not relevant" is misleading. *Id*. The final version of the Lock-Up Agreement, (*i.e.*, the document identified as version 20 on Weil Gotshal's DMS) was not a copy because there is no other version identical to it. Further, Mr. Woodworth, the Weil Gotshal attorney who drafted the Lock-Up Agreement, was the so-called "typist" referred to by the Noteholders.

[133] NH Brief at 28-30; NG Brief at 13-14. *See Chariot Grp., Inc. v. Am. Acquisition Partners, L.P.*, 751 F. Supp. 1144, 1150 (S.D.N.Y. 1990) ("It is not for the court to determine retrospectively that at some point in the evolution of a formal document that the changes being discussed became so 'minor' or 'technical' that the contract was binding despite the parties' unwillingness to have it executed and delivered.") (citations omitted), *aff'd without opinion*, 932 F.2d. 956 (2d Cir. 1991).

[134] Defendants cite these cases to support their claim that only postpetition modifications that alter estate obligations require approval: *In re Ionosphere Clubs, Inc.*, 100 B.R. 670 (Bankr. S.D.N.Y. 1989); *Bankers Trust Co. v. Seidle (In re Airlift Int'l Inc.)*, 70 B.R. 935 (Bankr. S.D. Fla. 1987); *Acton v. Fullmer (In re Fullmer)*, 323 B.R. 287 (Bankr. D. Nev. 2005). But this case is not about a purported prepetition agreement that was "corrected" or "modified" postpetition. There is no prepetition agreement in this case. As described above, this case is about when the Lock-Up Agreement reached its final form because only after that time did "[t]his Agreement . . . become effective and binding. . . ." Pl. Ex. 16, ¶ 10 (WGM00000801).

that the Lock-Up Agreement was still being revised when Old GM filed for bankruptcy. At 8:04 a.m. on June 1, 2009, Mr. Truong, then of Fortress, sent an email referring to the Lock-Up Agreement that said: "Still being worked through, but yes final docs will be sent around."[135] Mr. Truong testified that he stayed at Weil Gotshal's offices after sending this email until between 9 and 10 a.m. so he could get a copy of the final version of the Lock-Up Agreement.[136] At trial, Mr. Truong testified that "still being worked through likely represents, or refers to, the getting that hard copy, or getting a photocopy" of the Lock-Up Agreement. Mr. Truong's weak and half-hearted explanation is simply not credible. Mr. Truong does not even remember whether he left Weil Gotshal that morning with a copy or not. And, it bears noting that no hard copy of the Lock-Up Agreement has ever been produced from his files.[137] The obvious, and more plausible, meaning of Mr. Truong's "still-being-worked-through" email is that, as of 8:04 a.m. he was still waiting for the agreement to be completed.

The Noteholders rely on the testimony of Mr. Gropper to support their argument about the existence of some agreement to "conform" the extraordinary resolution to the Lock-Up Agreement text.[138] As discussed above, the need for even minor changes to a written agreement will prevent that agreement from being considered final.[139] Nevertheless, even if the Court finds

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[135] Pl. Ex. 177 at FOR_GM002899 (email from B. Truong to L. Cowen, dated June 1, 2009).

[136] Trial Tr. (9/20/2012), 38:23-39:21; 89:12-90:5 (Truong).

[137] Trial Tr. (9/20/2012), 89:12-90:5; 113:15-19 (Truong).

[138] New GM and the Defendants contend that Mr. Gropper circulated a blacklined version of the Lock-Up Agreement at 5:57 a.m. and another version at 6:30 a.m. (*i.e.*, Def. Ex. 183), and that the "6:30 a.m. draft circulated by Mr. Gropper set forth the parties' agreement that the language of the Extraordinary Resolution, Exhibit A to the Lock-Up Agreement, would 'conform' to the language in the body of the Lock-Up Agreement." JSF, ¶ 48.

[139] *Ciaramella v. Reader's Digest Ass'n, Inc.*, 131 F.3d 320, 325 (holding that terms remained to be negotiated where the final draft of the agreement contained a sample copy of a letter attached as Exhibit B to which parties had not yet agreed).

Mr. Gropper's testimony to be relevant (which it should not), his testimony should be disregarded because it is not credible. At trial, Mr. Gropper acknowledged that, at his deposition, he testified as follows about the 6:30 a.m. draft he supposedly circulated:

> Q What is the attachment to [Def. Ex. 183]?
> A I don't know.
> Q Does looking at the title of the attachment on the first page of this exhibit which says GM lock up agreement, does that refresh your recollection as to what this attachment is?
> A No.
> Q Do you have any reason to doubt that this is a draft of the lock up agreement as of 6:30 a.m. on Monday, June 1st?
> A Yes.
> Q And why do you doubt that?
> A Because I don't know who produced it. It could've been a mark-up from Canadian counsel who wasn't in the room. It could've been a mark-up from one of the clients who wasn't in the room. It could've been a mark-up from someone who wasn't a party to negotiations. I have no idea whether this was the current state of the document at that time."[140]

New GM's contention that Mr. Woodworth from Weil Gotshal received Mr. Gropper's comments to the Lock-Up Agreement at 7:30 a.m., went back to his office and "made a bunch of changes," printed the revised Lock-Up Agreement and brought it back to the conference room by 7:35 a.m. is not plausible.[141] As shown by the 8:43 Version, there is no dispute that Mr. Woodworth was making changes to the Lock-Up Agreement nearly every minute from *7:34 a.m.* until 8:12 a.m.[142] If Mr. Buonomo's testimony is to be believed, it would mean that Mr.

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[140] Trial Tr. (9/28/2012), 50:10-51:22 (Gropper). As this Court noted in *In re Adler, Coleman Clearing Corp.*, "[a]ssuming that [Defendant] was telling the truth at the time of his deposition testimony, his testimony at trial cannot be regarded as reliable or credible. While the converse is also true, and the Court cannot rule out the possibilities that [Defendant] suffered a convenient lapse of memory when he was deposed, or was not as prepared for his deposition as he might have been, the Court considers it appropriate, on balance, to credit the deposition testimony and reject the trial testimony, especially with all of the trial testimony's newly acquired detail. Common sense tells the Court that witnesses' memories dim with time, not improve." *In re Adler, Coleman Clearing Corp.*, 277 B.R. at 531.

[141] Trial Tr. (8/9/2012), 61:14-24 (Buonomo).

[142] *See* Pl. Ex. 687 at WGM00296316-17 (emphasis added).

Woodworth took Mr. Gropper's comments, revised and printed the Lock-Up Agreement, brought it back to the conference room and then went back to his office, all in less than four minutes.

C. The Parties Intended To Be Bound When The Lock-Up Agreement Was Complete And Aspired, But Failed, To Complete The Agreement Prepetition

Under New York law, "a contract is unenforceable if the parties did not intend to be bound until after the execution of a formal written agreement[,]" even if the parties have agreed upon all the terms.[143] The language of the parties' agreement is of critical importance in determining when they intend to be bound. The Second Circuit has recognized that "[t]he language the parties use in their draft agreements and in their contemporaneous communications is the most important indication of whether a signed writing is required before the parties are bound."[144] As described in the GUC Brief, the express terms of the NDA and the Lock-Up Agreement unambiguously confirm the parties' intention not to be bound until the agreement was completed and executed.[145]

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143 *See GSGSB, Inc. v. N.Y. Yankees*, 862 F. Supp. 1160, 1171-72 (S.D.N.Y. 1994) (citations omitted); *see also Chariot Grp.*, 751 F. Supp. at 1149 (S.D.N.Y. 1990).

144 *Chariot Grp.*, 751 F. Supp. at 1149.

145 The Noteholders mistakenly contend that, as a result of the clause providing that "this [A]greement" supersedes all prior negotiations, the Lock-Up Agreement, once signed, superseded the NDA. The Noteholders are incorrect, however, because such clause only states that prior negotiations with respect to the subject matter of the Lock-Up Agreement are superseded. In any event, even if the Lock-Up Agreement is held to supersede the NDA, the NDA is still evidence of the parties' intent to be bound only by a definitive agreement. Further, to the extent the Defendants are claiming that the 10:37 Version was a modification of a pre-filing version they allegedly signed before Old GM filed for bankruptcy, such an earlier, phantom version would be superseded by the 10:37 Version upon execution. Regardless, other than those of Appaloosa, there is only one set of signature pages so it is impossible that both a pre-bankruptcy filing version and the 10:37 Version were signed and delivered. *See Health-Chem Corp. v. Baker*, 915 F.2d 805, 811 (2d Cir. 1990) ("[w]hen the parties to a contract enter into a new agreement that expressly supersedes the previous agreement, the previous agreement is extinguished. . . .") (citations omitted). Further, as this Court is aware, on August 6, 2012 the GUC Trust submitted a motion *in limine* requesting that the Court exclude testimony at trial about the content of the supposed version of the Lock-Up Agreement, which has never been produced, that some witnesses contend was laying on a conference room table at Weil Gotshal on the morning of June 1, 2009 before Old GM filed for bankruptcy. *See* GUC Trust's Motion *in Limine* (Bankr. Dkt. No. 11999; Adv. Pro. No. 167). Any such testimony should also be given no weight because it is parol evidence. *See Mizuna, Ltd.*

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Despite the clear evidence to the contrary, the Defendants contend that the parties intended to be bound to the Lock-Up Agreement before Old GM filed for bankruptcy, and recite certain facts which they say indicate that intent (notwithstanding that the parties' express intent was to only be bound to the final, written agreement). For example, the Defendants claim that the Lock-Up Agreement was binding prepetition because: (i) several witnesses testified that all parties had signed off on the terms of the Lock-Up Agreement and executed the document before Old GM filed its bankruptcy petition,[146] (ii) Mr. Bolin, of Appaloosa, left Weil Gotshal's offices before Old GM's bankruptcy filing (although there is no evidence that Brian Pfeiffer, Appaloosa's counsel from Fried, Frank, Harris, Shriver & Jacobson LLP, left Weil Gotshal before Old GM's bankruptcy filing),[147] and (iii) the deal was reported to superiors at Old GM before the bankruptcy filing, who reported it to the Canadian government.[148]

But these facts in no way disprove the parties' express intention to only be bound by the

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v. Crossland Fed. Sav. Bank, 90 F.3d 650, 660 (2d Cir. 1996) ("parol evidence to show contemporaneous oral agreement is inadmissible, in part because it contradicts explicit notation that no oral arrangement or modification was to be binding upon the parties.") (citations omitted) (internal quotation marks omitted); *see also* Pl. Ex. 16, ¶ 10 (Lock-Up Agreement clause precluding oral modifications).

[146] The Defendants incorrectly assert that all of the parties testified that they executed the Lock-Up Agreement and released their signature pages prior to 7:15 a.m. on June 1, 2009. In fact, Mr. Cederholm testified that the final, executed version of the Lock-Up Agreement was signed between "seven and eight in the morning" on June 1. Trial Tr. (9/6/2012), 80:4-8 (Cederholm). As to the GM parties, there is no testimony about when Old GM, GM Nova Scotia or GM Canada released their signature pages. As acknowledged by Mr. Zirinsky at trial when asked about the signatures of the GM representatives, he "didn't personally go around and inspect every document to make sure that everybody had signed." Trial Tr. (8/8/2012), 148:20-21 (Zirinsky).

[147] The fact that Mr. Bolin left Weil Gotshal's office between 7 and 7:30 a.m. is not evidence that the Lock-Up Agreement was complete. Even in Mr. Buonomo's account of events, the agreement was not completed until after Mr. Bolin left Weil Gotshal. Trial Tr. (8/9/2012), 236:6-9 (Buonomo) ("and I do recall the only time in this whole thing as to which I have any degree of *precision* is that 7:35 time because *I was annoyed that we had gone over 7:30 with anything*. So I was conscious of that 7:35" time) (emphasis added). In fact, all parties agree that revisions to the Lock-Up Agreement were made after 7:00 a.m. JSF, ¶ 52.

[148] NG Brief at 12.

final agreement. *See, e.g., Chariot Grp.,* 751 F. Supp. at 1151 (noting that, although the parties had executed signature pages, given that further revisions occurred after execution, the parties "should have understood, that delivery of the signature pages . . . was contingent on . . . satisfaction with the draft of the Agreement."). While the GUC Trust does not dispute that the parties aspired to complete the Lock-Up Agreement before Old GM filed for bankruptcy – probably because they knew the agreement would be void if it were not completed prepetition – and may have in fact executed signatures pages before the filing, the evidence proves that the Lock-Up Agreement was not completed until after Old GM filed for bankruptcy.[149]

D. No Oral Agreement Was Ever Contemplated

According to the Second Circuit, "the sending back and forth of draft agreements, suggests strongly, if not conclusively, that the parties intended to be bound only once they had executed" the agreement.[150] Here, it is undisputed that the parties never intended to be bound by

149 *See, e.g., Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 261-62 (2d Cir. 1984), *cert. denied*, 496 U.S. 828 (1984) ("because the documents and testimony clearly showed that the intent of both parties was not to be bound prior to the execution of a formal, written contract[,]" the parties were "not bound by the 'agreement in principle', by the 'final drafts', or by any claimed oral understanding reached in the course of the extended negotiations."); *Bear Stearns Inv. Prods., Inc.*, 401 B.R. at 619 ("negotiating 'numerous' contract drafts" suggests the intention to remain unbound pending the completion of formal documentation); *Ciaramella*, 131 F.3d at 321 (holding that the parties intended to be bound only upon a written agreement despite counsel's verbal expression "we have a deal," where drafts of the agreement specifically stated it would not become effective until signed.); *Chariot*, 751 F. Supp. at 1150-51 (contracting parties "view the signed written instrument . . . as 'the contract', not as a memorialization of an oral agreement previously reached.") (citation omitted).

Defendants' reliance on a line of cases dealing with whether a contract is enforceable rather than when a contract becomes enforceable is misplaced. *See Tractebel Energy Mktg., Inc. v. AEP Power Mktg, Inc.*, 487 F.3d. 89 (2d Cir. 2007) (analyzing whether agreement was enforceable notwithstanding open terms); *F&K Supply, Inc. v. Willowbrook Dev. Co.*, 732 N.Y.S.2d 734 (App. Div. 3d Dep't 2001) (finding contract too vague and ambiguous as to material terms to be enforceable). The cases are clear, including those cited by the Defendants, that when parties intend to be bound only by a final agreement, they will not be bound before then. *See, e.g.*, *Adjustrite Sys., Inc. v. GAB Bus. Servs., Inc.*, 145 F.3d 543, 549 (2d Cir. 1998) (holding that agreement was not binding in the absence of a final instrument even though "all of the material terms of the transaction were negotiated and incorporated into the . . . document and that there was nothing left to negotiate but the 'legal phraseology.'").

150 *Chariot Grp.*, 751 F. Supp. at 1150. Defendants' reliance on a line of cases dealing with offer

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any oral understanding reached with regard to the Notes.[151] Although the Noteholders contend that "agreement on the material terms" was reached before Elliott became involved in the negotiations, this statement is belied by the factual record.[152] According to Mr. Cederholm, when he arrived at Weil Gotshal late in the afternoon on Sunday May 31, the parties were in the midst of negotiating the terms of the Lock-Up Agreement, most of the terms were still open for negotiation and there were still many drafting issues in the document that the parties were discussing.[153] Although Mr. Truong claims that the parties reached an oral agreement as to the business terms of a settlement on May 30, he concedes that the agreement was subject to the drafting and execution of the Lock-Up Agreement, which was heavily-negotiated.[154] The parties had numerous discussions about various drafts, after which a Weil Gotshal attorney would go off and work on the document and then come back with a new version for review.[155] Where it is contemplated that an agreement would be in the form of a formal written document, duly

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and acceptance is misplaced. Defendants cite *Schoenfeld v. Masucci*, 613 N.Y.S.2d 682 (App. Div. 1994), *leave to appeal denied*, 621 N.Y.S.2d 516 (Table) (1994) and *In re Randall's Island Family Golf Centers, Inc.*, 261 B.R. 96 (Bankr. S.D.N.Y. 2001), *aff'd*, 272 B.R. 521 (S.D.N.Y. 2002) for the proposition that an offeree's assent which contains immaterial differences from the original offer will bind the parties and are not considered counter offers. These cases deal with whether a contract was formed and not when a contract is entered into in circumstances where the parties express their intent to be bound only by a final, written document. In fact, the Noteholders have not cited a single case concerning when a contract is entered into. Under New York law, if either party to an alleged contract communicates an intention not to be bound absent a fully executed document, then no amount of negotiation or oral agreement as to specific terms will result in formation of a binding contract. *See Winston*, 777 F.2d at 80; *Ciaramella*, 131. F.3d at 322. Defendants also cite *In re Fullmer*, 323 B.R. at 297-99, in support of their contention that "[m]inor postpetition modifications to an agreement do not require court approval. . . ." NH Brief at 29. Unlike *Fullmer*, however, the issue here is not postpetition modifications to a prepetition agreement; rather, this case is about an agreement that was not completed until postpetition.

[151] Trial Tr. (9/6/2012), 64:18-22 (Cederholm).

[152] JSF, ¶¶ 42-43.

[153] Trial Tr. (9/6/2012), 71:17-72:5 (Cederholm).

[154] Trial Tr. (9/20/2012), 23:14-24:4; 80:16-18 (Truong).

[155] *Id*. at 81:20-82:5.

executed, "until such a document was executed and delivered, regardless of the state of negotiations, drafts of the agreement [are] nothing more than drafts."[156]

IV. THE LOCK-UP AGREEMENT IS VOID

Old GM's failure to seek or secure this Court's approval of the Lock-Up Agreement renders the agreement void *ab initio* because entry into the Lock-Up Agreement, and the actions taken by Old GM to implement that agreement, were postpetition transactions outside Old GM's "ordinary course of business." 11 U.S.C. § 363(b)(1); *Medical Malpractice Ins. Ass'n v. Hirsch (In re Lavigne)*, 114 F.3d 379, 384 (2d Cir. 1997).[157] New GM's contention that such actions are voidable, but not void, is incorrect.[158]

Further, this Court should reject New GM's meritless "no-harm-no-foul" argument that the estate would not benefit from establishing that the Lock-Up Agreement is void. Specifically, New GM concludes without any factual basis that the proceeds from the $450 Million Loan

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[156] *Chariot*, 751 F. Supp. at 1149.

[157] *See In re NextWave Pers. Commc'ns Inc.*, 244 B.R. 253, 275 (Bankr. S.D.N.Y. 2000), *subsequent mandamus proceeding*, 208 F.3d 137 (2d Cir. 2000) ("Actions which violate Section 363 are 'void.'") (citation omitted); *Kirschenbaum v. Nassau Cnty Dist. Attorney (In re Vitta)*, 409 B.R. 6, 16 (Bankr. E.D.N.Y. 2009) ("An agreement by a debtor to transfer property of the estate without prior notice and a hearing is void and of no force and effect.") (citation omitted).

[158] The Second Circuit has explicitly held that unauthorized postpetition transactions are "null and void." *See In re Lavigne*, 114 F.3d at 384; *accord In re Koneta*, 357 B.R. 540, 543-44 (Bankr. D. Ariz. 2006) ("[t]he usual effect of a sale or lease of property of the estate, conducted outside of the ordinary course of business but without adherence to the notice and hearing requirements of [section] 363(b)(1), is that any sale held is rendered null and void.") (1st alteration in original) (citation omitted). New GM's reliance on *McCord v. Agard (In re Bean)*, 252 F.3d 113 (2d Cir. 2001), is misplaced. As an initial matter, in *In re Bean*, the Second Circuit did not squarely address the issue of whether a postpetition transfer is void (as opposed to voidable), as it did in its holding in *In re Lavigne* and as the *Koneta* court did in that case. Further, the decision in *In re Bean* was clearly driven by the fact that the trustee there had abused his discretion by punitively suing to avoid a transfer as to which he had already recovered the value for the estate. *In re Bean,* 252 F.3d at 116 ("it is the rare bankruptcy trustee that has the audacity to bring such a claim"). Here, unlike *In re Bean*, the value of the Consent Fee has not been recovered for the Old GM estate from any source.

"never would have gone" to Old GM's creditors.[159] New GM's argument ignores the fact that the Committee was unaware of the $450 Million Loan at the time the Sale Order was approved, and, had it been aware of this massive eve of bankruptcy transfer, it may have (as it did with the term loan) negotiated a carve out for such potential recovery. More importantly, had this Court been aware of Old GM's transfer of funds to pay the Consent Fee, it might have insisted on such a carve out.[160]

New GM incorrectly argues that voiding the Lock-Up Agreement would only affect three particular Old GM obligations under the Lock-Up Agreement. To start with, New GM's argument makes no sense given how integral Old GM is to all aspects of the Lock-Up Agreement.[161] Even if true, such obligations do, in fact, involve property of Old GM's estate which should be distributed to Old GM's creditors. As just one example, but for Old GM's agreement to forgo its set-off right as to the Swaps, the Nova Scotia Trustee Claim would have been at least *$1 billion less* than it is today because: (i) the Nova Scotia Trustee Claim would not have included the Swaps (*i.e.*, it would have only included the Notes); and (ii) Old GM would

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[159] NG Brief at 15.

[160] As the Court stated, it "might well have refused to sign the order in its then existing form, and [. . .] would have insisted that the Lock-Up [A]greement not be insulated from judicial scrutiny no matter what threats the Nova Scotia [N]oteholders had made at the time." New GM SJ Hr'g Tr. 93:14-18.

[161] New GM contends incorrectly that pursuant to the severability clause in the Lock-Up Agreement, only those clauses that contained postpetition modifications would be unenforceable. NG Brief at 15. As already explained above, however, these were not "postpetition modifications" to a completed agreement, but rather postpetition revisions that were part of the effort to finalize the agreement in the first place. Further, in characterizing the postpetition revisions as minor, New GM ignores all of the edits to the extraordinary resolution (*i.e.*, the exhibit to the Lock-Up Agreement that was so integral that Mr. Buonomo characterized it as the "raison d'être" of the Lock-Up Agreement). Trial Tr. (8/10/2012), 115:2-10 (Buonomo). Finally, the argument that the postpetition revisions should simply be severed and struck from the agreement is without merit. It is true that where a provision in an agreement is invalid, courts enforce severability clauses. *P.B. v. L.B.*, 855 N.Y.S.2d 836, 844 (Sup. Ct. Richmond County 2008). However, where a clause that goes to the heart of an agreement is invalid, so too is the entire agreement. *See In re Clouse*, 446 B.R. 690, 705 (Bankr. E.D. Pa. 2010) ("if the invalid (void) portions of the [a]greement are esential or integral to the primary purpose of the [a]greement, the entire [a]greement must fall as invalid (void).") (citation omitted).

have asserted the swap liability against GM Nova Scotia as an offset to the Nova Scotia Trustee Claim.[162]

Finally, as set forth in the GUC Brief, Old GM's postpetition actions to implement the Lock-Up Agreement involved unauthorized uses of estate property outside of Old GM's ordinary course of business. These actions included Old GM's (i) execution of two postpetition amendments to the Trust Agreement which, among other things, facilitated payment of the Consent Fee postpetition; (ii) subordination of its claim under the Swaps and forfeiture of its right to set-off the liability owed to it under the Swaps; (iii) postpetition use of its corporate powers to cause GM Nova Scotia to deliver its consent to the Nova Scotia Bankruptcy Case and to the Lock-Up Agreement;[163] and (iv) postpetition use of its corporate powers to cause GM Nova Scotia to enter into a settlement that released GM Canada from its obligations under the Intercompany Loans.[164]

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162 For the reasons discussed below, the Swaps were not assigned to New GM. As a consequence, New GM's argument that "bankruptcy estate issues" relating to the Swaps "are moot" must fail. NG Brief at 16 n.23.

163 New GM's contention that Old GM's consent was not required for GM Nova Scotia to take the actions contemplated by the Lock-Up Agreement, including its entry into the June 25 settlement agreement with GM Canada, is mistaken. NG Brief at 23. Pursuant to the Lock-Up Agreement, GM Nova Scotia represented and warranted that (a) "[i]t has all requisite power and authority to enter into this Agreement and to carry out the transactions contemplated by, and perform its respective obligations under, this Agreement"; and (b) "[t]he execution and delivery of this Agreement by it and the performance of its obligations hereunder have been duly authorized by all necessary action on its part." Pl. Ex. 16, ¶ 4(a)-(b). Further, Old GM stipulated and acknowledged that GM Nova Scotia would deliver a consent to the Nova Scotia Bankruptcy Case. *Id*. at ¶ 6(b)(i). As such, the Lock-Up Agreement created the Nova Scotia Trustee Claim, contrary to the Defendants' contention otherwise. JSF, ¶ 65. As the sole shareholder of GM Nova Scotia, Old GM's consent to the foregoing was absolutely required. *See* Pl. Ex. 135 at NGM000012436 (Old GM's consent, as sole shareholder of GM Nova Scotia, to the Lock-Up Agreement and related transactions).

164 *See In re Lavigne*, 114 F.3d at 384 (citation omitted); *see also In re Consol. Auto Recyclers, Inc.*, 123 B.R. 130, 140-41 (Bankr. D. Me. 1991) (use of debtor's shares in its wholly-owned subsidiary to authorize chapter 11 petition for a subsidiary is a "use of" estate property outside the ordinary course).

V. THE CONSENT FEE PAYMENT SHOULD BE APPLIED TO REDUCE THE PRINCIPAL AMOUNT OF THE NOTES

As explained in the GUC Brief, the facts demonstrate that the Consent Fee was in fact a payment of principal, and therefore Disputed Claims should be reduced to reflect such payment. In response, the Noteholders argue that: (1) this Court does not have the authority to characterize the Consent Fee as a payment of principal; (2) a determination by the Court that the Consent Fee is a principal payment on the Notes would result in the "rewriting" of the terms of the Lock-Up Agreement;[165] and (3) the Court lacks subject matter jurisdiction to decide the true character of the Consent Fee. These arguments are without merit.

First, the Court's power to determine that the Consent Fee is a payment of principal is based directly on its authority to determine the allowance and amount of claims against Old GM's bankruptcy estate under section 502.[166] The authority to allow and disallow claims is a fundamental power of a bankruptcy court, and one that is integral to the court's administration of the bankruptcy estate.[167] As this Court has recognized, "nothing is more directly at the core of bankruptcy administration . . . than the quantification of all liabilities of the debtor."[168] The Court's authority to determine the allowance of claims against Old GM is further supplemented by the court's equitable powers under section 105 of the Bankruptcy Code.[169]

Here, the Court's authority to allow or disallow the Disputed Claims includes the "full

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165 NH Brief at 20.

166 *See* 11 U.S.C. § 502(b); 28 U.S.C. § 157(b)(2)(A) and (B).

167 *See Katchen v. Landy*, 382 U.S. 323, 329 (1966) (the power to allow and disallow claims is of basic importance in the administration of the bankruptcy estate).

168 *In re Saint Vincent's Catholic Med. Ctrs.*, 445 B.R. 264, 269 (Bankr. S.D.N.Y. 2011) (internal quotation marks omitted).

169 *See Pepper v. Litton*, 308 U.S. 295, 305, 308-09 (1939) (equitable powers are to be exercised by bankruptcy courts regarding the allowance of claims).

power to inquire into the validity of any alleged debt or obligation[s] of the bankrupt upon which a demand or a claim against the estate is based."[170] Accordingly, it is well within the purview of this Court to consider the entirety of the circumstances regarding the amounts alleged to be owing under the Notes, including payment of the Consent Fee. The Court's proper characterization of the Consent Fee does not offend the principle that a bankruptcy court's powers "must and can only be exercised within the confines of the Bankruptcy Code."[171]

Second, the Court's determination that the Consent Fee was in fact a payment of principal would not involve an impermissible "rewriting" of the Lock -Up Agreement. As an initial matter, and for the reasons set forth in the GUC Brief and herein, the Lock-Up Agreement is void, and there is no need for the Court to consider the language in that agreement that the Consent Fee does not "reduce, limit or impair" the Notes. But even if that language were not contained in a void agreement, it would certainly not be dispositive, because this Court is not bound by the labels or descriptions that interested parties use to describe their transactions.[172] Bankruptcy courts are, without question, authorized "to sift the circumstances surrounding any

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[170] *Katchen*, 382 U.S. at 329 (internal quotation marks omitted).

[171] *See Smart World Techs., LLC v. Juno Online Servs., Inc. (In Smart World Techs., LLC)*, 423 F.3d 166, 184 (2d Cir. 2005); *New Eng. Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores, Inc.)*, 351 F.3d 86, 92 (2d Cir. 2003).

[172] *See Kool, Mann, Coffee & Co. v. Coffey*, 300 F.3d 340, 364 (3d Cir. 2002) (notwithstanding the terms of an underlying promissory note, prepetition interest payments made by the debtor pursuant to a promissory note should be recharacterized as payments of principal because of the creditor's conduct in connection with the transaction); *Bozzuto's Inc. v. Vescio*, 234 F.3d 1261 (Table), No. 00-5040, 2000 WL 1715281, at *2 (2d Cir. 2000) (recharacterizing rental concessions as payments on debt); *Liona Corp. v. PCH Assocs. (In re PCH Assocs.)*, 949 F.2d 585, 597 (2d Cir. 1991) (recharacterizing a sale-leaseback transaction as an equitable mortgage); *see also United Airlines, Inc. v. HSBC Bank USA, N.A.*, 416 F.3d 609, 618 (7th Cir. 2005) (recharacterizing a purported lease as a secured loan), *cert. denied*, 547 U.S. 1003 (2006); *Spradlin v. Williams (In re Alma Energy, LLC)*, No. 10-80-ART, 2010 WL 4736905, at *1 (E.D. Ky. Nov. 16, 2010) (noting that "[s]ome situations simply call for a closer look" and remanding action to uphold creditor's claim for amounts based upon prepetition settlement for further scrutiny).

claim to see that injustice or unfairness is not done in administration of the bankrupt estate."[173] Indeed, in light of their argument that the Consent Fee is sheltered from avoidance under the safe harbor provision of section 546(e), it appears that even the Noteholders themselves understand the Consent Fee to be a payment on the Notes.[174]

Finally, it cannot seriously be argued that this Court lacks subject matter jurisdiction to determine this issue. Contrary to the Noteholders' suggestion, the determination of the proper treatment of the Consent Fee does not require this Court to "adjudicate the amount the Noteholders should be permitted to recover against GM Nova Scotia under the Notes."[175] While that claim is one to be decided by the Nova Scotia court, the matter before this Court is the allowance of the Disputed Claims, which necessarily involves a determination of the remaining amounts due and owing under the Notes. This Court certainly has jurisdiction to determine the validity and amount of claims that have been asserted against Old GM's estate.

VI. THE NOVA SCOTIA TRUSTEE CLAIM IS DUPLICATIVE OF THE GUARANTEE CLAIMS AND SHOULD BE DISALLOWED TO THE EXTENT OF THE NOTES

A. The Law of Every Applicable Jurisdiction Mandates That There Can Be Only One Allowed Claim For One Loss

Both the Nova Scotia Trustee Claim and the Guarantee Claims seek recovery on the principal and interest due on the Notes. Neither Wedlake nor the Noteholders can reasonably deny that the Nova Scotia Trustee Claim and the Guarantee Claims, to the extent of amounts

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173 *Pepper*, 308 U.S. at 308.

174 The Noteholders' insistence that the Consent Fee was in settlement of the Intercompany Loans, and not a payment on the Notes, is entirely inconsistent with their argument that the Consent Fee payment is exempt from avoidance under the safe harbor provision of section 546(e) of the Bankruptcy Code. NH Brief at 42-43. Although, for the reasons set forth above, the section 546(e) safe harbor provision does not apply under the circumstances of this case, the Noteholders' argument that it does is a tacit admission that the Consent Fee was a payment on the Notes.

175 NH Brief at 23.

sought under the Notes, are both asserted against Old GM on account of the same debt. Nor can they reasonably deny that it is the Noteholders that are the ultimate beneficiaries of both the Nova Scotia Trustee Claim and the Guarantee Claims.[176] Centuries of law in every applicable jurisdiction – Nova Scotia, Canada, New York, and the United States – clearly establish that there can only be a single distribution for the same debt for the benefit of the same parties.

Courts in the Second Circuit are consistent that one loss will merit only one allowed claim even if separate claims are asserted by nominally different claimants, where the ultimate beneficiary of the claims is the same person or entity. *See, e.g., In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 160 B.R. 882, 885-86 (Bankr. S.D.N.Y. 1993) (disallowing claim of pension trustee to the extent of duplication with the PBGC's claim).[177] Wedlake's focus on the supposed "separateness" of the Nova Scotia Trustee Claim and the Guarantee Claims is misplaced as a matter of law. Both claims arise from the same facts (the issuance and non-payment of the Notes) and both seek the same damages (the amounts due under the Notes), and as such are duplicative.[178] As discussed in greater detail in the expert report of Professor Mohamed F. Khimji, and as conceded by Wedlake's expert, Professor Edward Iacobucci, a claim for contribution under section 135 and a claim for a contractual guarantee for the same underlying debt are functional substitutes for each other.[179] The relevant inquiry is not whether two claims are brought under different legal theories, but whether a

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[176] Although the Nova Scotia Trustee Claim also asserts a purported claim by New GM for amounts due under the Swaps, the Lock-Up Agreement stipulates that any distribution on account of the Swaps shall be subordinated to payment in full of the Notes if any amount of the Nova Scotia Trustee Claim is disallowed. *See* Pl. Ex. 16, ¶ 6(b)(v) (WGM00000800) (executed version of the Lock-Up Agreement). The Noteholders, therefore, are effectively the only beneficiaries of the Nova Scotia Trustee Claim.

[177] *See also* GUC Brief at 73 n.347.

[178] *See Id*. at 70 n.341.

[179] Trial Tr. (11/26/2012), 57:18-58:19 (Iacobucci); Def. Ex. 321 (Hr'g Tr., *In re AbitibiBowater, Inc.*, et al. (12/9/2011), 135:7-23 (Iacobucci)); Khimji Report, ¶ 30.

claimant, or another on its behalf, seeks multiple payments for the same loss. Both the Canadian and U.S. courts hold that a claimant may receive only a single distribution on account of one loss, even if that loss can be proven under multiple legal theories.[180]

This principle of one payment for one loss holds even if a creditor can claim multiple promises to pay from the same debtor.[181] Thus, under well-established law, a creditor may not recover against a debtor on account of both a guarantee and the underlying debt, even if the debtor is both the guarantor and separately assumes the liability of the original maker of the note.[182] Therefore, the Nova Scotia Trustee Claim must be disallowed to the extent it seeks payment for amounts due under the Notes.

1. The Second Circuit's Holding In *Delta* Is Consistent With The Long-Standing Principles Of New York And Second Circuit Law That Creditors May Only Claim Once For One Loss, Even If The Claims Are Asserted By Nominally Different Claimants

Given the well-established principle that creditors may not recover on two claims on account of one loss from the same debtor, it is unsurprising that there is no case anywhere in any relevant jurisdiction in which a court has allowed a claim under section 135 of the Nova Scotia Companies Act and under a guarantee for the same underlying debt of the unlimited liability company to be enforced concurrently.[183] Wedlake and the Noteholders, however, insist that the

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[180] GUC Brief at 71 n.342; *see also Central Trust Co. v. Rafuse*, [1986] 2 SCR 147 at 176-177 (SCC) (attached as Tab 6 to Khimji Decl., Ex. C and attached hereto as Index No. 1).

[181] This is so because "[a]ny rule which would permit the proof of two notes for one indebtedness would permit the proof of a dozen, and would substitute for pro rata distribution among real creditors, distribution in accordance with the ability of the bankrupt to make manifold obligations for single debts." *John Matthews, Inc. v. Knickerbocker Trust Co.*, 192 F. 557 (2d Cir. 1911). *See also* GUC Brief at 71 n.343.

[182] *See Curtis v. Walpole Tire & Rubber Co.*, 227 F. 698, 703 (D. Mass. 1915) (disallowing indorsement claim by creditor because the debtor was already liable on the underlying note by acquisition of the original maker of the note).

[183] Trial Tr. (11/26/2012), 120:17-22 (Baird).

Second Circuit, in *Northwestern Mutual Life Insurance Co. v. Delta Air Lines, Inc. (In re Delta Air Lines, Inc.),* 608 F.3d 139 (2d Cir. 2010) ("*Delta*"), has overturned the fundamental principle prohibiting enforcement of duplicative claims against the same debtor, such that the Nova Scotia Trustee Claim is now allowable together with the Guarantee Claims. *Delta* does not so hold. Quite to the contrary, *Delta* cited with approval and relied upon the Bankruptcy Court's opinion, which analyzed *Finley, Kumble*, and noted "[n]ot surprisingly, the Bankruptcy Court disallowed the claims [of the PBGC and the pension plan trustee] to the extent that they sought compensation for the same underfunding of the pension plan."[184] Thus, in rendering its decision, the Second Circuit in no way disturbed the principle that double liability is precluded for a single injury or loss.[185]

Here, unlike in *Delta*, the ultimate beneficiaries of both claims are the Noteholders. Although the Guarantee Claims are asserted directly by the Noteholders and the Nova Scotia Trustee Claim is asserted by Wedlake in its fiduciary capacity on behalf of the Noteholders, both the Nova Scotia Trustee Claim and the Guarantee Claims, are, as a matter of substance, being asserted by the same parties (the Noteholders). Wedlake relies on this nominal difference in claimants to assert that the Noteholders are entitled to two recoveries under *Delta* because the claims asserted are being asserted by two "different" entities. This position is nonsensical. All trustees act in representative capacities, but this does not mean that trustees have claims that are

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[184] *In re Delta Air Lines, Inc.*, 370 B.R. 552, 556-57 n.1 (Bankr. S.D.N.Y. 2007), *aff'd*, Nos. 05–17923 (ASH), 07 Civ. 7745 (RMB), 7 Civ. 11437 (RMB), 8 Civ. 2411 (RMB), 08 Civ. 2449 (RMB), 08 Civ. 6879 (RMB), 2008 WL 4444001 (S.D.N.Y Sept. 29, 2008), *vacated and remanded*, 608 F.3d 139 (2d Cir. 2010).

[185] As explained in the GUC Brief, *Delta* involved very particular facts that are not like those here. Indeed, the Second Circuit recognized that, were it not for the peculiar fact of the "Bingham Term Sheet," the proper remedy would have been disallowance of the duplicate claim of the party that did not actually incur the loss at issue.

independent of those beneficiaries on whose behalf they act, thereby entitling the beneficiaries to two recoveries.[186]

In this case, unlike in *Delta*, Old GM made only one contractual promise to pay: the guarantee. Wedlake attempts to construe the incorporation of GM Nova Scotia as an unlimited liability company as akin to a separate contractual promise by Old GM to pay, despite the utter lack of any evidence in the record that Old GM actually made or intended to make a promise to the Noteholders to pay twice on account of their one loss.[187] On the contrary, Wedlake's argument finds no support in either the offering circular for the Notes or the terms and conditions of the Notes themselves. The documents provide, for example, that GM Nova Scotia may reorganize, with no requirement that GM Nova Scotia remain a ULC and that GM Nova Scotia may be merged into Old GM, thus eliminating any possibility of a section 135 claim; and that all the proceeds of the Notes would be for the benefit of Old GM.[188] Given these terms and disclosures, no reasonable purchaser could have construed Old GM's membership interest in GM Nova Scotia as equivalent to a separate promise to pay on a section 135 claim on top of the contractual guarantee.[189]

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[186] *See In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 160 B.R. at 899. *See supra* note 177.

[187] GHW Brief at 8, 10-11.

[188] *See* Def. Ex. 14 at 18-19, § 11 (NGM000012069-70) (offering circular) ("Consolidation, Merger or Sale of Assets"); Def. Ex. 297 at DEF3866 (schedule 1 to fiscal and paying agency agreement).

[189] The terms of the Notes and offering circular also undermine Wedlake's argument that the law of substantive consolidation allows the Noteholders to claim twice on account of their one loss. *See* GHW Brief at 10-11. No reasonable Noteholder could have relied on the separate corporate structures of GM Nova Scotia and Old GM in extending credit in light of these disclosures. Further, as a matter of law, substantive consolidation, which seeks to consolidate the assets and liabilities of two separate debtors, has no applicability here. No party disputes that the Noteholders have a claim against Old GM under the guarantee and that they also have a claim against GM Nova Scotia under the Notes. The issue here is whether the Noteholders are entitled to a *third* claim (*i.e.*, a *second* guarantee claim) against Old GM.

2. The Rule Against Double Proof Is An Equitable Principle That Prevents Concurrent Enforcement Of The Nova Scotia Trustee Claim And The Guarantee Claims For Amounts Due Under The Notes

In Canada, the long-standing rule against double proof embodies the same principle that one loss merits one distribution and prevents claimants from recovering on the basis of two claims for one underlying debt against the same debtor.[190] The purpose of this rule is to prevent the exact result the Noteholders are attempting to achieve here; that is, obtain higher dividends than other creditors by asserting rights to payment under different theories of recovery for amounts owing under the Notes against Old GM.[191] This rule is an equitable one[192] applicable in any context in which creditors attempt to assert multiple claims against one debtor on account of what is, in substance, the same debt, and contrary to Wedlake's assertions, is not limited to Canadian bankruptcy cases.[193]

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190 *See, e.g., Husky Oil Operations Ltd. v. Minister of National Revenue*, [1995] 3 SCR 453, ¶ 53 (Supreme Court of Canada, 1995) (attached as Tab 8 to Khimji Decl., Ex. C and attached hereto as Index No. 2) ("It may well be that technically there are two claims against the debtor in respect of the transaction and two separate liabilities of the debtor arising out of the transaction. . . . *Technically, they are two separate liabilities, but in substance they are the same*; and in respect of that liability there could not be a double proof against the estate.") (emphasis added) (citations omitted).

191 *See Re Polly Peck International plc*. [1996] 2 All ER 433, [1996] BCC 486 (Ch D) 1995 (U.K.) (attached as Tab 26 to Khimji Decl., Ex. C and attached hereto as Index No. 3) (quoting *Re Oriental Commercial Bank, Ex parte European Bank* (1871) 7 Ch App 99 at 103-104, attached as Tab 16 to the Khimji Decl., Ex. C and attached hereto as Index No. 4) (the purpose of the rule against double proof is to prevent a creditor from "getting his debtor to enter into several distinct contracts with different people for the same debt, to obtain higher dividends than the other creditors, and perhaps get his debt paid in full.").

192 *Martin v. McMullen* (1891), 18 OAR 559 at 565, [1891] OJ No. 35 (attached hereto as Index No. 5) ("the principle involved seems to be a general principle of equity, applicable to all cases of suretyship.").

193 *See, e.g., Owners of Steamship Enterprises of Panama Inc. v. Owners of SS Ousel (The Liverpool No 2)* [1963] P 64 (CA) at 84 (attached as Tab 28 to Khimji Decl., Ex. C and attached to the GUC Brief as Index No. 10) (applying the rule against double proof in an admiralty case); *Independent Order of Foresters v. Trustees of Lethbridge Northern Irrigation Dist.*, [1943] 3 W.W.R. 297, [1943] 4 D.L.R. 793, *reversed on other grounds*, [1944] 1 W.W.R. 206, [1944] 1 D.L.R. 660 (Alta. C.A.) (attached hereto as Index No. 6) (applying the rule against double proof in a garnishment proceeding under the Execution Creditors Act and noting that "[t]he principle is not limited to bankruptcy.").

Polly Peck, a case relied upon by Wedlake, acknowledged that *Liverpool* is not a bankruptcy

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The Nova Scotia Trustee Claim and the Guarantee Claims may not be concurrently enforced against Old GM under the rule against double proof because both claims are asserted on account of the same debt. The relevant test, as articulated by an Ontario court in the leading Canadian case on the rule against double proof, is "whether two payments are being sought for a liability which, if the company were solvent, could be discharged as regards both claimants by one payment" (the "**O&Y Test**").[194] The court emphasized that, in evaluating whether two claims are on account of the same debt, the court looks to the *substance* of the underlying debt, not the form, and noted the following:

> it is . . . a fallacy to argue . . . that, because overlapping liabilities result from separate and independent contracts with the debtor, that, by itself, is determinative of whether the rule can apply. The test is in my judgment a much broader one which transcends a close jurisprudential analysis of the persons by and to whom the duties are owed. It is simply whether the two competing claims are, in substance, claims for payment of the same debt twice over.[195]

The court in *Olympia & York* focused on whether there was an "inseparable nexus" between the two alleged debts on account of which the creditors sought recovery and held that there was such a nexus because of the "total effect of the arrangements . . . and the reasoning

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case, characterizing *Liverpool* as "the most distant analogy for the application of the rule, since it was an admiralty case." [1996] 2 All ER 433, [1996] BCC 486 (Ch D) at 443. Wedlake argues that the rule against double proof is irrelevant here because it is only a rule of claims administration in bankruptcy and there is no pending bankruptcy case of Old GM in Canada. *See* GHW Brief at 21. However, its own expert, David Baird, conceded at trial that the rule applies in any situation where there are competing claims to an insufficient fund and he concedes that the case of Old GM is one in which there are competing claims to an insufficient fund. Trial Tr. (11/26/2012), 113:2-10 (Baird).

194 *See Olympia & York Developments (Re)* (1998), 4 CBR (4th) 189, [1998] OJ No. 4903 (Ont. Bktcy.) at ¶ 45 ("*Olympia & York*") (attached as Tab 25 to Khimji Decl., Ex. C and attached to the GUC Brief as Index No. 11) (citing *Barclays Bank Ltd v. T.O.S.G. Trust Fund Ltd.* [1984] 2 WLR 49 (CA), attached as Tab 2 to Khimji Decl., Ex. C and attached hereto as Index No. 7).

195 *Id*. at ¶ 28 (quoting *Barclays Bank* at 636).

behind" what were, in that case, facially two debts.[196] Here, the substance of the debt underlying both the Nova Scotia Trustee Claim and the Guarantee Claims, to the extent of the amounts owed under the Notes, is the same debt. Thus, even more so than in *Olympia & York*, there is an "inseparable nexus" between the Nova Scotia Trustee Claim and the Guarantee Claims. To the extent of their overlap, they are claims for exactly the same debt. If Old GM were solvent, payment of the Guarantee Claims would discharge the Nova Scotia Trustee Claim to the extent of the amounts sought for the Notes and payment of the Nova Scotia Trustee Claim would discharge the Guarantee Claims in full; thus the two claims cannot be concurrently enforced against Old GM.

Wedlake cites to *Polly Peck*, an English case, and argues that the O&Y Test is not applicable but that even if it was applicable, it is not satisfied in this case.[197] These arguments are meritless. First, *Polly Peck* is an English case, not a Canadian case, and while English cases are influential in Canada, *Olympia & York* remains good law in Canada. Indeed, the court in *Olympia & York* considered *Polly Peck* in detail and held that it was factually distinguishable from *Olympia & York* and therefore declined to follow it.[198] Second, Wedlake argues that the O&Y Test does not apply because, according to Wedlake, *Polly Peck* disavowed the O&Y Test.[199] Contrary to Wedlake's assertion, the court in *Polly Peck* did not disavow the O&Y Test, but merely cautioned that in a group insolvency situation, it "may not be a wholly reliable

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[196] *Id*. at ¶ 28. *See also Husky Oil* at ¶ 53 (holding that a contractor cannot be held liable for two claims concurrently because there is an inseparable nexus between the two claims).

[197] Wedlake relies heavily on *Polly Peck*, which, like *Olympia & York*, did not involve a ULC. Trial Tr. (11/26/2012), 121:24-123:4 (Baird). The holding of *Polly Peck* was based on the specific facts of that case. *Id*. at 129:14-130:11 (Baird).

[198] *See Olympia & York* at ¶ 39 (p. 14).

[199] GHW Brief at 25. Wedlake also argues that disallowing the Nova Scotia Trustee claim would disregard the separate legal personality of GM Nova Scotia. This argument is similarly without merit and is addressed in greater detail in Section VI(C), *infra*.

test."[200] Significantly, neither *Polly Peck* nor *Olympia & York* involved a claim for contribution from a member of a ULC but rather involved two claims arising from a parent company guarantee of its subsidiary's debt, and the intercompany liability resulting from the subsidiary's loaning the proceeds of that debt to the parent.[201] Whether a "double proof" has been lodged on account of what is in substance the same debt turns on the facts of each particular case.[202] The Court in *Olympia & York* considered *Polly Peck*, and the group insolvency issue under the facts before it, and held that the two claims in *Olympia & York* were double proofs. Here, there is no second debt as section 135 explicitly refers to debts owed by the company to its creditors (*i.e.*, amounts owing by GM Nova Scotia under the Notes), and both the Nova Scotia Trustee Claim and the Guarantee Claims assert liability under the same debt.

Wedlake also argues that a solvent Old GM's payment in full of the Nova Scotia Trustee Claim would not automatically discharge liability under the Nova Scotia Trustee Claim and the Guarantee Claims because such discharge depends upon the Nova Scotia Trustee actually making a distribution to the Noteholders.[203] Both of Wedlake's experts, however, concede that if Wedlake receives a distribution on account of the Nova Scotia Trustee Claim, it would be duty-bound to distribute that to GM Nova Scotia's creditors.[204] Given that the rule against double

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[200] *Polly Peck* at 445; Trial Tr. (11/26/2012), 129:1-16 (Baird).

[201] Similarly, *In re Kaupthing Singer & Friedlander Ltd* [2011] UKSC 48, [2012] 1 AC 804 (attached as Tab 13 to Khimji Decl., Ex. C and attached hereto as Index No. 8), also cited by Wedlake, does not involve a ULC. Trial Tr. (11/26/2012) 121:34-123:4 (Baird).

[202] *Olympia & York*, ¶ 37.

[203] *Id*. at 115:25-116:21.

[204] *See* Trial Tr. (11/26/2012), 67:13-68:12 (Iacobucci); Trial Tr. (11/26/2012), 116:22-117:1 (Baird). Mr. Baird further concedes that the distribution from Wedlake to the Noteholders is a "mechanical" step. Trial Tr. (11/26/2012), 117:2-120:7 (Baird). *See also In re Paraguassu Steam Tramroad Co.* (1872) 8 Ch App 254 at 262 (attached as Tab 17 to Khimji Decl., Ex. C and attached hereto as Index No. 9) ("The different sections of the Act . . . all have in view the payment, pari passu and

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proof looks to the substance, not the form, the mere existence of this "mechanical" step cannot overcome the conclusion that the Nova Scotia Trustee Claim and the Guarantee Claims are double proofs and cannot be concurrently enforced.

B. Section 135 Of The Nova Scotia Companies Act Does Not Entitle The Noteholders To Two Claims On Account Of One Loss

1. The History And Purpose Of Section 135 Indicates Legislative Intent To Preclude Concurrent Enforcement Of The Nova Scotia Trustee Claim And The Guarantee Claims

The history and purpose of section 135 are clear that section 135 is a means of enforcing a ULC's existing debts to its creditors and does not itself create any new debt owed to the ULC.[205] The legislative intent of this statute is to channel rights to collect a ULC's debts to a trustee[206] in order to promote an orderly and efficient winding up of the ULC's affairs.[207] Neither the plain language of the statute nor its legislative history indicate that the legislature intended to overturn firmly established law and permit the creditors of a ULC holding a contractual guarantee from a member for a ULC's debt to claim, by virtue of section 135, twice on account of their single debt. Disallowance of the Nova Scotia Trustee Claim to the extent of the amount of the Notes is consistent with section 135.[208]

Wedlake's focus on the eight statutory qualifications under section 135(a) through (g) is

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equally, of the debts due to the creditors; and the hand which receives the calls necessarily receives them as a statutory trustee for the equal and ratable payment of all the creditors.").

205 Khimji Report, ¶¶ 3, 18, 28.

206 Wedlake mischaracterizes Professor Khimji's testimony and claims that Professor Khimji argues that section 135 channels the right to collect a ULC's debts to the *company*. GHW Brief at 18. Professor Khimji has made clear in his report that the right to collect is channeled to a *trustee for the benefit of the creditors of the ULC, not to the company itself*. Khimji Report, ¶ 27; Khimji Decl. Ex. B ("**Khimji Rebuttal Report**") at 3-5. Thus, Wedlake's argument that the history of section 135 supports a finding that a claim under section 135 is owed to the company is meritless. GHW Brief at 17-19.

207 Khimji Report, ¶¶ 18, 27.

208 *See* Khimji Report, ¶¶ 12-33.

misleading. As discussed in greater detail in pages 6-7 of Professor Khimji's rebuttal report, Old GM does not attempt to qualify (in other words, limit) its liability under the Notes and the issue here is not whether Old GM is liable for amounts owing under the Notes. Rather, the issue is whether Old GM is liable twice for the amounts owing under the Notes. Under these circumstances, Old GM's liability on the Notes is unlimited (*i.e.,* not qualified) for the purposes of section 135 and the contractual guarantee is simply a privately agreed-upon mechanism for the enforcement of that same debt.[209]

Wedlake faults Professor Khimji's statutory analysis, asserting that Canadian law accords almost no deference to legislative history when interpreting statutes.[210] Wedlake misconstrues both Canadian and Nova Scotia law and the testimony of its own expert, Professor Iacobucci. The Canadian Supreme Court has made clear that, when interpreting a Canadian statute, "the words of an Act are to be read in the 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."[211] Thus, Professor Iacobucci concedes that even where the words of a statute are "precise and unequivocal," as he wrongly asserts is the case here, Canadian law requires consideration of matters other than the plain language of the statute, including the scheme and

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[209] *Id*. Further, even assuming that Professor Iacobucci is correct that the eight qualifications under section 135 should be interpreted as "exceptions" to the general rule of member liability, Old GM's giving of a contractual guarantee should be interpreted as a separate contractual limitation of its section 135 liability under qualification (f). *See* NSCA 135(f) (attached to the GUC Brief as Index No. 3) ("nothing in this Act shall invalidate any provision contained in any contract whereby the liability of the individual members of the contract is restricted"); Khimji Rebuttal Report at 7. Similarly, the provisions in the offering circular and the Notes that GM Nova Scotia may reorganize with no requirement that it remain a ULC, and that GM Nova Scotia may be merged into Old GM contractually limit Old GM's section 135 liability and should be interpreted as a section 135(f) limitation. *See* Def. Ex. 14 at 18-19, § 10 (NGM000012069-70); Def. Ex. 297 at DEF3866.

[210] GHW Brief at 16.

[211] *Canada Trustco Mortgage Co. v. R.*, 2005 SCC 54 at ¶ 10 (p. 13) (internal quotation marks omitted) (attached hereto as Index No. 10).

object of the act and the intent of Parliament in enacting the law.[212] This is precisely the analysis Professor Khimji undertook and Professor Iacobucci did not.

Wedlake also criticizes Professor Khimji's attention to the history of section 38 of the 1862 U.K. Companies Act, which Professor Iacobucci concedes is "the same statute" as section 135 of the Nova Scotia Companies Act.[213] However, as Professor Iacobucci's course-book indicates, because the 1862 Companies Act was the model for the provincial acts of several Canadian provinces and continues to be for Nova Scotia, "knowledge of the history of the British company law is also important for an understanding of the early Canadian developments."[214] Wedlake's criticism is particularly puzzling in light of the Nova Scotia Interpretations Act, which requires that, when interpreting a Nova Scotia statute, a court consider, among other things, the former law, including other enactments upon the same or similar subjects and the history of legislation on the subject.[215] It is telling that Professor Iacobucci offers no opinion on the accuracy of Professor Khimji's historical and legislative history analysis, having not done the research himself.[216] The legislative history of section 135 of the Nova Scotia Companies Act and section 38 of the U.K. Companies Act demonstrate that the scheme and object of section 135 and the intent of the legislature are that where a separate contractual guarantee exists,

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[212] Trial Tr. (11/26/2012), 50:6-51:6 (Iacobucci).

[213] *Id*. at 55:12-56:3 ("They must have copied 38 when they drafted 135. . . .").

[214] *See* Edward Iacobucci, et al., *Cases, Materials and Notes on Partnerships and Canadian Business Corporations*, 5th ed. (Toronto: Thomson Reuters, 2011) at 47-49 (attached hereto as Index No. 11).

[215] *See* Section 9(5) of the *Interpretation Act*, RSNS 1989, c. 235 (attached as Tab 33 to Khimji Decl., Ex. C and attached to the GUC Brief as Index No. 8); *see also* Trial Tr. (11/26/2012), 53:18-55:11 (Iacobucci).

[216] *Id*. at 56:4-57:4.

enforcement of that guarantee is instead of, and not in addition to, enforcement of a claim under section 135.[217]

C. Disallowance Of The Nova Scotia Trustee Claim Does Not Impermissibly Disregard The Separate Legal Personality Of GM Nova Scotia

1. The Nova Scotia Trustee Claim Does Not Belong To GM Nova Scotia

Wedlake's assertion that the Nova Scotia Trustee Claim belongs to GM Nova Scotia and that disallowance of the Nova Scotia Trustee Claim, therefore, would impermissibly disregard the separate legal personality of GM Nova Scotia should be rejected. As an initial matter, this assertion is entirely inconsistent with the Noteholders' position in this case that it is they, as the only real creditors of GM Nova Scotia, and not GM Nova Scotia itself, who (purportedly) gave consideration for the release of the Intercompany Loans.[218] Further, as a matter of law, liability under section 135 is not a debt owed to the ULC[219] and, therefore, is not an asset of the ULC.[220]

Webb v. Whiffin,[221] which Wedlake cites for the proposition that a section 135 claim belongs to the ULC, is distinguishable. *Webb* dealt with a claim against a member for unpaid capital.[222] Professor Iacobucci concedes that a claim for unpaid capital is not like a section 135 contribution claim because a ULC's corporate powers with respect to a claim for unpaid capital

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[217] Khimji Report, ¶ 32.

[218] NH Brief at 10.

[219] The statute provides that a member is "liable to contribute to the assets of the company." N.S.C.A.§ 135.

[220] Khimji Report, ¶ 28 (section 135 does not create a separate and independent claim owned by the ULC). *See also In re Whitehouse & Co*. (1878) 9 Ch D 595 at 599-600 (attached as Tab 18 to Khimji Decl., Ex. C and attached hereto as Index No. 12) ("It is a mistake to call [the liability of a contributor in winding-up under the 1862 U.K. Companies Act] a debt due to the company. It is no such thing. It is not, as has been supposed, in any shape or way a debt due to the company, but it is a liability to contribute to the assets of the company; and when we look further into the Act, it will be seen that it is a liability to contribution to be enforced by the liquidator.").

[221] (1872) LR 5 HL 711(attached as Tab 29 to Khimji Decl., Ex. C and attached hereto as Index No. 13).

[222] *Id*. at 735-36.

is very different from its powers with respect to a section 135 contribution claim.[223] Thus, *Webb* does not support the conclusion that a section 135 claim is a claim of the ULC and not effectively a claim of the ULC's creditors.[224]

2. **The Principle Of Separate Legal Personality Of GM Nova Scotia Does Not Support Allowance Of The Nova Scotia Trustee Claim To The Extent Of Duplication With The Guarantee Claims**

That Old GM and GM Nova Scotia have separate legal personalities is not disputed. The issue in this case is whether GM Nova Scotia is liable twice for amounts owing under the Notes. Section 135 creates a procedural mechanism for the enforcement of a ULC's debts owed to its creditors against members, but does not create a new debt for the benefit of the ULC.[225] Therefore, both the Guarantee Claims and the Nova Scotia Trustee Claim relate to the same debt against the same debtor for the benefit of the same party and the principle of separate legal personalities is simply not relevant to a determination of whether both claims should be concurrently allowed against Old GM.[226]

Even if, as Wedlake argues, the Nova Scotia Trustee Claim is construed to be an asset of

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[223] *See* Trial Tr. (11/26/2012), 63:23-66:12 (Iacobucci) (a claim for unpaid capital shares is an asset of the ULC, which the ULC may pledge as security for a company debt, but a claim for contribution under section 135 cannot be pledged); *see also* Def. Ex. 321 (Hr'g Tr., *In re Abitibibowater, Inc., et al.* (12/9/2011), 123:24-125:5 (Iacobucci)) (same).

[224] Wedlake also argues that section 77(2) of the Canadian *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3 (attached as Tab 32 to Khimji Decl., Ex. C and attached hereto as Index No. 14), – which provides that the amount that a member is liable to contribute on his unpaid shares of capital or in his liability to the corporation, its members or creditors "shall be deemed" an asset of the corporation and a debt "payable to the trustee," BIA, § 77(2) – transforms a contribution claim into an asset of the ULC. However, being "deemed" an asset of the ULC means the opposite of actually being an asset of the ULC. Trial Tr. (9/21/2012), 114:1-10 (Khimji) (Black's Law Dictionary defines "deemed" to treat something as (1) if it were really something else, or (2) qualities that it does not have; the deeming provision of the BIA does not mean that a contribution claim is an asset of the ULC, but that it is treated as such for a particular purpose). Thus, section 77(2) of the BIA does not support the conclusion that the Nova Scotia Trustee Claim belongs to GM Nova Scotia.

[225] Khimji Report, ¶ 9-10.

[226] Trial Tr. (9/21/2012), 123:10-125:13 (Khimji).

GM Nova Scotia, the disallowance of the Nova Scotia Trustee Claim to the extent of duplication with the Guarantee Claims would not violate the principle of separate legal personality. The rule against double proof applies to prevent even *different creditors* from proving multiple claims for the same debt against the same debtor.[227]

Finally, although not necessary in this case, separate legal personalities may be disregarded where it is necessary to properly apply a statute or to prevent an unjust result. Wedlake's own expert's course-book notes that "courts have repeatedly stated that, sometimes, the legal personality of the corporation may be disregarded for the purpose of imposing liability directly upon shareholders or if necessary for the correct construction or application of a legal standard."[228] The court in *Olympia & York* specifically considered whether the existence of a separate legal personality prevented disallowance of a duplicative claim and concluded that it did not.[229] While courts should be careful to respect separate corporate existence, this principle does not trump the importance of *pari passu* distribution to all creditors.[230] Thus, though not necessary here for reasons already discussed above, this Court may, applying Canadian law and interpreting section 135, look beyond the purported separate legal personality of GM Nova Scotia and disallow the Nova Scotia Trustee Claim.

D. Wedlake Resorts To Baseless <u>Attacks On Professor Khimji's Qualifications</u>

Since the law is not on Wedlake's side, Wedlake resorts to meritless attacks on the

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227 Khimji Report, ¶ 34-35.

228 Iacobucci, et al., *supra*, at 87. Courts may disregard separate legal personalities if it would produce results "flagrantly opposed to justice," *Clarkson Co. Ltd. v. Zhelka*, [1976] 2 OR 565 (HC) at ¶ 80 (attached hereto as Index No. 15), or when "construing *a statute*, contract or other document." *Transamerica Life Ins. Co. of Canada v. Canada Life Assurance Co.* (1996), 28 OR (3d) 423 (Gen. Div.), *aff'd* [1997] OJ No. 3754 (CA) at ¶ 19 (emphasis added) (attached hereto as Index No. 16).

229 *Olympia & York*, ¶ 36.

230 *Id*. at ¶ 27.

qualifications of Professor Khimji.[231] In doing so, Wedlake ignores the fact that Professor Khimji was qualified as an expert witness on the exact matters in dispute here, not just by this Court in this case, but previously by the bankruptcy court for the District of Delaware in the case of *In re AbitibiBowater* (Case No. 09-11296).[232] Wedlake also ignores the fact that Professor Khimji, unlike either of its experts, taught business associations and commercial law at a Nova Scotia law school and has consulted for the Government of Nova Scotia on amendments to the Nova Scotia Companies Act.[233] Wedlake's criticism that Professor Khimji is not a bankruptcy expert is simply irrelevant given that the rule against double proof is not limited to bankruptcy,[234] and because Professor Khimji has previously testified as a qualified expert on the rule against double proof to the extent it implicates claims under section 135 of the Nova Scotia Companies Act.[235]

At the same time, Wedlake exaggerates the qualifications of its own expert. Wedlake touts the "more than 50 articles" Professor Iacobucci has published,[236] but neglects to mention that none of these publications involved the Nova Scotia Companies Act.[237] The "course book discussing Nova Scotia ULCs which he teaches in class," *id.*, turns out to be an 829 page course-book containing cumulatively less than one page on Nova Scotia ULCs.[238]

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231 GHW Brief at 13-15.

232 *See* Khimji Report, ¶ 4.

233 *Id*. at ¶¶ 1, 3; Trial Tr. (11/26/2012), 41:11-17 (Iacobucci).

234 *See* Section VI(A)(2), *supra*.

235 *See generally* Def. Ex. 321 (Hr'g Tr., *In re Abitibibowater, Inc., et al.* (12/9/2011), 176:16-254:14 (Khimji)); *see also* Trial Tr. (9/21/2012), 114:18-114:24 (Khimji) (Professor Khimji is qualified to opine on the section 135 and double liability issues relevant to this case even if the issues are related to bankruptcy or insolvency).

236 GHW Brief at 14.

237 Trial Tr. (11/26/2012), 40:10-16 (Iacobucci).

238 *See* Iacobucci, et al., *supra*, at 65, 158; *see also* Trial Tr. (11/26/2012), 40:18-41:10 (Iacobucci).

E. The Nova Scotia Trustee Claim Must Be Disallowed Pursuant To Section 502(e) Of The Bankruptcy Code

Pursuant to section 502(e)(1)(B), a claim must be disallowed if the following three elements are established: (1) the party asserting the claim must be liable with the debtor on the claim of a third party; (2) the claim must be contingent at the time of its allowance or disallowance; and (3) the claim must be for reimbursement or contribution.[239] Wedlake does not dispute, and thus concedes, that the first element – that Old GM and GM Nova Scotia are co-debtors who are jointly liable under the Notes – is satisfied.[240] Instead, Wedlake focuses on the latter two elements, and argues that the Nova Scotia Trustee Claim is neither a claim for contribution nor a contingent claim. Wedlake's arguments do not withstand scrutiny.

First, Wedlake's argument that the Nova Scotia Trustee Claim is not a claim for contribution ignores the plain language of the very statute that gives rise to its claim. As this Court has recognized, "[w]hether a Claim is one for reimbursement or contribution depends on its characterization under state or federal statutory law or common law."[241] Here, section 135 expressly provides that, upon a winding up, a member of a ULC is to "*contribute* to the assets of the company."[242] Wedlake's puzzling suggestion that the word "contribute" is used in the statute in the "ordinary" sense, and not in the "particular sense applicable to 502(e)(1)(B)," finds no support in the law. To the contrary, it is recognized that "[t]he plain meaning of the [1862 Companies] Act is a legal or equitable liability to contribute in the character of a partner."[243]

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239 *In re Lyondell Chem. Co.*, 442 B.R. 236, 243 (Bankr. S.D.N.Y. 2011).

240 *See* GHW Brief at 26.

241 *In re GCO Servs., LLC*, 324 B.R. 459, 465 (Bankr. S.D.N.Y. 2005) (quoting L. King, et al., Collier on Bankruptcy, ¶ 502.06[2][a] (15th ed. Rev. 2003)); *see also In re APCO Liquidating Trust*, 370 B.R. 625, 631 (Bankr. D. Del. 2007).

242 N.S. Companies Act at § 135 (emphasis added).

243 *In re European Society Arbitration Acts*, (1878) 8 Ch D 679, at 708 (attached hereto as Index No.

Footnote continued on next page

Wedlake cites to this Court's decision in *In re Chemtura Corp.*, 436 B.R. 286 (Bankr. S.D.N.Y. 2010), in support of its argument that the Nova Scotia Trustee Claim is not a claim for contribution within the meaning of section 502(e)(1)(B) because GM Nova Scotia has not yet paid its underlying debt on the Notes.[244] This argument is illogical. The payment of the underlying debt is not necessary to establish a contribution claim against a co-debtor. Indeed, in *Chemtura*, the Court held that the contribution claims at issue there satisfied each of the elements of section 502(e)(1)(B), notwithstanding that the underlying claims had not yet been paid – a fact that rendered the claims contingent.[245]

Further to this point, the Nova Scotia Trustee Claim is also most certainly a contingent claim. As this Court recognized in *Lyondell*, "until and unless amounts *are actually paid*, the claims for reimbursement or contribution with respect to those amounts remain contingent for 502(e)(1)(B) purposes."[246] Faced with the fact that GM Nova Scotia has not paid the Notes, Wedlake is left to argue that the "theory that a claim is contingent until payment is made is inapplicable here."[247] But Wedlake's attempt to limit such a "theory" to CERCLA environmental remediation cases where the underlying liability is subject to change finds no basis in the law, and is contrary to the very purpose of section 502(e)(1)(B).

Indeed, Wedlake acknowledges in its brief that the purpose of the statute is "to ensure that the estate will not be liable to the primary obligor and the guarantor for the same debt," and

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Footnote continued from previous page
17). As discussed in Section VI(B)(I), *supra*, the 1862 U.K. Companies Act was the model for the provincial acts of several Canadian provinces, and continues to be for Nova Scotia.

[244] *See* GHW Brief at 26.

[245] *In re Chemtura Corporation*, 436 B.R. at 297.

[246] *In re Lyondell*, 442 B.R. at 248.

[247] GHW Brief at 27.

to "prevent competition between a creditor and his guarantor for the limited proceeds in the estate."[248] Simply put, Wedlake's recognition of the purpose of section 502(e)(1)(B) cannot be squared with its argument that the statute does not require disallowance of the Nova Scotia Trustee Claim. Accordingly, because it is a contingent claim for contribution that is being asserted to recover the same debt asserted under the Guarantee Claims, the Nova Scotia Trustee Claim must be disallowed pursuant to Section 502(e)(1)(B) of the Bankruptcy Code.

VII. THE PORTION OF THE NOVA SCOTIA TRUSTEE CLAIM THAT IS BASED ON THE SWAPS SHOULD BE DISALLOWED

A. The Swaps Were Not Assumed And Assigned To New GM

The Swaps were not assumed and assigned to New GM. The Sale Order sets forth the "exclusive" procedures for the assumption and assignment of contracts in this case.[249] Those procedures were not followed with respect to the Swaps.[250] In particular, notice was never sent to GM Nova Scotia. Of greater significance, however, is *New GM's failure to identify the Swap Documents in the assumption and assignment database*.[251] All parties agree that there are four

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[248] *Id*. at n.115; *see In re APCO Liquidating Trust*, 370 B.R. at 634 ("The sole purpose served by section 502(e)(1)(B) is to preclude redundant recoveries on identical claims against insolvent estates in violation of the fundamental Code policy fostering equitable distribution among all creditors of the same class.'") (quoting *Juniper Dev. Grp. v. Kahn (In re Hemingway Transp., Inc.)*, 993 F.2d 915, 923 (1st Cir. 1993)).

[249] As New GM specifically stated to the Court, the assumption and assignment procedures approved in the Sale Order are the "exclusive procedures for the assumption and assignment of designated executory contracts and unexpired leases." *See Motion (I) For Declaratory Relief Regarding The Status Of A Certain Sublease Or, In The Alternative, Relief From The Assumption And Assignment Of A Certain Sublease To GM Pursuant To Rule 60(b) And (II) To Rescind The Agreement To Resolve Objection To Cure Notice Between GM And Knowledge Learning Corporation Dated August 14, 2009* at ¶ 8 (Bankr. Dkt. No. 4895).

[250] *See* Pl. Ex. 275, ¶ 10 (Sale Procedures Order) (Bankr. Dkt. No. 274) (as a condition to the assumption of an executory contract, Old GM was required to provide an assumption and assignment notice containing an objection deadline to the contracting counterparty, in the form attached as Exhibit D to the Sale Procedures Order, with instructions for how to access the assumption and assignment database).

[251] Pl. Ex. 281 (email from R. Berkovich to E. Fisher dated Apr. 22, 2010, attaching excerpt from

Footnote continued on next page

Swap Documents related to the Swaps: (i) a 1992 ISDA Master Agreement that is *unsigned and undated*; (ii) a schedule to the ISDA Master Agreement dated as of October XX, 2001; (iii) a July 10, 2003 confirmation relating to one series of Notes; and (iv) a July 10, 2003 confirmation relating to the other series of Notes .[252] New GM suggests that the identification of an "ISDA Master Agreement dated October 15, 2001" in the assumption database sufficiently identified the Swaps at issue here for assumption.[253] But that document has no relation to these Swaps and is presumably related to some earlier swap.[254] Consistent with the above, New GM initially acknowledged that it did not believe it had a right to the Swaps.[255]

B. The Swaps Were Expressly Excluded From The 363 Sale To New GM

Under the MSPA, Old GM retained all of its "right, title and interest in and to" and did not "sell, transfer, assign, convey or deliver" to New GM, certain assets (the "**Excluded Assets**").[256] The Swaps and swap liability constitute Excluded Assets under the MSPA. Schedule 2.2(b)(iv) identifies 142 entities that were excluded from the sale to New GM (the "**Excluded Entities**").[257] GM Nova Scotia is identified as an Excluded Entity, and Excluded

Footnote continued from previous page
assumption and assignment database).

252 *See* Pl. Ex. 315 (Nova Scotia Trustee Claim, Exhibit E (GHW0003704), copies of the swap agreements (ISDA Master Agreement at GHW0003705; schedule at GHW0003729; confirmations at GHW0003737 and GHW0003742)); *see also* Def. Ex. 22 (Weil notes that the "Master Agreement is just the standard form 1992 ISDA"); Trial Tr. (8/7/2012), 35:3-36:25 (Wedlake).

253 NG Brief at 33-34.

254 *See* JSF, ¶ 6 (citing to Def. Ex. 11, the October 15, 2001 swap confirmation that all parties agree is not one of the four Swap Documents relevant to this case).

255 GUC Brief at 82 n.359.

256 MSPA § 2.2(b). The MSPA makes clear that "the Purchased Assets shall not, and shall not be deemed to, include the" Excluded Assets. *Id*.

257 *See Notice Of Filing Of The Amended Master Sale And Purchase Agreement And Certain Exhibits And Sections Of The Disclosure Schedule Thereto* at Disclosure Sch. 2.2(b)(iv), ¶ 55 (Bankr. Dkt. No. 2649). New GM incorrectly states that only four entities were excluded from the sale. NG Brief at 34 n.44.

Entities are within the definition of Excluded Assets.[258]

Section 2.2(b)(v)(ii) of the MSPA defines "Excluded Contracts" as all prepetition executory contracts "that have not been designated as or deemed to be Assumable Executory Contracts . . . or that are determined, pursuant to the procedures set forth in the Sale Procedures Order, not to be assumable and assignable to" New GM (collectively, the "**Excluded Contracts**"), "*including any accounts receivable arising out of or in connection with any Excluded Contact*."[259] Because the Swaps were not assumed and assigned, they are Excluded Contracts. As a result, the swap liability constitutes an account receivable arising out of or in connection with the Swaps, and such receivable was expressly excluded from the sale to New GM.

Further, section 2.2(b)(iii) of the MSPA states that Excluded Assets include all receivables other than "Intercompany Obligations" (which the Swaps were not) "exclusively related to any Excluded Assets."[260] Because the swap liability is purportedly an amount that would, in the future, become due by GM Nova Scotia to Old GM, such amount constitutes a receivable related to GM Nova Scotia. As a result, for this separate reason, the swap liability is an Excluded Asset.[261]

C. The Swaps Are Not Purchased Assets Under The MSPA

New GM argues that the Swaps somehow constitute Purchased Assets under sections 2.2(a)(iv) and (xiii) of the MSPA. This argument fails. Section 2.2(a) provides, in relevant part,

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[258] MSPA § 2.2(b)(iii).

[259] *Id*. at § 2.2(b)(vii) (emphasis added).

[260] *Id*. at § 2.2(b)(iii). The Swaps were not "Intercompany Obligations" because no amount was owed or due under the Swaps as of the closing of the 363 Sale.

[261] Moreover, all claims relating exclusively to the Excluded Assets (*i.e.*, all claims relating to GM Nova Scotia or the Swaps) and all "financial arrangements" relating exclusively to the Excluded Assets were not sold to New GM. *See Id*. at §§ 2.2(b)(x) and (xii).

that the Purchased Assets "shall consist of the right, title and interest that" Old GM possesses in certain assets "as the same may exist as of the Closing" but "in every case, excluding the Excluded Assets."

New GM's contention that the swap liability constitutes an "intercompany obligation" under section 2.2(a)(iv) of the MSPA "owed or due" to Old GM as of July 10, 2009 is incorrect.[262] It is undisputed that the swap liability was not owed or due as of such date. This fact is confirmed by Wedlake's admission that one reason for its purported "disclaimer" of the Swaps in 2010 was because GM Nova Scotia's liability related to the Swaps "could have continued to grow."[263]

New GM's contention that claims under the Swaps were purchased under section 2.2(a)(xiii) of the MSPA is also incorrect. Section 2.2(a)(xiii) excludes from the universe of Purchased Assets all claims that relate exclusively to the Excluded Assets. Because claims under the Swaps relate exclusively to GM Nova Scotia, such claims were not included in the sale to New GM.

D. Even If The Swaps Were Purchased Contracts, New GM Assumed The Swap Liability

New GM contends that the Swaps were validly assumed and assigned, and, as a result, the Swaps are deemed Purchased Contracts under section 2.2(a)(x) of the MSPA.[264] Purchased Contracts include all contracts other than the Excluded Contracts, including any executory contract that was assumed and assigned. Assuming, *arguendo*, that the Swaps were assumed and assigned and are therefore deemed to be Purchased Contracts, New GM necessarily assumed all

262 NG Brief at 34.

263 GHW Brief at 40.

264 *See Statement Of Undisputed Material Facts In Support Of Motion For Summary Judgment Filed By General Motors LLC* at 29, ¶ 69(v) (Bankr. Dkt. No. 11851).

liabilities under each Purchased Contract pursuant to section 2.3(a)(ii) of the MSPA.

It makes perfect sense that Old GM would be released from all obligations with respect to Purchased Contacts that New GM acquired. This idea is confirmed by the language in the Sale Order, which provides that Old GM has been "forever released from any and all liability under the Purchased Contracts." Thus, regardless of whether New GM has any rights in the Swaps, the portion of the Nova Scotia Trustee Claim that is based on the Swaps is invalid and should be disallowed.

E. The Express Provisions Of The Swaps Govern Their Termination And Calculation Of Amounts Due

A separate and independent basis to disallow the Swaps is that they were not terminated in accordance with their terms. Absent proper termination by the non-defaulting party (New GM), no payment is due under the Swaps.[265]

Wedlake admits that the termination provisions set forth in the Swaps were not followed.[266] Instead, Wedlake contends that it is permitted under Canadian law to disclaim the Swaps and thus disregard their express terms.[267] Wedlake's contention is disingenuous, however, because Canadian law *precludes* the disclaimer of "eligible financial contract[s]" (*e.g.*, Swaps).[268] Further, Wedlake's argument that it feared ongoing or personal liability is a fallacy because, most importantly, Wedlake knew that it could not be exposed to any liability whatsoever based on the Swaps due to the fact that, as discussed above, New GM assumed the

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[265] As discussed in Argument Section VII(B) of the GUC Brief, GM Nova Scotia's purported disclaimer in January of 2010 did not effect an early termination under the ISDA Master Agreement entitling New GM to a claim for payment, because the ISDA expressly requires, among other things, that the non-defaulting party issue a termination notice specifying the default and designating a *future* early termination date – not a date before the time such notice is effective.

[266] GHW Brief at 38-39.

[267] *Id*. at 39-40.

[268] *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3, s. 65.11 (attached hereto as Index No. 18).

swap liability in connection with the 363 Sale.[269] Moreover, a non-defaulting counterparty's failure to promptly terminate a swap agreement amounts to a waiver of that right and precludes such party from a chance to "play the market" once an event of default has occurred.[270] By sitting on its termination rights, New GM waived them.

Finally, if, for the sake of argument only, New GM does have a claim under the Swaps against GM Nova Scotia, it certainly does not have a claim in the amount asserted. There is simply no authority to suggest that a court will ignore the termination or damages provisions of a contract solely because it was disclaimed in bankruptcy, and Wedlake has not cited a single case in support of such a theory. As explained in the GUC Brief, New GM's claim under the Swaps disregards the contractually specified method for calculating amounts due in an effort to improperly inflate the claim against Old GM.

VIII. THE JOINT STATEMENT OF FACTS RELIES ON EXHIBITS NOT IN EVIDENCE

As set forth in the Appendix hereto, Defendants' and New GM's post-trial submissions improperly rely upon certain exhibits that are not admitted into evidence.

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[269] *Id*. at 40.

[270] *In re Lehman Brothers Holdings Inc.*, No. 08-13555 (JMP), Hr'g Tr. at 111:23-112:2 (Dkt. No. 5261) (Sept. 15, 2009) (oral ruling on motion to compel Metavante Corp. to perform under an executory contract).

CONCLUSION

WHEREFORE, the GUC Trust respectfully requests entry of a judgment disallowing the Disputed Claims in full, and granting such other relief as the Court deems just and proper.

Dated: New York, New York
July 11, 2013

Respectfully submitted,

By: /s/ Eric B. Fisher
Barry N. Seidel
Eric B. Fisher
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Counsel for the Motors Liquidation Company GUC Trust

APPENDIX

References to the following exhibits in the Joint Statement of Facts should be struck as these exhibits are not in evidence:

1. Def. Ex. 123 (p. 20, n. 106)
2. Def. Ex. 141 (p. 29, n. 164)
3. Def. Ex. 149 (p. 29, n. 164)
4. Def. Ex. 151 (p. 29, n. 164)
5. Def. Ex. 152 (p. 29, n. 164)
6. Def. Ex. 157 (p. 29, n. 164)
7. Def. Ex. 181 (p. 29, n. 164)
8. Def. Ex. 185 (p. 29, n. 164)
9. Def. Ex. 187 (pgs. 33, 34, n. 191, 201)[1]
10. Def. Ex. 496 (p. 21, n. 109)[2]

In addition, references to the following exhibits in the Joint Statement of Facts, which are not in evidence, should be replaced with the exhibit numbers for duplicate exhibits that are in evidence:

1. Def. Ex. 111 (p. 18, n. 91) – replace with Pl. Ex. 93.
2. Def. Ex. 171 (p. 29, n. 164) – replace with Pl. Exs. 297 and 298.
3. Def. Ex. 172 (p. 29, n. 164) – replace with Pl. Ex. 421 (different Bates number but the same email).
4. Def. Ex. 173 (p. 29, n. 164) – replace with Pl. Ex. 114 (different Bates number but the same email).
5. Pl. Ex. 701 (p. 21, n. 113) – replace with Def. Ex. 498.

[1] Def. Ex. 187 was used in the examination of Mr. Racich, but not moved into evidence.

[2] Def. Ex. 496 was used in the deposition of Mr. Lopez, but not moved into evidence.

Index No. 9

ICLR: Chancery Appeal/Volume 8 /In re PARAGUASSU STEAM TRAMROAD COMPANY. BLACK & CO.'S CASE. - (1872) L.R. 8 Ch.App. 254

(1872) L.R. 8 Ch.App. 254

[COURT OF APPEAL IN CHANCERY]

In re PARAGUASSU STEAM TRAMROAD COMPANY. BLACK & CO.'S CASE.

1872 Dec. 11.

LORD SELBORNE, L.C., SIR W. M. JAMES and SIR G. MELLISH, L.JJ.

Company - Winding-up - Calls - Set-off.

In winding up a company, debts cannot be set off against calls.

A contractor agreed with a company to supply them with steam-engines at a fixed price, and to take shares in the company, payment of the calls on which should not be enforced until at least two engines should have been paid for, and the contractor might set off against the calls the money due to him. The contractor took shares accordingly, and made two engines for the company, which were not taken by the company or paid for. The company was afterwards ordered to be wound up by the Court, and a call was made by the liquidator:-

Held (reversing the decision of *Bacon*, V.C.), that the contractor could not set off the amount due to him from the company under his agreement as damages or otherwise against the amount due by him on the calls.

Brighton Arcade Company v. Dowling (1) disapproved of.

ON the 20th of October, 1868, Messrs. *Black & Co*., engineers, made an agreement with the *Paraguassu Steam Tramroad Company* for the supply of locomotive engines to the company on the following terms:- That *Black & Co*. would, for ten years, make all locomotive engines which the company should require, at £1100 for each engine, to be paid as therein provided. That during each of the first five years the company would accept

at least four of such engines, and during each of the next two years two of such engines. That the first order was to be for two engines. That all engines should be paid for when the delivery notes of the same were presented at the offices of the company. That instead of paying cash the company might give acceptances as therein provided. That *Black & Co*. would, by themselves or their nominees, subscribe for at least 198 £20 shares in the company, and would pay £6 on each share, being the amount of calls then made; and that no further payment of calls should be enforced in respect of such shares until at least two engines should have been paid for in the manner thereinbefore provided; and during the continuance of this agreement *Black & Co*. might set off against the calls upon all or any of the said shares the

(1) Law Rep. 3 C. P. 175.

amount which was due to them or for which they held the company's acceptances. That the company should pay, by way of liquidated damages, the sum of £500 for each engine which they should order and not accept.

Black & Co., in execution of this agreement, duly applied for and were allotted 198 shares, and paid £6 on each; and they were duly registered as shareholders. They then made two engines, and on the 6th of July, 1869, wrote to the company to say that they were ready. They received an answer that, pending advices from *Brazil*, the directors were anxious not to send out any engines. *Black & Co*. were not able to induce the company to take the engines, which remained in the hands of *Black & Co*.

On the 22nd of January, 1870, an order was made for winding up the company by the Court. An official liquidator was appointed, and a call of £12 a share was made.

Black & Co., who had been placed on the list of contributories in respect of the 198 shares, claimed to be creditors of the company for, 1, the sum of £2200 and interest for the two engines made, and a sum of £38 for the cost of warehousing them; and, 2, £500 liquidated damages for each of twelve other engines not made, but, as they contended, ordered; and they claimed to set off these sums against the call made on them. They produced evidence that the engines could not be disposed of, being of an unusual gauge, and that they had

gone to the expense of machinery on purpose for making these engines.

The matter came before the Vice-Chancellor *Bacon* on summons, and His Honour made an order that *Black & Co*. were entitled to set off against the call, £1000 as liquidated damages for the two engines actually made, £10 for interest thereon, and £38 for the cost of warehousing the engines; and that *Black & Co*. were to be at liberty to prove for other damages by reason of the non-performance of the agreement by the company, and to set off the sum so proved against the amount payable by them under the call (1).

The company appealed.

(1) 1872. Nov. 7.

SIR JAMES BACON, V.C., said that he did not think the 25th section of the *Companies Act*, 1867, and still less the decision of the Vice-Chancellor *Wickens* in *Cleland's Case* (Law Rep.

Mr. ***Eddis, Q.C.***, and Mr. ***Jackson***, for the Appellants:-

We say that calls cannot be set off against debts unless the contract to do so is registered under the *Companies Act*, 1867 (30 & 31

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14 Eq. 387), had anything to do with the matter before the Court. The statute prohibited the allotting of shares on any other terms than those of payment in cash; but that prohibition did

not apply to this case. This was an allotment of shares, and they were to be paid for in cash. There was no necessity for any registration of such a contract. The contract constituted by the allotment of the shares was a contract for the payment of money in respect of the shares. The question was, whether it was competent to the company, who were entitled to allot the shares and entitled to exact the payment for them in cash, to stipulate that when that payment in cash came to be made, then, by reason of other transactions between the parties, the amount of the debt due to the company should be set off against the payment in cash. His Honour did not find that *Cleland's Case* touched that question in the slightest degree. In *Cleland's Case*, a man to whom (let it be assumed) a debt was due, agreed to cancel that debt if the company would give him shares which he should not be required to pay for in cash. That was as directly in the teeth of the Act of Parliament as anything could be; but in neither of the subsequent cases, nor in any of the observations made by the Vice-Chancellor *Wickens*, was there anything which resembled or referred to a case like this.

The directors were perfectly at liberty to enter into this contract - a perfectly just, proper, and business-like contract. There was no money to pay with, and they entered into the contract with manufacturers for the supply of engines which were absolutely necessary for the accomplishment of the object of the company, agreeing to pay certain moneys at certain times in a certain way, and stipulating that the contractors should take shares in the company. There was a further stipulation that the company would not call upon the contractors for the payment in actual cash, and that if the company owed the contractors any money they should be at liberty to set it off against the cash due for the calls. What was there unreasonable in that? How did *Grissell's Case*, or any other case which had been cited, affect the question. It was a plain, simple, and honest contract, as to which his Honour saw no difficulty whatever.

To the extent of the liquidated damages there was a clear right of set-off.

The unliquidated damages stood on a different footing. His Honour agreed with *Black & Co*. that they might set off against the calls upon all or any of the shares the amount due to them or for which they held the company's acceptances; but the amount duo to them could only be ascertained and become due from the company when a jury, if it went to a jury, had determined the amount of the unliquidated damages to which they are entitled.

The £500 could not be taken as the right sum for damages.

After having heard further argument on this point, his Honour came to the conclusion that there must be an inquiry as to the amount of the unliquidated damages. The evidence was

Vict. c. 131, s. 25): *Grissell's Case* (1). In *Brighton Arcade Company v. Dowling* (2) the company was voluntarily wound up, and, moreover, the debt was subsequent: *Cleland's Case* (3). In some cases, such as *Elkington's Case* (4), the company got the equivalent of cash: here they got nothing. The public are entitled to know that the whole capital called up actually comes to the hands of the company, either in money or in money's worth. Here the only claim of *Black & Co*. is for a tort committed by the company in not taking and paying for these engines. It is the very mischief which this clause in the Act is intended to prevent. The rules in Bankruptcy do not prevail in winding up.

Mr. ***Kay, Q.C.***, Mr. ***Higgins, Q.C.***, and Mr. ***C. Hall***, for *Black & Co.*:-

We only took our shares on the faith of this agreement, and if the company is not bound by the agreement, we are not bound to take the shares, and ought to be struck off the list: *Alabaster's Case* (5). At all events, we ask to set off the sums due to us at the date of the call. At law we should have a right to set off the sums actually due to us, and the Winding-up Acts make no difference in the legal rights of the shareholders and creditors, but only in the mode of administering these rights. The 98th and 103rd sections of the *Companies Act*, 1862, do not interfere with any rights which shareholders may have. The only alteration is, that the liquidator takes the place of the directors. It is not true that

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that *Black & Co*. had made preparation for the execution of these orders, and had sustained a loss in consequence of not completing them, and they would probably have a right to compensation for the loss which they had sustained by reason of their not being able to complete their engines, and by reason of the default of the company in taking the whole number of engines. *Grissell's Case* had decided that for any debt a shareholder could not, in

the absence of special agreement, set off any call, but must come in and prove as a creditor. The 158th section of the Act of 1862 provided for all claims against the company, present or future, certain or contingent, ascertained or sounding only in damages; and the 25th Rule of the Gen. Ord. of 11th November, 1862, provided for valuing the claim as at the date of the order to wind up, the meaning of which was that there should be no after-claims.

(1) Law Rep. 1 Ch. 528.

(2) Ibid. 3 C. P. 175.

(3) Ibid. 14 Eq. 387.

(4) Ibid. 2 Ch. 511.

(5) Ibid. 7 Eq. 273.

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shareholders must always pay: *Elkington's Case* (1); *Pellatt's Case* (2). The case of unliquidated damages is expressly provided for by sect. 158 of the Act of 1862. It is not pretended that the agreement was not valid and within the powers of the directors; and the Act of 1867, with the exception perhaps of the 25th section, actually extends the powers of the directors: *In re Baglan Hall Colliery Company* (3). If the directors had given *Black & Co*. a mortgage on the calls, that would have been valid, and this is exactly the same. The agreement to take shares was part of the original agreement, and the company cannot hold *Black & Co*. to one part of the agreement and repudiate the other part. Whatever may be the case as to the damages for the other engines, the right of *Black & Co*. as to the two engines made is undeniable.

LORD SELBORNE, L.C. :-

The argument of the Respondents has extended to two points, one of which was and the other was not the subject of the decision of the Vice-Chancellor.

I propose first to advert to that point which was not the subject of decision by the Vice-Chancellor.

It has been argued that unless the Respondents are entitled to the set-off which they claim, they are entitled to be entirely exonerated from the liability of shareholders, and to have their names taken off the list of contributories. For that contention I can find no ground whatever, the facts being simply these:- [His Lordship then stated the facts of the case.] I should have thought, until I heard this argument, that it was much too late for any one to suggest that in a question with creditors, a registered shareholder could possibly be taken off the list on the ground of anything contained in such an agreement as that of the 20th of October. That is not the contract between himself and the company under which he was constituted a shareholder, but is a collateral and preliminary contract, though no doubt made in the expectation of his becoming a shareholder in consequence of the arrangement then made. The case of *Oakes v. Turquand* (4) decided that when a man has, under the 123rd section of the Act of

(1) Law Rep. 2 Ch. 511.

(2) Ibid. 527.

(3) Law Rep. 5 Ch. 346.

(4) Ibid. 2 H. L. 325.

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1862, with his own consent, become fully a legal shareholder by registration of shares which he has agreed to take, equities which might be good as between the shareholder and the company cannot,

after a winding-up, be set up against the creditors of the company. In this case, putting the argument of Mr. *Kay* and Mr. *Higgins* at the highest, it would be simply this, that we ought to set up an equity to rescind and avoid the contract for shares, on the ground that the consideration for that contract had more or less failed. In *Oakes v. Turquand* the House of Lords held that down to the very day of the winding-up, that is to say, the day which is to be considered under the Act of Parliament as the commencement of the winding-up, the contract was voidable at the option of the parties. But they further decided, that that option not having been exercised so as to avoid the contract before winding-up, it then ceased to be capable of being avoided as against creditors; and putting the argument of the Respondents at the highest, it could not be carried beyond that point. This is a question with creditors, and creditors only, and it arises after the winding-up, no attempt having been made to have their names withdrawn from the register before the commencement of the winding-up.

Pellatt's Case (1) has really no application whatever. There, according to the view the Court took of the facts, the liability of the alleged contributory to be treated as a shareholder rested *in fieri*. There had been no registration of him as a shareholder with his consent, and there can be no doubt that in that state of things creditors can have no better right than the company to the specific performance of an unexecuted contract with a person whose name is not duly upon the register. In those cases, what is a defence against the company is a defence against the creditors, because the alleged contributory is not a member, and cannot be made so except upon the terms of the contract, if any, by which he has agreed to become one.

Elkington's Case (2) is, in its circumstances, very similar to *Pellatt's Case*, with the exception that there Messrs. *Elkington* had, besides making the original agreement, at the same time applied for shares, had received notice of allotment, and had been registered in due course as shareholders. That case was decided the other

(1) Law Rep. 2 Ch. 527.

(2) Law Rep. 2 Ch. 511.

way, and it was held that, being complete legal shareholders, they could not, as against creditors, be released on the ground of anything collateral which might be contained in any other agreement. *Stace and Worth's Case* (1) has no application at all. There the shares, in respect of which alone the man could be made a shareholder, were held not to be well created.

I pass, therefore, from that portion of the case, and now come to the other. The Vice-Chancellor has here held, apparently upon the ground that an agreement had been made between the parties expressly to that effect, that calls made in the winding-up, and under the powers of the Act of Parliament, should be set off against the debt claimed by the shareholders, who are also creditors of the company. His Honour has gone further, and has said that this doctrine applies not only to the debt, but also to any unliquidated damages in respect of a breach of contract to be ascertained under the winding-up; and he has held that calls might be set off because there was a special agreement to that effect, though this is not merely a voluntary winding-up (if that would make any difference), but a winding-up by the Court. The point, therefore, which his Honour has decided is simply this: that a company may contract with one of its shareholders, so as to take him, in case of a winding-up, out of the law laid down in *Grissell's Case* (2), and give him, in substance, a right to be paid out of his own calls in preference to other creditors; which right, but for such special contract, he would not have had. It is probably enough to say that the law generally has been settled by *Grissell's Case* upon the interpretation of the Act of Parliament, and of the rules laid down in that Act of Parliament, as to the mode in which, under a winding-up, the money arising from calls is to be applied in payment of the debts of the creditors, *pari passu*, and without preference.

That case (being decided by an authority which we ought to treat as binding on ourselves, even if we doubted that it was right) has determined that in general such a set-off is not to be allowed. That decision being founded upon the interpretation of the Act of Parliament, it is very difficult to understand how it can be seriously argued that a company and one of its shareholders can, by

(1) Law Rep. 4 Ch. 682.

(2) Law Rep. 1 Ch. 528.

any agreement they choose to enter into between themselves, over-ride, and relieve themselves from the operation of the Act of Parliament. The principle of the winding-up enactments is like that of the Bankruptcy Acts. It is a particular statutory mode of doing justice between the members and the creditors of companies which have ceased to carry on business, and which, generally speaking, are insolvent. It is to be observed that, if the company is not insolvent, the law laid down in *Grissell's Case* (1) will do the shareholder no harm, because, if there is a surplus after paying all the debts in full, of course his debt will be paid among the rest, and the right of set-off will not be wanted to do justice between him and the other shareholders. That being so, it is impossible to entertain the idea that, if the law is as laid down in that case, any company can, by any private contract, take a particular creditor, who is also a shareholder, out of the operation of that law unless the contract comes within the permissive portion of the 25th section of the Act of 1867. But in this case the course prescribed by that section has not been followed, and I do not propose to say more on the subject, except that I greatly doubt whether that Act does not supply additional reason against holding that the set-off in this case can be allowed.

I think it right, rather in consequence of what was said by the Court of Common Pleas in the case of the *Brighton Arcade Company v. Dowling* (2) than for any other reason, to observe that I entertain no doubt whatever that *Grissell's Case* was decided on the soundest principles. What is the ordinary law of set-off? It is what in the civil law was called compensation, and simply means this: that when you have got two cross demands of a nature substantially the same, and due to and from *A*. and *B*. in the same right, that is to say, when the one is a creditor in his own right and debtor also in his own right to the other, the one debt may be set off against the other at the option of the party from whom payment is demanded. But it is essential in such cases that the rights should be substantially the same. If they were apparently the same at law but different in equity, set-off would not be allowed here; nor do I suppose that, in the present state of the law, it would be allowed at common law either. But here the rights

(1) Law Rep. 1 Ch. 528.

(2) Law Rep. 3 C. P. 175.

are substantially different. The moment that the winding-up takes place, the whole administration is

carried on with a view to the payment of the debts of the creditors, and in the first instance to payment *pari passu*. The different sections of the Act - those which define the liability of limited companies, the 7th, 8th, 23rd, and 38th - those which deal with the administration of assets, the 98th, 101st, and 133rd - those which give the power to make calls, not in the ordinary way, but specially for the purposes of this Act, the 102nd and 133rd - all have in view the payment, pari passu and equally, of the debts due to the creditors; and the hand which receives the calls necessarily receives them as a statutory trustee for the equal and rateable payment of all the creditors. The result of this contention, that one particular creditor may pay himself in full by retaining his own calls and not paying them, would, in effect, be to give him a preference, and to exonerate him from his obligation as a shareholder to contribute towards the payment of the debts of the other creditors. That appears to me to be utterly opposed to the whole principle of the law of set-off, and to all the provisions of the Act which bear on the subject.

As the case in the Common Pleas substantially is not before us I think it wiser and better not to say more on that subject than this: that, although recognizing the soundness of *Grissell's Case* (1), when the winding up is by the Court, or voluntary under the supervision of the Court, and professing not to depart from it, the Court of common Pleas has thought it inapplicable to a case of voluntary liquidation where the Court has not intervened; and, in order to arrive at that conclusion, has certainly shaken, by some of the observations made, a portion of the foundation for the conclusion in *Grissell's Case* - I mean that part of the judgment of Lord *Chelmsford* which relates to the 133rd section. The Court of Common Pleas apparently thought that a voluntary liquidation under the Act is a matter in which the shareholders merely are concerned. Whenever that subject shall be required to be reviewed and further considered, I hope attention will be paid to several sections in the Act, to which, as far as I can see, attention was not particularly directed on that occasion. I own that I am rather at a loss to see how that application of the

(1) Law Rep. 1 Ch. 528.

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assets in payment of all the debts *pari passu*, which the 133rd section expressly requires, can be made if one creditor is to retain the whole of his debt out of his calls in a way which will give him a preference over others. Yet that section is one which expressly applies to every voluntary liquidation; and if it should be said that creditors have no interest in a voluntary liquidation because the company may be presumed to be solvent, I hope, whenever that question comes to be considered again, attention may be directed to the third branch of the 129th section, which shews

that the pecuniary difficulties of the company are contemplated as one of the reasons for voluntary liquidation. I hope attention will also be directed to the 135th section, which, in a case of voluntary liquidation without reference to supervision, enables the meeting to delegate the liquidation to its creditors; also to the 152nd and 161st sections, which, in cases of voluntary liquidation, enable a majority of creditors to bind the minority by an arrangement which they make with the liquidators. Attention should also be directed to the 158th section, which introduces new rules as to proveable debts and liabilities, which are equally applicable to the case of voluntary liquidation; and, further, to the 138th section, which introduces in those cases, if an application is made to the Court, all the power which the Court would have in a case where it was itself winding up the company. This, in my judgment, would include, if proper applications were made, the power to allow a set-off in certain cases and not in others, as specified in the 101st section, and also the power to stay the actions of creditors.

I have thought it right to say so much, because it does seem to me a matter of great importance that a distinction tending to introduce different principles of administration, so far as creditors are concerned, between the cases of voluntary winding-up and winding up under supervision or by the Court, may not be finally established unless it be on very full consideration of everything in the statute that is material. It does not seem to me, I confess, a very satisfactory mode of arriving at such a distinction to say that the creditors may always go to the Court and get an order for supervision or for a compulsory winding-up, and that if they do not they may be considered as having no substantial interest

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in what is going on. This Court has on many occasions shewn a great disposition to encourage and support, as far as may be right and proper, the practice of voluntary winding-up. If creditors under a voluntary winding-up are in substantially a different position, there are probably very few cases in which it would not be expedient for them to induce the Court to interfere. If they are entitled fully to the same rights, they probably will not think it necessary to apply to the Court unless there is some reason to distrust the way in which the affairs are being conducted. Here, however, that point is not before us, because this is not the case of a voluntary winding-up. The circumstances are exactly those which happened in *Grissell's Case* (1). It is, in fact, that case over again.

I am clearly of opinion that it is not competent for any persons whatever, by any antecedent contract, to alter the administration of the assets of the company under such a winding-up. I am not at all sure that, on the construction of this particular contract, it is necessary to hold that there has been any attempt to do so; but even if there was an attempt, my judgment would be that that attempt is necessarily ineffectual, because it would be an attempt, by private agreement, to get out of and over-ride an Act of Parliament.

SIR W. M. JAMES, L.J. :-

I am of the same opinion; and I desire it to be understood that I concur in the doubts which the Lord Chancellor has expressed whether the case in the Common Pleas can be reconciled with *Grissell's Case*.

SIR G. MELLISH, L.J. :-

I am of the same opinion. The effect of the 38th section of the Act of 1862 is clearly to make every person who is at the time of the winding-up a shareholder, liable to contribute to the debts of the company, that liability being limited to the amount unpaid upon his shares. If there be an amount which at the time of the winding-up is unpaid on his shares, then he is liable to contribute that amount towards payment of the debts of the company.

(1) Law Rep. 1 Ch. 528.

In the present case that was plainly the position of *Black & Co*. at the time when the winding-up order was made. Then the 98th section says that the assets, which clearly include the unpaid portions of all shares, are to be applied in discharge of the liabilities. If the case stood upon that section alone it might be a very considerable question whether the meaning was not that the money was to be called up and applied among all the creditors, so that the shareholder should only receive his share of his debt; but that is, in my judgment, made quite clear by the 101st section. Although that section does not in terms say that there is to be no set-off, yet it shews that the Legislature, in framing that section, thought it had already been enacted that there should be no set-off, because in the 101st section they proceed to say that where there is unlimited liability, then, in the case of any independent contract, there may be a set-off. The reasonable distinction between a company with unlimited and limited liability is obvious. In the case of unlimited liability the reason of allowing the set-off in respect of one particular call is, that it does not at all prejudice the rights of the other creditors, because all the shareholders are liable to the fullest amount of everything they possess, and therefore if that call does not pay the creditors all their debts in the case of an unlimited company, then another call may be made on the shareholders, including this particular shareholder, and so on, until the shareholders have been made to pay everything they can pay and the debts are

satisfied. Therefore it appears to me to be plainly enacted that the assets are to be so dealt with, and it is quite clear that the company cannot, by making an agreement with a particular shareholder, save him from that liability which the Act of Parliament has imposed upon him.

Then as to the question whether this is ultrà vires, I am disposed to think that the contract is not really ultrà vires. It is only that the statute has put a certain construction upon it. Certain persons had agreed that there should be a set-off, and then the Act of Parliament says that that set-off shall not prevent the liability to pay up all the unpaid calls upon shares, but shall be binding as between the particular shareholder and the other shareholders after the creditors have been paid in full. The contract, as it appears to me, must be construed with reference to

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the provisions of the Act of Parliament, and the effect therefore is, that without being ultrà vires it cannot prevent those who plainly are contributories from being liable to be called upon in respect of the unpaid sums due from them.

Solicitors: Messrs. *Williamson, Hill, & Co.*; Messrs. *Wansey & Bowen*.

Index No. 10

SUPREME COURT OF CANADA

CITATION: Canada Trustco Mortgage Co. *v.* Canada, [2005] 2 S.C.R. 601, 2005 SCC 54

DATE: 20051019
DOCKET: 30290

BETWEEN:

Her Majesty the Queen
Appellant
v.
Canada Trustco Mortgage Company
Respondent

CORAM: McLachlin C.J. and Major, Bastarache, Binnie, LeBel, Deschamps, Fish, Abella and Charron JJ.

REASONS FOR JUDGMENT: (paras. 1 to 81)
McLachlin C.J. and Major J. (Bastarache, Binnie, LeBel, Deschamps, Fish, Abella and Charron JJ. concurring)

Canada Trustco Mortgage Co. *v.* Canada, [2005] 2 S.C.R. 601, 2005 SCC 54

Her Majesty The Queen *Appellant*

v.

Canada Trustco Mortgage Company *Respondent*

Indexed as: Canada Trustco Mortgage Co. *v.* Canada

Neutral citation: 2005 SCC 54.

File No.: 30290.

2005: March 8; 2005: October 19.

Present: McLachlin C.J. and Major, Bastarache, Binnie, LeBel, Deschamps, Fish, Abella and Charron JJ.

on appeal from the federal court of appeal

Income tax — Tax avoidance — Interpretation and application of general anti-avoidance rule — Mortgage company claiming substantial capital cost allowance following sale-leaseback transactions involving trailers — Whether general anti-avoidance rule applicable to deny tax benefit — Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 245.

CTMC carries on business as a mortgage lender, and as part of its business operations, it obtains large revenues from leased assets. CTMC purchased a number of trailers which it then circuitously leased back to the vendor in order to offset revenue from its leased assets by claiming a substantial capital cost allowance ("CCA") on the trailers for the 1997 taxation year. This arrangement allowed CTMC to defer paying taxes on the amount of profits reduced by the CCA deductions, which would be subject to recapture into income when the trailers were disposed of at a future date. The Minister of National Revenue reassessed CTMC and disallowed the CCA claim. On appeal, the Tax Court of Canada set aside the Minister's decision. The court found that the transaction fell within the spirit and purpose of the CCA provisions of the *Income Tax Act*, and concluded that the general anti-avoidance rule ("GAAR") in s. 245 of the Act did not apply to deny the tax benefit. The Federal Court of Appeal affirmed the Tax Court's decision.

Held: The appeal should be dismissed.

The application of the GAAR involves three steps. It must be determined: (1) whether there is a tax benefit arising from a transaction or series of transactions within the meaning of s. 245(1) and (2) of the *Income Tax Act*; (2) whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit"; and (3) whether there was abusive tax avoidance under s. 245(4), in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer. The burden is on the taxpayer to refute points (1) and (2), and on the Minister to establish point (3). Since the Crown has agreed with the Tax Court's finding that there was

a tax benefit and an avoidance transaction, the only issue in this case is whether there was abusive tax avoidance under s. 245(4). [17] [66-67]

Section 245(4) imposes a two-part inquiry. First, the courts must conduct a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act. Second, the court must examine the factual context of the case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose. Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions contemplated by the provisions. In the end, if the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer. [55] [58] [66]

Once the provisions of the *Income Tax Act* are properly interpreted, it is a question of fact for the Tax Court judge whether the Minister, in denying the tax

benefit, has established abusive tax avoidance under s. 245(4). Provided the Tax Court judge has proceeded on a proper construction of the provisions of the Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error. [46]

Here, the Tax Court judge's decision must be upheld. His conclusions were based on a correct view of the law and were grounded in the evidence. The transaction at issue was not so dissimilar from an ordinary sale-leaseback as to take it outside the object, spirit or purpose of the relevant CCA provisions of the Act. The purpose of the CCA provisions of the Act, as applied to sale-leaseback transactions, was, as found by the Tax Court judge, to permit the deduction of a CCA based on the cost of the assets acquired. This purpose emerges clearly from the scheme of the Act's CCA provisions as a whole. The Minister's suggestion that the usual result of the CCA provisions of the Act should be overridden by s. 245(4) in the absence of real financial risk or "economic cost" in the transaction must be rejected. This suggestion distorts the purpose of the CCA provisions by reducing them to apply only when sums of money are at economic risk. The applicable CCA provisions of the Act do not refer to economic risk. They refer only to "cost" and in view of the text and context of the CCA provisions, they use "cost" in the well-established sense of the amount paid to acquire the assets. Where Parliament has wanted to introduce economic risk into the meaning of cost related to CCA provisions, it has done so expressly. [74-75] [78] [80]

Cases Cited

Not followed: *OSFC Holdings Ltd. v. Canada*, [2002] 2 F.C. 288, 2001 FCA 260; **referred to:** *Mathew v. Canada*, [2005] 2 S.C.R. 643, 2005 SCC 55; *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804; *Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622; *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536; *Craven v. White*, [1989] A.C. 398; *W. T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1981] 1 All E.R. 865; *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336; *Water's Edge Village Estates (Phase II) Ltd. v. Canada*, [2003] 2 F.C. 25, 2002 FCA 291.

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APPEAL from a judgment of the Federal Court of Appeal (Rothstein, Evans and Pelletier JJ.A.) [2004] 2 C.T.C. 276, 2004 D.T.C. 6119, [2004] F.C.J. No. 249 (QL), 2004 FCA 67, affirming a decision of Miller J.T.C.C., [2003]

4 C.T.C. 2009, 2003 D.T.C. 587, [2003] T.C.J. No. 271 (QL), 2003 TCC 215. *Appeal dismissed.*

Graham Garton, Q.C., Anne-Marie Lévesque and *Alexandra K. Brown*, for the appellant.

Al Meghji, Monica Biringer and *Gerald Grenon*, for the respondent.

The judgment of the Court was delivered by

THE CHIEF JUSTICE AND MAJOR J. —

1. <u>Introduction</u>

1 This appeal and its companion case, *Mathew v. Canada*, [2005] 2 S.C.R. 643, 2005 SCC 55 (hereinafter "*Kaulius*"), raise the issue of the interplay between the general anti-avoidance rule ("GAAR") and the application of more specific provisions of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). The Act continues to permit legitimate tax minimization; traditionally, this has involved determining whether the taxpayer brought itself within the wording of the specific provisions relied on for the tax benefit. Onto this scheme, the GAAR has superimposed a prohibition on abusive tax avoidance, with the effect that the literal application of provisions of the Act may be seen as abusive in light of their context and purpose. The task in this appeal is to unite these two approaches in a framework that reflects the intention of Parliament in enacting the GAAR and achieves consistent, predictable and fair results.

2. Facts

2 The respondent, Canada Trustco Mortgage Company ("CTMC"), carries on business as a mortgage lender. As part of its business operations, CTMC enjoyed large revenues from leased assets. In 1996 it purchased a number of trailers which it then circuitously leased back to the vendor, in order to offset revenue from its leased assets by claiming considerable capital cost allowance ("CCA") on the trailers in the amount of $31,196,700 against $51,787,114 for the 1997 taxation year. The essence of the transaction is explained in the memorandum of Michael Lough, CTMC's officer in charge of the recommendation to proceed: "The transaction provides very attractive returns by generating CCA deductions which can be used to shelter other taxable lease income generated by Canada Trust." This arrangement allowed CTMC to defer paying taxes on the amount of profits reduced by the CCA deductions which would be subject to recapture into income when the trailers were disposed of at a future date and presumably in excess of the amount claimed as CCA.

3 The details of the transaction are complex and described in greater detail in the Appendix. Briefly stated, on December 17, 1996, CTMC, with the use of its own money and a loan of approximately $100 million from the Royal Bank of Canada, purchased trailers from Transamerica Leasing Inc. ("TLI") at fair market value of $120 million. CTMC leased the trailers to Maple Assets Investments Limited ("MAIL") who in turn subleased them to TLI, the original owner. TLI then prepaid all amounts due to MAIL under the sublease. MAIL placed on deposit an amount equal to the loan for purposes of making the lease payments and a bond was pledged as security to guarantee a purchase option payment to CTMC at the end of

the lease. These transactions allowed CTMC to substantially minimize its financial risk. They were also accompanied by financial arrangements with various other parties, not relevant to this appeal.

4 On October 18, 2002, the Minister of National Revenue reassessed CTMC on its 1997 taxation year and denied the CCA claim of $31,196,700 on the basis that CTMC had not acquired title to the trailers and, in the alternative, that the GAAR applied to deny the deduction. CTMC appealed to the Tax Court of Canada.

5 The Crown abandoned the argument that CTMC had failed to obtain title to the trailers and the appeal before the Tax Court proceeded solely on the issue of whether the GAAR applied to deny the deduction. A similar reassessment with respect to CTMC's 1996 taxation year was statute-barred. The Tax Court found in favour of CTMC, as did the Federal Court of Appeal. For the reasons that follow, we would dismiss the Crown's appeal.

3. Legislative Provisions

6 This appeal and its companion case *Kaulius* were brought and argued under s. 245 of the *Income Tax Act*. The relevant provisions of the Act, as they applied to the parties, read in part:

> **245. (1)** [Definitions] In this section,
>
> "tax benefit" means a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act;
>
> . . .
>
> "transaction" includes an arrangement or event.

(2) [General anti-avoidance provision] Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

(3) [Avoidance transaction] An avoidance transaction means any transaction

(*a*) that, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit; or

(*b*) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit.

(4) [Where s. (2) does not apply] For greater certainty, subsection (2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse of the provisions of this Act or an abuse having regard to the provisions of this Act, other than this section, read as a whole.

(5) [Determination of tax consequences] Without restricting the generality of subsection (2),

(*a*) any deduction in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,

(*b*) any such deduction, any income, loss or other amount or part thereof may be allocated to any person,

(*c*) the nature of any payment or other amount may be recharacterized, and

(*d*) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequences to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result, directly or indirectly, from an avoidance transaction.

. . .

248. . . .

(10) [Series of transactions] For the purposes of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series.

7 A recent amendment to s. 245 (*Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19, s. 52) has no application to the judgments under appeal. Although this amendment was enacted to apply retroactively, it cannot apply at this stage of appellate review, after the parties argued their cases and the Tax Court judge rendered his decision on the basis of the GAAR as it read prior to the amendment. Furthermore, even if this amendment were to apply, it would not warrant a different approach to the issues on appeal. In our view, this amendment to s. 245 serves *inter alia* to make it clear that the GAAR applies to tax benefits conferred by Regulations enacted under the *Income Tax Act*. The Tax Court judge in the instant case proceeded on this assumption, which was not challenged by the parties in submissions before us.

4. Judicial Decisions

4.1 *Tax Court of Canada*, [2003] 4 C.T.C. 2009, 2003 TCC 215

8 The Tax Court judge found an avoidance transaction giving rise to a tax benefit under s. 245(1) and (3) of the Act. He inquired into the purpose of the CCA provisions of the *Income Tax Act* as applied to sale-leaseback arrangements, in order to determine if the transaction was abusive under s. 245(4) of the Act. He held that the purpose of the CCA provisions permitted the deduction of CCA based on the "cost" of the trailers, as defined by the transactions documents. He went on to conduct a detailed analysis of the legal transactions. He found that CTMC had acquired title and became the legal owner of the trailers, and declined to

recharacterize the legal nature of the transaction. The transactions in issue, in his view, amounted to an ordinary sale-leaseback. The Tax Court judge found that the transaction fell within the spirit and purpose of the CCA provisions of the Act, and concluded that the GAAR did not apply to disallow the tax benefit.

4.2 *Federal Court of Appeal*, [2004] 2 C.T.C. 276, 2004 FCA 67

9 The Federal Court of Appeal unanimously dismissed the appeal, relying on the reasons in *OSFC Holdings Ltd. v. Canada*, [2002] 2 F.C. 288, 2001 FCA 260 ("*OSFC*"), in which the court had set out a two-stage analysis for abuse under the GAAR, focussed first on interpretation of the specific provisions at issue, second on the overarching policy of the *Income Tax Act*. Evans J.A., for the court, held that the Tax Court judge had not erred in concluding that, for the purposes of s. 245(4) of the Act, the transactions at issue did not constitute a misuse of a provision of the Act or an abuse of the CCA scheme as a whole. He noted that counsel for the appellant did not seek to recharacterize the transactions and did not allege that they were a sham, but argued instead that the policy underlying s. 20(1)(*a*) and the CCA provisions as a whole was "to permit taxpayers to claim CCA in respect of the 'real' or 'economic' cost that they incurred in acquiring an asset, and not the 'legal' cost, that is, on the facts of this case, the purchase price paid by the taxpayer" (para. 2). Going on to consider policy, Evans J.A. found that there was no clear and unambiguous policy underlying s. 20(1)(*a*) or the CCA scheme read as a whole that rendered the transaction a misuse or abuse of those provisions.

5. Analysis

5.1 *General Principles of Interpretation*

10 It has been long established as a matter of statutory interpretation that "the words of an Act are to 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": see *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804, at para. 50. The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.

11 As a result of the Duke of Westminster principle (*Commissioners of Inland Revenue v. Duke of Westminster*, [1936] A.C. 1 (H.L.)) that taxpayers are entitled to arrange their affairs to minimize the amount of tax payable, Canadian tax legislation received a strict interpretation in an era of more literal statutory interpretation than the present. There is no doubt today that all statutes, including the *Income Tax Act*, must be interpreted in a textual, contextual and purposive way. However, the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation. Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume

that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.

12 The provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently. As stated at para. 45 of *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622:

> [A]bsent a specific provision to the contrary, it is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable to those taxpayers who have not chosen to structure their transactions that way. [Emphasis added.]

See also *65302 British Columbia*, at para. 51, *per* Iacobucci J. citing P. W. Hogg and J. E. Magee, *Principles of Canadian Income Tax Law* (2nd ed. 1997), at pp. 475-76:

> It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision.

13 The *Income Tax Act* remains an instrument dominated by explicit provisions dictating specific consequences, inviting a largely textual interpretation. Onto this compendium of detailed stipulations, Parliament has engrafted quite a different sort of provision, the GAAR. This is a broadly drafted provision, intended to negate arrangements that would be permissible under a literal interpretation of other provisions of the *Income Tax Act*, on the basis that they amount to abusive tax avoidance. To the extent that the GAAR constitutes a "provision to the contrary" as

discussed in *Shell* (at para. 45), the Duke of Westminster principle and the emphasis on textual interpretation may be attenuated. Ultimately, as affirmed in *Shell*, "[t]he courts' role is to interpret and apply the Act as it was adopted by Parliament" (para. 45). The court must to the extent possible contemporaneously give effect to both the GAAR and the other provisions of the *Income Tax Act* relevant to a particular transaction.

5.2 *Interpretation of the GAAR*

14 The GAAR was enacted in 1988, principally in response to *Stubart Investments Ltd. v. The Queen*, [1984] 1 S.C.R. 536, which rejected a literal approach to interpreting the Act. At the same time, the Court rejected the business purpose test, which would have restricted tax reduction to transactions with a real business purpose. Instead of the business purpose test, the Court proposed guidelines to limit unacceptable tax avoidance arrangements. Parliament deemed the decision in *Stubart* an inadequate response to the problem and enacted the GAAR.

15 The *Explanatory Notes to Legislation Relating to Income Tax* issued by the Honourable Michael H. Wilson, Minister of Finance (June 1988) ("Explanatory Notes") are an aid to interpretation. The Explanatory Notes state at the outset that they "are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe". They state the purpose of the GAAR at p. 461:

> New section 245 of the Act is a general anti-avoidance rule which is intended to prevent abusive tax avoidance transactions or arrangements but at the same time is not intended to interfere with legitimate commercial and family transactions. Consequently, the new rule seeks to

distinguish between legitimate tax planning and abusive tax avoidance and to establish a reasonable balance between the protection of the tax base and the need for certainty for taxpayers in planning their affairs.

16 The GAAR draws a line between legitimate tax minimization and abusive tax avoidance. The line is far from bright. The GAAR's purpose is to deny the tax benefits of certain arrangements that comply with a literal interpretation of the provisions of the Act, but amount to an abuse of the provisions of the Act. But precisely what constitutes abusive tax avoidance remains the subject of debate. Hence these appeals.

17 The application of the GAAR involves three steps. The first step is to determine whether there is a "tax benefit" arising from a "transaction" under s. 245(1) and (2). The second step is to determine whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being "arranged primarily for *bona fide* purposes other than to obtain the tax benefit". The third step is to determine whether the avoidance transaction is abusive under s. 245(4). All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit.

5.3 *Tax Benefit*

18 The first step in applying the GAAR is to determine whether there is a tax benefit arising from a transaction or series of transactions of which the transaction is part.

19 "Tax benefit" is defined in s. 245(1) as "a reduction, avoidance or deferral of tax" or "an increase in a refund of tax or other amount" paid under the Act.

Whether a tax benefit exists is a factual determination, initially by the Minister and on review by the courts, usually the Tax Court. The magnitude of the tax benefit is not relevant at this stage of the analysis.

20 If a deduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction results in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. For example, characterization of an amount as an annuity rather than as a wage, or as a capital gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements. In all cases, it must be determined whether the taxpayer reduced, avoided or deferred tax payable under the Act.

5.4 *Avoidance Transaction*

21 The second requirement for application of the GAAR is that the transaction giving rise to the tax benefit be an avoidance transaction within s. 245(3). The function of this requirement is to remove from the ambit of the GAAR transactions or series of transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose. The majority of tax benefits claimed by taxpayers on their annual returns will be immune from the GAAR as a result of s. 245(3). The GAAR was enacted as a provision of last resort in order to address abusive tax avoidance, it was not intended to introduce uncertainty in tax planning.

22 A "transaction" is defined under s. 245(1) to include an arrangement or event. Section 245(3) specifically defines "avoidance transaction" as a transaction that results in a tax benefit, either by itself or as part of a series of transactions, "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit". These two underlined expressions warrant further discussion.

5.4.1 Series of Transactions

23 Section 245(2) reads:

> (2) [General anti-avoidance provision] Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

24 Section 245(3) reads in part:

> (3) [Avoidance transaction] An avoidance transaction means any transaction
>
> (*a*) that, but for this section, would result, directly or indirectly, in a tax benefit . . .; or
>
> (*b*) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit . . . .

25 The meaning of the expression "series of transactions" under s. 245(2) and (3) is not clear on its face. We agree with the majority of the Federal Court of Appeal in *OSFC* and endorse the test for a series of transactions as adopted by the House of

Lords that a series of transactions involves a number of transactions that are "pre-ordained in order to produce a given result" with "no practical likelihood that the pre-planned events would not take place in the order ordained": *Craven v. White*, [1989] A.C. 398, at p. 514, *per* Lord Oliver; see also *W. T. Ramsay Ltd. v. Inland Revenue Commissioners*, [1981] 1 All E.R. 865.

26 Section 248(10) extends the meaning of "series of transactions" to include "related transactions or events completed in contemplation of the series". The Federal Court of Appeal held, at para. 36 of *OSFC*, that this occurs where the parties to the transaction "knew of the . . . series, such that it could be said that they took it into account when deciding to complete the transaction". We would elaborate that "in contemplation" is read not in the sense of actual knowledge but in the broader sense of "because of" or "in relation to" the series. The phrase can be applied to events either before or after the basic avoidance transaction found under s. 245(3). As has been noted:

> It is highly unlikely that Parliament could have intended to include in the statutory definition of "series of transactions" related transactions completed in contemplation of a subsequent series of transactions, but not related transactions in the contemplation of which taxpayers completed a prior series of transactions.
>
> (D. G. Duff, "Judicial Application of the General Anti-Avoidance Rule in Canada: *OSFC Holdings Ltd. v. The Queen*" (2003), 57 I.B.F.D. Bulletin 278, at p. 287)

5.4.2 Primarily for *Bona Fide* Purposes

27 According to s. 245(3), the GAAR does not apply to a transaction that "may reasonably be considered to have been undertaken or arranged primarily for

bona fide purposes other than to obtain the tax benefit". If there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary. If so, the GAAR cannot be applied to deny the tax benefit.

28 While the inquiry proceeds on the premise that both tax and non-tax purposes can be identified, these can be intertwined in the particular circumstances of the transaction at issue. It is not helpful to speak of the threshold imposed by s. 245(3) as high or low. The words of the section simply contemplate an objective assessment of the relative importance of the driving forces of the transaction.

29 Again, this is a factual inquiry. The taxpayer cannot avoid the application of the GAAR by merely stating that the transaction was undertaken or arranged primarily for a non-tax purpose. The Tax Court judge must weigh the evidence to determine whether it is reasonable to conclude that the transaction was not undertaken or arranged primarily for a non-tax purpose. The determination invokes reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

30 The courts must examine the relationships between the parties and the actual transactions that were executed between them. The facts of the transactions are central to determining whether there was an avoidance transaction. It is useful to consider what will not suffice to establish an avoidance transaction under s. 245(3). The Explanatory Notes state, at p. 464:

> Subsection 245(3) does not permit the "recharacterization" of a transaction for the purposes of determining whether or not it is an

> **avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes.**

31 According to the Explanatory Notes, Parliament recognized the Duke of Westminster principle "that tax planning — arranging one's affairs so as to attract the least amount of tax — is a legitimate and accepted part of Canadian tax law" (p. 464). Despite Parliament's intention to address abusive tax avoidance by enacting the GAAR, Parliament nonetheless intended to preserve predictability, certainty and fairness in Canadian tax law. Parliament intends taxpayers to take full advantage of the provisions of the *Income Tax Act* that confer tax benefits. Indeed, achieving the various policies that the *Income Tax Act* seeks to promote is dependent on taxpayers doing so.

32 Section 245(3) merely removes from the ambit of the GAAR transactions that may reasonably be considered to have been undertaken or arranged primarily for a non-tax purpose. Parliament did not intend s. 245(3) to operate simply as a business purpose test, which would have considered transactions that lacked an independent *bona fide* business purpose to be invalid.

33 The expression "non-tax purpose" has a broader scope than the expression "business purpose". For example, transactions that may reasonably be considered to have been undertaken or arranged primarily for family or investment purposes would be immune from the GAAR under s. 245(3). Section 245(3) does not purport to protect only transactions that have a real business purpose. Parliament wanted many schemes that do not have any business purpose to endure. Registered Retirement Savings Plans (RRSPs) are one example. Parliament recognized that many provisions

of the Act confer legitimate tax benefits notwithstanding the lack of a real business purpose. This is apparent from the general language used throughout s. 245, as opposed to language which would have adopted a broad anti-avoidance test subject to exemptions for specific schemes like RRSP transactions.

34 If at least one transaction in a series of transactions is an "avoidance transaction", then the tax benefit that results from the series may be denied under the GAAR. This is apparent from the wording of s. 245(3). Conversely, if each transaction in a series was carried out primarily for *bona fide* non-tax purposes, the GAAR cannot be applied to deny a tax benefit.

35 Even if an avoidance transaction is established under the s. 245(3) inquiry, the GAAR will not apply to deny the tax benefit if it may be reasonable to consider that it did not result from abusive tax avoidance under s. 245(4), as discussed more fully below.

5.5 *Abusive Tax Avoidance*

36 The third requirement for application of the GAAR is that the avoidance transaction giving rise to a tax benefit be abusive. The mere existence of an avoidance transaction is not enough to permit the GAAR to be applied. The transaction must also be shown to be *abusive* under s. 245(4).

37 It is this requirement that has given rise to the most difficulty in the interpretation and application of the GAAR. A number of features have provoked judicial debate. The section is cast in terms of a double negative, stating that the

GAAR does "not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse . . . or an abuse". It is tempered by the word "reasonably", suggesting some ministerial and judicial leeway in determining abuse. It does not precisely define abuse or misuse. To further complicate matters, the English and French versions of s. 245(4) differ. Overarching these particular difficulties is the central issue of the relationship between the GAAR and more specific provisions of the Act.

5.5.1 <u>"Misuse and Abuse": Two Different Concepts?</u>

38 We turn first to the debate about "misuse" and "abuse" which has arisen from the different English and French versions of s. 245(4). This arises from the apparently disjunctive version of the subsection in English ("misuse of the provisions of this Act" or "abuse having regard to the provisions of this Act . . . read as a whole") and the non-disjunctive French version ("*d'abus dans l'application des dispositions de la présente loi lue dans son ensemble*"). This discrepancy led the majority of the Federal Court of Appeal to conclude in *OSFC* that s. 245(4) mandates two different inquiries. The first was whether there was a misuse of the particular provisions of the Act that were relied upon to achieve the tax benefit. The second was whether there was an abuse of any policy of the Act read as a whole. The term "policy" was used to refer collectively to purpose, object, spirit, scheme or policy (*OSFC*, at para. 66).

39 With respect, we cannot agree with this interpretation of s. 245(4). Parliament could not have intended this two-step approach, which on its face raises the impossible question of how one can abuse the Act as a whole without misusing

any of its provisions. We agree with the Tax Court judge, in the present case, at para. 90, that "[i]n effect, the analysis of the misuse of the provisions and the analysis of the abuse having regard to the provisions of the *Act* read as a whole are inseparable." As discussed more fully below, the interpretation of specific provisions of the Act cannot be separated from contextual considerations arising from other provisions. The various provisions of the *Income Tax Act* must be interpreted in their contextual framework, so that the Act functions as a coherent whole, with respect to the particular statutory scheme engaged by the transactions.

40 There is but one principle of interpretation: to determine the intent of the legislator having regard to the text, its context, and other indicators of legislative purpose. The policy analysis proposed as a second step by the Federal Court of Appeal in *OSFC* is properly incorporated into a unified, textual, contextual, and purposive approach to interpreting the specific provisions that give rise to the tax benefit.

41 The courts cannot search for an overriding policy of the Act that is not based on a unified, textual, contextual and purposive interpretation of the specific provisions in issue. First, such a search is incompatible with the roles of reviewing judges. The *Income Tax Act* is a compendium of highly detailed and often complex provisions. To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped. Did Parliament intend judges to formulate taxation policies that are not grounded in the provisions of the Act and to apply them to

override the specific provisions of the Act? Notwithstanding the interpretative challenges that the GAAR presents, we cannot find a basis for concluding that such a marked departure from judicial and interpretative norms was Parliament's intent.

42 Second, to search for an overriding policy of the *Income Tax Act* that is not anchored in a textual, contextual and purposive interpretation of the specific provisions that are relied upon for the tax benefit would run counter to the overall policy of Parliament that tax law be certain, predictable and fair, so that taxpayers can intelligently order their affairs. Although Parliament's general purpose in enacting the GAAR was to preserve legitimate tax minimization schemes while prohibiting abusive tax avoidance, Parliament must also be taken to seek consistency, predictability and fairness in tax law. These three latter purposes would be frustrated if the Minister and/or the courts overrode the provisions of the *Income Tax Act* without any basis in a textual, contextual and purposive interpretation of those provisions.

43 For these reasons we conclude, as did the Tax Court judge, that the determinations of "misuse" and "abuse" under s. 245(4) are not separate inquiries. Section 245(4) requires a single, unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance.

5.5.2 Abusive Tax Avoidance: A Unified Interpretative Approach

44 The heart of the analysis under s. 245(4) lies in a contextual and purposive interpretation of the provisions of the Act that are relied on by the taxpayer, and the application of the properly interpreted provisions to the facts of a given case. The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law. The textual, contextual and purposive interpretation of specific provisions of the *Income Tax Act* is essentially a question of law but the application of these provisions to the facts of a case is necessarily fact-intensive.

45 This analysis will lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions of the *Income Tax Act* in order to achieve an outcome that those provisions seek to prevent. As well, abusive tax avoidance will occur when a transaction defeats the underlying rationale of the provisions that are relied upon. An abuse may also result from an arrangement that circumvents the application of certain provisions, such as specific anti-avoidance rules, in a manner that frustrates or defeats the object, spirit or purpose of those provisions. By contrast, abuse is not established where it is reasonable to conclude that an avoidance transaction under s. 245(3) was within the object, spirit or purpose of the provisions that confer the tax benefit.

46 Once the provisions of the *Income Tax Act* are properly interpreted, it is a question of fact for the Tax Court judge whether the Minister, in denying the tax benefit, has established abusive tax avoidance under s. 245(4). Provided the Tax Court judge has proceeded on a proper construction of the provisions of the Act and

on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.

47 The first part of the inquiry under s. 245(4) requires the court to look beyond the mere text of the provisions and undertake a contextual and purposive approach to interpretation in order to find meaning that harmonizes the wording, object, spirit and purpose of the provisions of the *Income Tax Act*. There is nothing novel in this. Even where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities. "After all, language can never be interpreted independently of its context, and legislative purpose is part of the context. It would seem to follow that consideration of legislative purpose may not only resolve patent ambiguity, but may, on occasion, reveal ambiguity in apparently plain language." See P. W. Hogg and J. E. Magee, *Principles of Canadian Income Tax Law* (4th ed. 2002), at p. 563. In order to reveal and resolve any latent ambiguities in the meaning of provisions of the *Income Tax Act*, the courts must undertake a unified textual, contextual and purposive approach to statutory interpretation.

48 As previously stated, the predominant issue in this and its companion appeal is what constitutes abusive tax avoidance. The Explanatory Notes state in part, at pp. 464-65:

> Subsection 245(4) recognizes that the provisions of the Act are intended to apply to transactions with real economic substance, not to transactions intended to exploit, misuse or frustrate the Act to avoid tax. It also recognizes, however, that a number of provisions of the Act either contemplate or encourage transactions that may seem to be primarily tax-motivated. . . . It is not intended that section 245 will apply to deny the tax benefits that result from these transactions as long as they are carried out within the object and spirit of the provisions of the Act read as a

> whole. Nor is it intended that tax incentives expressly provided for in the legislation would be neutralized by this section.
>
> Where a taxpayer carries out transactions primarily in order to obtain, through the application of specific provisions of the Act, a tax benefit that is not intended by such provisions and by the Act read as a whole, section 245 should apply. This would be the case even though the strict words of the relevant specific provisions may support the tax result sought by the taxpayer. Thus, where applicable, section 245 will override other provisions of the Act since, otherwise, its object and purpose would be defeated.
>
> . . . Thus, in reading the Act as a whole, specific provisions will be read in the context of and in harmony with the other provisions of the Act in order to achieve a result which is consistent with the general scheme of the Act.
>
> Therefore, the application of new subsection 245 must be determined by reference to the facts in a particular case in the context of the scheme of the Act. . . . This can be discerned from a review of the scheme of the Act, its relevant provisions and permissible extrinsic aids.

49 In all cases where the applicability of s. 245(4) is at issue, the central question is, having regard to the text, context and purpose of the provisions on which the taxpayer relies, whether the transaction frustrates or defeats the object, spirit or purpose of those provisions. The following points are noteworthy:

(1) While the Explanatory Notes use the phrase "exploit, misuse or frustrate", we understand these three terms to be synonymous, with their sense most adequately captured by the word "frustrate".

(2) The Explanatory Notes elaborate that the GAAR is intended to apply where under a literal interpretation of the provisions of the *Income Tax Act*, the object and purpose of those provisions would be defeated.

(3) The Explanatory Notes specify that the application of the GAAR must be determined by reference to the facts of a particular case in the context of the scheme of the *Income Tax Act*.

(4) The Explanatory Notes also elaborate that the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance.

50 As previously discussed, Parliament sought to address abusive tax avoidance while preserving consistency, predictability and fairness in tax law and the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear.

51 The interpretation of the provisions giving rise to the tax benefit must, in the words of s. 245(4) of the Act, have regard to the Act "read as a whole". This means that the specific provisions at issue must be interpreted in their legislative context, together with other related and relevant provisions, in light of the purposes that are promoted by those provisions and their statutory schemes. In this respect, it should not be forgotten that the GAAR itself is part of the Act.

52 In general, Parliament confers tax benefits under the *Income Tax Act* to promote purposes related to specific activities. For example, tax benefits associated with business losses, CCA and RRSPs, are conferred for reasons intrinsic to the activities involved. Unless the Minister can establish that the avoidance transaction frustrates or defeats the purpose for which the tax benefit was intended to be conferred, it is not abusive.

53 Care must be taken in assessing the purposes for which the provisions at issue confer a tax benefit. "The [*Income Tax Act*] is a complex statute through which Parliament seeks to balance a myriad of principles" (*Shell*, at para. 43). The conferring of particular tax benefits can serve a variety of independent and interlocking purposes. These range from imposing fair business accounting principles and promoting particular kinds of commercial activity, to providing family and social benefits.

54 In interpreting the provisions of the *Income Tax Act*, the statutory language must be respected and should be interpreted according to its well-established legal meaning. In some cases, a contextual and purposive interpretation may add nuance to the well-established legal meaning of the statutory language. Section 245(4) does not rewrite the provisions of the *Income Tax Act*; it only requires that a tax benefit be consistent with the object, spirit and purpose of the provisions that are relied upon.

55 In summary, s. 245(4) imposes a two-part inquiry. The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids. The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.

56 The Explanatory Notes elaborate that the provisions of the *Income Tax Act* are intended to apply to transactions with real economic substance. Although the expression "economic substance" may be open to different interpretations, this

statement recognizes that the provisions of the Act were intended to apply to transactions that were executed within the object, spirit and purpose of the provisions that are relied upon for the tax benefit. The courts should not turn a blind eye to the underlying facts of a case, and become fixated on compliance with the literal meaning of the wording of the provisions of the *Income Tax Act*. Rather, the courts should in all cases interpret the provisions in their proper context in light of the purposes they intend to promote.

57 *Courts have to be careful not to conclude too hastily that simply because* a non-tax purpose is not evident, the avoidance transaction is the result of abusive tax avoidance. Although the Explanatory Notes make reference to the expression "economic substance", s. 245(4) does not consider a transaction to result in abusive tax avoidance merely because an economic or commercial purpose is not evident. As previously stated, the GAAR was not intended to outlaw all tax benefits; Parliament intended for many to endure. The central inquiry is focussed on whether the transaction was consistent with the purpose of the provisions of the *Income Tax Act* that are relied upon by the taxpayer, when those provisions are properly interpreted in light of their context. Abusive tax avoidance will be established if the transactions frustrate or defeat those purposes.

58 Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their

context and purpose. When properly interpreted, the statutory provisions at issue in a given case may dictate that a particular tax benefit may apply only to transactions with a certain economic, commercial, family or other non-tax purpose. The absence of such considerations may then become a relevant factor towards the inference that the transactions abused the provisions at issue, but there is no golden rule in this respect.

59 Similarly, courts have on occasion discussed transactions in terms of their "lack of substance" or requiring "recharacterization". However, such terms have no meaning in isolation from the proper interpretation of specific provisions of the *Income Tax Act*. The analysis under s. 245(4) requires a close examination of the facts in order to determine whether allowing a tax benefit would be within the object, spirit or purpose of the provisions relied upon by the taxpayer, when those provisions are interpreted textually, contextually and purposively. Only after first, properly construing the provisions to determine their scope and second, examining all of the relevant facts, can a proper conclusion regarding abusive tax avoidance under s. 245(4) be reached.

60 A transaction may be considered to be "artificial" or to "lack substance" *with respect to specific provisions* of the *Income Tax Act*, if allowing a tax benefit would not be consistent with the object, spirit or purpose of those provisions. We should reject any analysis under s. 245(4) that depends entirely on "substance" viewed in isolation from the proper interpretation of specific provisions of the *Income Tax Act* or the relevant factual context of a case. However, abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the

provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.

61 A proper approach to the wording of the provisions of the *Income Tax Act* together with the relevant factual context of a given case achieve balance between the need to address abusive tax avoidance while preserving certainty, predictability and fairness in tax law so that taxpayers may manage their affairs accordingly. Parliament intends taxpayers to take full advantage of the provisions of the Act that confer tax benefits. Parliament did not intend the GAAR to undermine this basic tenet of tax law.

62 The GAAR may be applied to deny a tax benefit only after it is determined that it was not reasonable to consider the tax benefit to be within the object, spirit or purpose of the provisions relied upon by the taxpayer. The negative language in which s. 245(4) is cast indicates that the starting point for the analysis is the assumption that a tax benefit that would be conferred by the plain words of the Act is not abusive. This means that a finding of abuse is only warranted where the opposite conclusion — that the avoidance transaction was consistent with the object, spirit or purpose of the provisions of the Act that are relied on by the taxpayer — cannot be reasonably entertained. In other words, the abusive nature of the transaction must be clear. The GAAR will not apply to deny a tax benefit where it may reasonably be considered that the transactions were carried out in a manner consistent with the object, spirit or purpose of the provisions of the Act, as interpreted textually, contextually and purposively.

5.6 *Burden of Proof*

63 The determination of the existence of a tax benefit and an avoidance transaction under s. 245(1), (2) and (3) involves factual decisions. As such, the burden of proof is the same as in any tax proceeding where the taxpayer disputes the Minister's assessment and its underlying assumptions of facts. The initial obligation is on the taxpayer to "refute" or challenge the Minister's factual assumptions by contesting the existence of a tax benefit or by showing that a *bona fide* non-tax purpose primarily drove the transaction: see *Hickman Motors Ltd. v. Canada*, [1997] 2 S.C.R. 336, at para. 92. It is not unfair to impose this burden, as the taxpayer would presumably have knowledge of the factual background of the transaction.

64 By contrast, the inquiry into abusive tax avoidance under s. 245(4) involves a textual, contextual and purposive analysis of the provisions on which the tax benefit is based. We see no reason to maintain the distinction between a theoretical and practical perspective on the burden of proof, adopted by the majority of the Federal Court of Appeal in *OSFC*. The Federal Court of Appeal held that there is no burden on either party at the stage of interpreting the provisions at issue, since this is a question of law, which is ultimately for the court to decide. It went on to state at para. 68 that "from a practical perspective, . . . [t]he Minister should set out the policy with reference to the provisions of the Act or extrinsic aids upon which he relies".

65 For practical purposes, the last statement is the important one. The taxpayer, once he or she has shown compliance with the wording of a provision, should not be required to disprove that he or she has thereby violated the object, spirit or purpose of the provision. It is for the Minister who seeks to rely on the GAAR to

identify the object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated, when the provisions of the Act are interpreted in a textual, contextual and purposive manner. The Minister is in a better position than the taxpayer to make submissions on legislative intent with a view to interpreting the provisions harmoniously within the broader statutory scheme that is relevant to the transaction at issue.

5.7 *Summary*

66 The approach to s. 245 of the *Income Tax Act* may be summarized as follows.

1. Three requirements must be established to permit application of the GAAR:

(1) A *tax benefit resulting from a transaction* or part of a series of transactions (s. 245(1) and (2));

(2) that the transaction is an *avoidance transaction* in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and

(3) that there was *abusive tax avoidance* in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

2. The burden is on the taxpayer to refute (1) and (2), and on the Minister to establish (3).

3. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.

4. The courts proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act.

5. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose.

6. Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported

to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.

7. Where the Tax Court judge has proceeded on a proper construction of the provisions of the *Income Tax Act* and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error.

6. Application to the Facts of This Case

67 The appellant Crown agreed with the finding of the Tax Court judge that there was a tax benefit and an avoidance transaction. Therefore, the only issue is whether there was abusive tax avoidance under s. 245(4).

68 The respondent purchased and leased trailers in order to generate CCA deductions, which were then used to shelter other taxable lease income generated by CTMC. It is common ground that on their face, the CCA provisions permit the deductions claimed. It is also common ground that a standard sale-leaseback transaction, involving qualifying assets, where the vendor is also the lessee, is consistent with the object, spirit or purpose of the CCA provisions. However, the appellant submits that the manner in which the respondent structured and financed the purchase, lease and sublease of the trailers contravened the object, spirit or purpose of the CCA regime and resulted in abusive tax avoidance under s. 245(4) of the *Income Tax Act*.

69 As discussed above, the practical burden of showing that there was abusive tax avoidance lies on the Minister. The abuse of the Act must be clear, with the result that doubts must be resolved in favour of the taxpayer. The analysis focusses on the purpose of the particular provisions that on their face give rise to the benefit, and on whether the transaction frustrates or defeats the object, spirit or purpose of those provisions.

70 The appellant submits that the object and spirit of the CCA provisions are "to provide for the recognition of money spent to acquire qualifying assets to the extent that they are consumed in the income-earning process", relying on the reasons of Noël J.A. in *Water's Edge Village Estates (Phase II) Ltd. v. Canada*, [2003] 2 F.C. 25, 2002 FCA 291, at para. 44. The appellant submits that the transaction involved no real risk and that CTMC thus did not actually spend $120 million to purchase the trailers from TLI. In the appellant's view, CTMC created a "cost for CCA purposes that is an illusion" without incurring any "real" expense. This, the appellant argues, contravenes the object and spirit of the CCA provisions and constitutes abusive tax avoidance within s. 245(4) of the Act. The appellant summarizes its main submission as follows:

> In this case, the pre-ordained series of transactions misuses and abuses the CCA regime because it manufactures a cost for CCA purposes that does not represent the real economic cost to CTMC of the trailers. CTMC borrowed $97.4 million from the Royal Bank, but . . . the loan was effectively repaid in its entirety on the day it was made. The assignment by CTMC to the Bank of MAIL's rent payments under the lease continued the circular flow of money . . . . <u>There was no risk at all that the rent payments would not be made.</u> Even the $5.9 million that CTMC apparently paid in fees was fully covered as it, along with the rest of CTMC's contribution of $24.9 million in funding, will be reimbursed when the $19 million bond pledged to CTMC matures in December 2005 at $33.5 million.

> CTMC incurred no real economic cost, and thus was not entitled to any "recognition for money spent to acquire qualifying assets". [Emphasis added; paras. 80-81.]

71 The respondent takes a different view of the purpose of the CCA provisions and the transaction. It relies on the Tax Court judge's conclusion that the transaction was a profitable commercial investment and fully consistent with the object and spirit of the Act. The respondent submits that its deductions were permitted under the "Leasing Property Rules" and the "Specified Leasing Property Rules" of the Act. It argues that the specific rules enacted by Parliament to address CCA on leased assets are plainly a vital part of the statutory scheme, and that the GAAR cannot be utilized to change the scope of those rules. The respondent submits that it is the policy of the Act that "cost" means the price that the taxpayer gave up in order to get the asset, except in specific and precisely prescribed circumstances not here applicable. The respondent argues that the GAAR cannot be used to override Parliament's explicit policy decision to limit the scope of the rules.

72 The respondent argues that the transaction was consistent with the object and spirit of the legislation. The Act's inclusion of specific provisions that take "cost" to mean the amount "at risk" in limited circumstances illustrates the general policy of the Act that the term "cost" outside of those specific provisions means cost as understood at law, namely the amount paid. A cost is not reduced to reflect a mitigation of economic risk. In the result, the respondent argues that on the facts of this case "it may reasonably be considered that the transaction would not result directly or indirectly in a misuse . . . or an abuse . . ." under s. 245(4).

73 We are of the view that the appellant's arguments do not reflect a proper interpretation of the GAAR and that the respondent's position should prevail. We are led to this conclusion by a textual, contextual and purposive interpretation of the relevant provisions of the *Income Tax Act*.

74 Textually, the CCA provisions use "cost" in the well-established sense of the amount paid to acquire the assets. Contextually, other provisions of the Act support this interpretation. Finally, the purpose of the CCA provisions of the Act, as applied to sale-leaseback transactions, was, as found by the Tax Court judge, to permit deduction of CCA based on the cost of the assets acquired. This purpose emerges clearly from the scheme of the CCA provisions within the Act as a whole. The appellant's argument was not that the purpose of these provisions was unclear, but rather that the GAAR ought to override their accepted purpose and effect, for reasons external to the provisions themselves.

75 The appellant suggests that the usual result of the CCA provisions of the Act should be overridden in the absence of real financial risk or "economic cost" in the transaction. However, this suggestion distorts the purpose of the CCA provisions by reducing them to apply only when sums of money are at economic risk. The applicable CCA provisions of the Act do not refer to economic risk. They refer only to "cost". Where Parliament wanted to introduce economic risk into the meaning of cost related to CCA provisions, it did so expressly, as, for instance, in s. 13(7.1) and (7.2) of the Act, which makes adjustments to the cost of depreciable property when a taxpayer receives government assistance. "Cost" in the context of CCA is a well-understood legal concept. It has been carefully defined by the Act and the jurisprudence. Like the Tax Court judge, we see nothing in the GAAR or the object

of the CCA provisions that permits us to rewrite them to interpret "cost" to mean "amount economically at risk" in the applicable provisions. To do so would be to invite inconsistent results. The result would vary with the degree of risk in each case. *This would offend the goal of the Act to provide sufficient certainty and predictability* to permit taxpayers to intelligently order their affairs. For all these reasons, we agree with the Tax Court judge's conclusion that the "cost" was $120 million, not zero as argued by the appellant.

76 The appellant's submissions on this point amount to a narrow consideration of the "economic substance" of the transaction, viewed in isolation from a textual, contextual and purposive interpretation of the CCA provisions. It did not focus on the purpose of the CCA provisions read in the context of the Act as a whole, to determine whether the tax benefit fell outside the object, spirit or purpose of the relevant provisions. Instead, it simply argued that since there was (as it alleged) no "real economic cost", the GAAR must apply. As discussed earlier, the application of the GAAR is a complex matter of statutory interpretation in which the object, spirit and purpose of the provisions giving rise to the tax benefit are assessed in light of the requirements and wording of the GAAR. While the "economic substance" of the transaction may be relevant at various stages of the analysis, this expression has little meaning in isolation from the proper interpretation of specific provisions of the Act. Any "economic substance" must be considered in relation to the proper interpretation of the specific provisions that are relied upon for the tax benefit.

77 The appellant originally suggested that the GAAR should be used to override the usual effect of the CCA provisions for a second reason — namely that the relationships and transactions that are expressed in the documents are abusive of the

provisions of the *Income Tax Act* and should be set aside. It properly abandoned this argument and the submission that the transaction was a sham before the Federal Court of Appeal. Here the documents detailing the transaction left no uncertainty as to the relationships between the parties. CTMC paid $120 million to TLI for the equipment, partly with borrowed funds and partly with its own money. Having become the owner of the equipment, it leased it to MAIL. MAIL then subleased it back to the vendor, TLI. The relationships between the parties as expressed in the relevant documentation were not superfluous elements; they were the very essence of the transaction.

78 As the Tax Court judge concluded, under the CCA scheme, "[l]eases of such [exempt] properties will continue to be viewed as acceptable means of providing lower cost financing" (para. 67). TLI's use of the money ultimately reduced the risk, but a company in the financing business is expected to do what it can to reduce risk. Therefore, the way the borrowed money was used provided no grounds for concluding that there was abusive tax avoidance. The Tax Court judge, after considering all the circumstances, found that the transaction was not so dissimilar from an ordinary sale-leaseback to take it outside the object, spirit or purpose of the relevant CCA provisions of the Act and Regulations.

79 In determining the result in this appeal, the Tax Court judge's conclusions on matters of fact should not be displaced provided that they are based on the correct legal analysis and find support in the evidence.

80 The Tax Court judge's analysis on the issue of abuse under s. 245(4) is largely consistent with the approach to the application of the GAAR we have adopted. He rejected the two-stage overriding-policy approach to abuse and misuse. He went

on to inquire into the policy or purpose underlying the CCA treatment in sale-leaseback arrangements. Construing the CCA provisions as a whole, he rejected the submission that "cost" in the relevant provisions of the Act should be reread as "money at risk", and he also rejected the argument that the "economic substance" of the transaction determined that there was abusive tax avoidance. He conducted a detailed analysis of the transactions to determine whether they fell within the object, spirit or purpose of the CCA provisions. In the end, he concluded that a tax benefit was consistent with the object, spirit and purpose of the CCA provisions and held that the GAAR could not apply to disallow the tax benefit. These conclusions were based on a correct view of the law and were grounded in the evidence. They should be confirmed.

7. Conclusion

81 We would dismiss the appeal with costs.

APPENDIX

1. The following parties weave through the multiple transactions at one point or another:

Canada Trustco Mortgage Company ("CTMC" or "Purchaser" or "Lessor" or "Borrower"), respondent, was a large diversified financial institution carrying on business in Canada.

Royal Bank of Canada (Canadian branch) ("RBC" or "Lender").

Transamerica Leasing Inc. ("TLI" or "Vendor" or "Sublessee"), a corporation in the United States.

Maple Assets Investments Limited ("MAIL" or "Lessee" or "Sublessor"), a limited liability company incorporated under the laws of England.

Maple Assets Charitable Trust ("MACT" or "Trust"), constituted by an instrument of trust dated December 17, 1996, owns 100 percent of the shares in MAIL.

Royal Bank of Canada Trust Company (Jersey) Limited ("RBC Jersey" or "Trustee") is the trustee of MACT and is a wholly owned subsidiary of RBC, incorporated in Jersey.

Royal Bank of Canada Trust Corporation Limited ("RBCTC" or "Manager"), a company incorporated in England, undertook to manage and fulfil the affairs and obligations of MAIL under the relevant transactions and to provide the directors and officers of MAIL.

Transamerica Finance Corporation ("TFC" or "Guarantor"), the parent corporation of TLI, who guaranteed to MAIL the performance of all TLI's obligations under the sublease agreement and to CTMC all TLI's obligations under the "Equipment Purchase Agreement".

Macquarie Corporate Finance (USA) Inc. ("Lease Arranger").

II. CTMC held as part of its ongoing business a portfolio of loans and leases to generally larger corporations and government agencies. CTMC testified that it was looking for a leasing arrangement in the range of $100 million. It specified the type of equipment (long-term assets that were easy to value, such as tractors or trailers), the duration of the lease and the strength of the proposed lessee. The structure of the leasing arrangement was left to the Lease Arranger. The trailers remained in the possession of TLI and CTMC continued to own the trailers, to lease them out, and to earn income from them. CTMC previously entered into similar arrangements to the one implemented in this case. The Lease Arranger arranged the TLI deal which was approved by CTMC's Board of Directors. The key transactions proceeded as follows:

The Purchase and Sale of the Trailers

III. On December 17, 1996, CTMC and TLI entered into an agreement for the purchase and sale of trailers at a fair market value of $120 million. TLI agreed to sell and CTMC agreed to purchase the trailers absolutely and ownership in the trailers passed from TLI to CTMC.

IV. On December 17, 1996, for administrative convenience, CTMC appointed TLI as trustee and agent of CTMC to hold in TLI's name, the certificate of title, certificate of ownership, registration and like documentation in respect of the trailers.

Lease of the Trailers to MAIL and the Option to Purchase

V. The terms of the Lease between CTMC and MAIL included the following:

1. the term was for an initial period ending December 1, 2014;

2. the rent payments under the Lease were based upon an effective interest rate of 8.5 percent;

3. MAIL, as lessee, was required to make semi-annual payments to CTMC; and

4. MAIL was provided with an option to purchase the trailers, $84 million being the First Option Value on December 1, 2005 and another option exercisable at the fair market value on December 1, 2014.

Sublease of the Trailers to TLI

VI. Most of the terms of the Sublease to TLI are similar to those in the Lease to MAIL. The Sublease provided TLI with purchase options similar to those provided to MAIL.

Security for the Sublease

VII. On December 17, 1996, pursuant to the terms of the Sublease, TLI prepaid all amounts due to MAIL under the Sublease (approximately $120 million). As a result of the prepayment, TLI had no ongoing Sublease

payment obligations and there was no credit risk to MAIL under the terms of the Sublease. TLI maintained certain obligations with respect to indemnities and early termination. TLI retained a net present value benefit of 3.35 percent of the cost of the trailers being the difference between the payment TLI received from CTMC for the sale of the trailers and the prepayment of rent TLI paid to MAIL.

Security for the Lease

VIII. On December 17, 1996, MAIL applied the prepayment it received from TLI as follows:

1. MAIL placed on deposit with the RBC an amount equal to the Loan (approximately $100 million); and

2. MAIL paid the balance of the prepayment (approximately $20 million) to RBC Jersey on the condition that RBC Jersey use these funds to purchase a Government of Ontario Bond ("Bond"), maturing on December 1, 2005.

IX. On December 17, 1996, the Bond was pledged to CTMC as security for MAIL's obligation to pay the Purchase Option Payments or the Termination Values under the Lease. The risk of the inability of MAIL to pay the First Option Value was removed by the acquisition of the Bond and the provision to CTMC of a security interest in the Bond.

Security for the Loan

X. On December 17, 1996, CTMC assigned to RBC the rent payments owed to CTMC from MAIL under the Lease. CTMC also provided MAIL with an irrevocable instruction to pay the assigned rent payments to RBC such that RBC would apply the rent payments directly to the installment payments due by CTMC to RBC under the terms of the Loan Agreement. RBC's recourse under the Loan was limited to the rent payments assigned to it by CTMC.

XI. The rent payments under the Lease and a portion of the First Option Value would be applied to pay off the RBC loan and the remainder of the purchase option price would be covered by the Bond.

The Effect of Non-Recourse Debt on Regulatory Capital Requirements

XII. The use of non-recourse debt to finance the purchase of the trailers significantly improved CTMC's management of regulatory capital requirements.

Guarantees

XIII. On December 18, 1996, TFC, the parent corporation of TLI, unconditionally and irrevocably guaranteed to MAIL and to CTMC the performance of TLI's obligations under the relevant transactions.

Reversibility of the Transactions

XIV. The transactions in issue could be unwound if there were adverse changes affecting CTMC.

Return on Investment

XV. CTMC would realize a before-tax return of approximately $8.5 million from the transactions.

Appeal dismissed with costs.

Solicitor for the appellant: Deputy Attorney General of Canada, Ottawa.

Solicitors for the respondent: Osler, Hoskin & Harcourt, Toronto.

Index No. 11

CASES, MATERIALS AND NOTES ON PARTNERSHIPS AND CANADIAN BUSINESS CORPORATIONS

Puri, Anand, Daniels, Dhir, Iacobucci, Lee, MacIntosh, Waitzer & Ziegel

Fifth Edition

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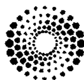

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Chapter 2

Evolution of Business Corporations Law and the Nature of Corporate Personality

1. INTRODUCTION

In this introductory part of the chapter, we begin with a description of the evolution of Canadian corporations law (subsection (a)) and of the constitutional basis for corporations law (b), before presenting the statutory provisions that establish the separate legal personality of corporations (c) and the classic decision of the House of Lords in *Salomon v. Salomon & Co.* (d).

(a) History of Canadian Business Corporation Law

(i) British Origins

The evolution of Canadian corporations law has been much influenced by British and American law. The British influence is the older of the two. Since a knowledge of the history of British company law is also important for an understanding of the early Canadian developments, it will be appropriate to start with it here.

The common law recognizes two principal forms of incorporation, *viz.* (a) incorporation by exercise of the royal prerogative (usually referred to as incorporation by letters patent or, more colloquially, royal charter), and (b) incorporation by a private or general act of the legislature. Until well into the eighteenth century incorporation by royal charter was by far the most common method. Even it was used very sparingly until the sixteenth and seventeenth centuries to incorporate companies with commercial purposes such as the Hudson Bay Company, the London East India Company and the Levant Company for overseas trade and colonization of territories. These early charters were usually accompanied by monopolies of one description or another. Limited liability was not expressly conferred by these charters and limited liability for investors did not become a controversial issue until the early part of the nineteenth century.

By the turn of the eighteenth century there was a lively trade in royal charters of companies, and this was accompanied by frenetic speculation in the shares of these companies. The South Sea Company was the most

notorious of them. It nearly collapsed in 1720 amidst much scandal and allegations of corruption in high places. That same year Parliament adopted the "*Bubble Act*" (6 Geo. 1, c. 18), an obscure piece of legislation, the only sure feature of which was that it substantially froze the development of British company law for over a century and generally cast commercial companies under a pall.

The beginning of the industrial revolution in the United Kingdom was accompanied by growing pressure for the repeal of the *Bubble Act* and a more accessible form of incorporation. The *Bubble Act* was repealed in 1825, but the first general Act for the incorporation of companies, the *Joint Stock Companies Act* (7 & 8 Vic. cc. 110 & 111), was not adopted until 1844. This Act introduced incorporation by registration, the method that has remained in dominant use in the U.K. since then and subsequently became the standard model of incorporation in most of the Commonwealth. However, the Act of 1844 still withheld the privilege of limited liability. The difficulties were compounded because the courts held that the joint stock companies were merely large partnerships and that each shareholder was a partner, even though the management of the companies was usually vested in directors or trustees.

The battle for limited liability was finally won in 1855 with the adoption of the *Limited Liability Act* (18 & 19 Vic., c. 133). This Act also introduced the requirement that incorporated companies with limited liability include the term "Limited" or "Ltd." as part of the company's name so as to warn the public of this "dangerous" new entity! The 1855 Act and earlier legislation were replaced in 1862 by the *Companies Act* (25 & 26 Vic., c. 89). This is the title by which all subsequent general companies legislation in the U.K. has come to be identified. The 1862 Act also became the model for several of the later Canadian provincial Acts.

(ii) Early Canadian Corporations Law

None of the Canadian provinces and territories adopted general incorporation legislation before the middle of the nineteenth century. Prior to this period, incorporation by private Act was the common procedure and was used substantially for the same purposes as in the U.K.

The first general legislation consisted of two Acts, both passed in 1849, one for Upper Canada and the other for Lower Canada. These authorized the incorporation of joint stock companies for the construction of roads and bridges. Both provided for incorporation by registration of appropriate documents with the registrar of the counties through which the road was to pass or in which the work was to be situated. The 1849 Acts were followed by a more broadly aimed Act of 1850 which permitted the incorporation of companies for "manufacturing, mining, mechanical and chemical purposes." This too was a registration Act and was modelled on a New York statute of 1848.

In 1860 another general Act was adopted for the incorporation of commercial companies and this provided for incorporation by judicial decree. In 1864, a third general Act, *viz.* by Letters Patent issued under the seal of the Governor in Council. According to Wegenast (*The Law of Canadian Companies* (1931)), the idea of incorporation by letters patent pursuant to a general Act may have been suggested by an English Act of 1844 for the incorporation of joint stock banks. The letters patent method of incorporation exerted great influence on the general incorporation Acts of other provinces and on federal corporate legislation. It was not abolished in Ontario until 1970, and not by the federal government until the adoption of the *Canada Business Corporations Act* (CBCA) in 1975.

The first general incorporation Act was adopted by the federal Parliament in 1869. This repealed the pre-Confederation legislation providing for incorporation by registration and judicial decree and re-enacted the Act of 1864. The 1864 Act also served as a model for the subsequent incorporation legislation of New Brunswick, Manitoba and Prince Edward Island. The other provinces (British Columbia, Alberta, Saskatchewan and Nova Scotia) adopted at different times the British method of incorporation by registration and also adopted many of the other provisions in the British Act of 1862. One of the unfortunate consequences of this schism was that at a crucial conceptual level Canada was divided into two camps, since the method of incorporation also brought in its train important substantive differences. A further difficulty arose because it was not always easy to determine how much of the English jurisprudence, built as it was around companies incorporated by registration, was relevant to companies incorporated by letters patent. That rift has only been healed (and only partly at that) over the past 30 years with the re-introduction of incorporation by registration.

(iii) Modern Canadian Corporations Law

Until the 1960s, Canadian corporation law developments largely consisted of fleshing out and amending the nineteenth century legislation, and there were few basic conceptual changes. A new era in corporate legislation was introduced in 1970 with the adoption of an entirely new Act, the Ontario *Business Corporations Act* (OBCA) (R.S.O. 1970, c. 53). The Act largely implemented the recommendations of the Interim Report of the Select Committee on Company Law ("Report of the Lawrence Committee") which was published in 1967. The new Ontario Act replaced incorporation by letters patent with incorporation by registration, permitted the incorporation of one-person corporations, largely immunized third parties from the effects of the *ultra vires* doctrine, regularized pre-incorporation contracts, introduced a new regulatory framework for the issuance and transfer of investment securities, partially codified the duties of directors and officers, regulated insider trading in the corporation's securities, permitted derivative actions and improved minority shareholder protection in other important respects.

peers in construing legislation and therefore much less reluctant to give words their ordinary meaning even if this leads to anomalous results. Second, there were prominent barristers such as Francis B. Palmer, the author of a leading company law text that is still widely used in England, who thought British partnership law constituted a trap for the unwary investor and who welcomed the 1856 Act as a solution to these difficulties. Palmer published in 1877 an influential text, *Private Companies: Their Formation and Advantages*, which did much to encourage the incorporation of private companies. Third, the "Great Depression," which hit Victorian England and lasted from 1873-1896, reminded the business community of the vulnerability of unincorporated partnerships and made incorporation and the limited liability it conferred very attractive.

These cumulative factors presumably influenced the law lords in *Salomon* in deciding to reverse the Court of Appeal's decision. The House of Lords' decision also appears to have won widespread approval. The report of the Loreburn Committee in 1906 on company law amendments recommended the formal recognition of private companies and their being relieved from several onerous requirements incumbent on public companies. These recommendations were implemented in the *Companies Act* of 1907.

2. LIMITED LIABILITY AND CREDITOR PROTECTION

(a) Statutory Provisions

In *Salomon*, the creditors of Salomon & Co. could look only to the corporation, and not to its shareholder Aron Salomon, for payment of what they were owed. The protection of their personal assets from liability is, as Lord Macnaghten observed, one of the reasons why entrepreneurs use the corporate form rather than carrying on business as an unincorporated proprietorship or partnership.

In most jurisdictions, the limited liability of shareholders is today provided for by statute. For instance, s. 45(1) of the CBCA and s. 87(1) of the BCBCA provide that, with some exceptions (discussed below), a shareholder is not liable for the obligations of the corporation. Limited liability does not inevitably flow from the proposition that the corporation is a separate entity. Some early general incorporations statutes provided for unlimited shareholder liability. Today, three jurisdictions permit the formation of companies with unlimited shareholder liability: see BCBCA, part 2.1; and *Business Corporations Act*, R.S.A. 2000, c. B-9, part 2.1; and *Nova Scotia Companies Act*, R.S., c. 81, s. 9(c).

3. PIERCING THE CORPORATE VEIL

(a) What is Piercing the Corporate Veil?

The expression "piercing the corporate veil" or "lifting the corporate veil" can refer to two distinct legal phenomena each of which may be described, loosely, as "disregard[ing] the separate legal personality of a corporation" (*642947 Ontario Ltd. v. Fleischer*, 2001 CarswellOnt 4296, 56 O.R. (3d) 417 (Ont. C.A.)). First, the expression can refer to the imposition of liability upon the shareholders of a corporation for the obligations of the corporation. A person wronged by an impecunious corporation might ask a court to hold the corporation's shareholders liable for her loss — that is, to pierce the corporate veil.

Second and more generically, the expression can refer to the non-recognition of the separate personality of a corporation where the correct construction of a statutory or other legal standard so requires. Sometimes, for instance, in construing words that might be thought to refer to a single legal person (such as "owner," or "employer" or "taxpayer"), a court will decide that the relevant unit of analysis is not a corporation in isolation but a corporation together with other entities such as its parent, subsidiary or shareholders. For instance, in *De Salaberry v. Minister of National Revenue*, excerpted below, the Federal Court took into account the conduct of a group of corporations under common ownership in characterizing the actions of one of them of tax purposes, rather than viewing the taxpayer's conduct in isolation.

(b) What is the Basis for Piercing the Corporate Veil?

At first glance, corporations statutes are clear in providing that the corporation is a legal person separate and distinct from its shareholders and that the latter are not liable for the obligations of the former. For instance, the CBCA provides, at s. 45, that "the shareholders of a corporation are not, as shareholders, liable for any liability, act or default of the corporation" (except in three specific circumstances not relevant here). Nevertheless, courts have repeatedly stated that, sometimes, the legal personality of the corporation may be disregarded for the purpose of imposing liability directly upon shareholders or if necessary for the correct construction or application of a legal standard.

What is the legal justification for doing so? The jurisprudence has been criticized (including by judges themselves) for incoherence — in *Clarkson Co. Ltd. v. Zhelka*, excerpted below, Thompson J. stated that the cases on veil-piercing "illustrate no consistent principle." He went on to offer, as an approximation of the underlying principle, that the separate personality of a corporation will not be upheld where it would produce results "flagrantly opposed to justice." But "justice" is a vague concept. As you study the decisions excerpted in this part of the chapter, try to flesh the concept out by (i) identifying the facts that courts have treated as material in determining

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apply equally to the corporation and its directors, officers, shareholders, agents and employees. For applications of similar provisions, see *Corkery v. Foster Wedekind* (1987), 45 D.L.R. (4th) 159, 1987 CarswellAlta 262 (Q.B.) and *Sandilands v. Powell*, 2003 ABCA 162, 2003 CarswellAlta 956, 330 A.R. 92 (Alta. C.A.).

It appears that interest in professional corporations in Canada is (or was) largely motivated by tax considerations. Fundamentally, the benefits associated with professional corporations versus limited liability partnerships vary by type of professional, size of firm, and objective of incorporation (Vern Krishna, "Professional Corporations" (2005) 25:9 Lawyers Weekly (QL)).

(e) Unlimited Liability Companies

Alone among Canadian jurisdictions, Nova Scotia permits the incorporation of "unlimited liability companies" ("ULCs"), which are corporations without limits on the liability of their members (see *Companies Act*, R.S.N.S. 1989, c. 81, s. 9(c)). A ULC's name may not include the words "limited" or "incorporated", although it can use the words "company" or "Co." and identify itself as a ULC. The liability of members of a ULC is unlimited, but, unlike partners who bear direct liability to creditors on an ongoing basis, the liability of ULC members arises only on the winding up of the ULC in the event that its assets are insufficient to meet its obligations. Members can limit their personal liability to third parties by contract, and there are numerous limitations on the liability of former members (*Companies Act*, s. 135). In addition, investors in a ULC typically insulate themselves from unlimited personal liability by interposing a limited liability corporation or limited partnership between themselves and the ULC.

The principal reason for using a ULC is the fact that US tax rules permit the ULC to elect to be taxed as a partnership in the US, even though it is a corporation for all purposes (including tax) in Canada.

6. CORPORATE NAMES

One of the more important matters that must be decided upon in the incorporation process is the selection of a corporate name. The legislation in all jurisdictions seeks to regulate the use of corporate names, primarily with a view to ensuring that the public will not be misled by confusingly similar corporate names. The statutory provisions vary from province to province, both in the degree of their complexity and in the detail of their requirements. The relevant statute must be consulted in each case to determine the appropriate requirements. See, for example, *CBCA* ss. 10–13 and *OBCA* ss. 8-12. There may be additional statutory requirements outside of the corporation law statutes. For example, in Ontario, a corporation must comply with the *Business Names Act* R.S.O. 1990 c. 17 (*BNA*) in order to register its name. Per s. 7(1) of the *BNA*, a corporation must comply with

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In re WHITEHOUSE & CO.

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1878
July 27.

Company—Voluntary Liquidation—Contributory—Debt due from Company—Right of Set-off against Calls—Companies Act, 1862, *ss.* 38, 101, 138.

Where a limited company is in voluntary liquidation, a contributory cannot set off a debt due to him from the company against calls made against him either by the company before or by the liquidator after the resolution to wind up.

Brighton Arcade Company v. *Dowling* (1) disapproved of.

Statement.

WHITEHOUSE & Co., Limited, was a company duly registered under the *Companies Act*, 1862.

At a meeting of the company held on the 7th of December, 1877, a resolution was passed for a voluntary winding-up, and a liquidator was appointed.

This was a summons taken out by the liquidator, asking that *David Rose* and *Henry Fulwood Rose*, who had both been settled on the list of contributories, might be ordered to pay respectively the sums of £289 2*s.* 9*d.* and £142 7*s.* alleged to be due from them in respect of calls made, as to part, by the directors of the company shortly before the date of the resolution to wind up, and as to the remainder, by the liquidator since that date.

Against his call *David Rose* claimed to set off the sum of £272 17*s.* 5*d.* due to him from the company on two promissory notes; and *Henry Fulwood Rose*, being a creditor of the company for £2500 advanced by him on mortgage, refused to make any payment whatever on account of his call, contending that he was entitled to set off the same against the mortgage debt.

Both contributories were admitted by the liquidator to be creditors of the company for the amounts claimed.

The summons was argued before his Lordship in Chambers, but was, by his Lordship's direction, adjourned into Court for judgment.

Argument.

Millar, for the liquidator, contended that there was no right in a shareholder to set off a debt due to him from the company

(1) Law Rep. 3 C. P. 175.

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against calls in a voluntary winding-up; and cited *Grissell's Case* (1); *Black & Co.'s Case* (2), in which the contrary decision of the Court of Common Pleas in *Brighton Arcade Company* v. *Dowling* (3) was disapproved of; *Gibbs and West's Case* (4); and *Stone* v. *City and County Bank* (5).

Everitt, for Messrs. *Rose*, relied on *Brighton Arcade Company* v. *Dowling* as an authority precisely in point; and also cited *Barnett's Case* (6), in which *Calisher's Case* (7) was discussed.

Judgment.

JESSEL, M.R.:—

This case was argued before me in Chambers, but as it raised a question of very great general importance, and as to which the authorities are conflicting, I said I would give my judgment in Court, and I now give judgment accordingly.

The application was an application under the 138th section of the *Companies Act*, 1862, by the liquidator under a voluntary winding-up of this company, that two contributories of the name of *David Rose* and *Henry Fulwood Rose* might pay sums respectively of £289 2*s.* 9*d.* and £142 7*s.* which were due from them partly in respect of a call made by the company before the winding-up, and partly in respect of a call made by the liquidator in the course of the voluntary winding-up.

The amounts due on the calls were not disputed, but the contributories claimed to be allowed as set-off, as regards *David Rose*, nearly the whole amount of the claim, and as regards *Henry Fulwood Rose*, the whole amount, because he said he was a creditor for a larger sum. The liquidator admitted that the two contributories were creditors for those respective amounts, and therefore the only question that I have to decide is whether, under those circumstances, they were liable to pay the calls, or whether they were entitled to the benefit of the sets-off claimed.

Now the question as regards set-off has been the subject of judicial decision, and no doubt is a matter of the greatest import-

(1) Law Rep. 1 Ch. 528.
(2) Ibid. 8 Ch. 254.
(3) Ibid. 3 C. P. 175.
(4) Law Rep. 10 Eq. 312.
(5) 3 C. P. D. 282.
(6) Law Rep. 19 Eq. 449.
(7) Law Rep. 5 Eq. 214.

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ance. On the one side there is an authority, which I must consider in point, cited on behalf of the contributories; and on the other side there are certain authorities cited—and to which I shall refer—questioning the soundness of that authority.

The case cited on behalf of the contributories was the case of the *Brighton Arcade Company* v. *Dowling* (1). The chief cases cited on behalf of the liquidator were the well-known case of *Grissell* (2) and the case of *Black & Co.* (3), which certainly throw very great doubt on the decision of the Court of Common Pleas.

On considering the matter, I came to the conclusion that it was open to me to decide the case, notwithstanding the case in point decided by the Court of Common Pleas, and notwithstanding that the case was decided ten years ago, and was a decision of the full Court of Common Pleas.

Now the real point, I think, should be first considered on principle; then I will consider one or two sections of the Act of Parliament, and then the authorities.

First of all, it must be remembered that at common law there was originally no right of set-off at all, and it was not till the statutes of set-off in the beginning of the reign of *George* II. that there was any such right established; and when we look at the terms of those Acts of Parliament—there were two of them (4) —it is plain they only applied to what was then an action at common law—and so it has been held—and that they only applied to the case of mutual debts, whatever they might be. That was followed by the Courts of Equity and extended; that is to say, certain cases were held to be within the equity of the statutes, although not within their actual words. Courts of Equity allowed set-off, but the Court of Equity, following the spirit of the statutes, would not allow a man to set off, even at law, where there was an equity to prevent his doing so; that is to say, where the rights, although legally mutual, were not equitably mutual.

That being the state of the law, it is obvious that when you have a demand at law to set off against a Plaintiff, it must be

(1) Law Rep. 3 C. P. 175.
(2) Ibid. 1 Ch. 528.
(3) Ibid. 8 Ch. 254.
(4) 2 Geo. 2, c. 22, s. 13, and 8 Geo. 2, c. 24, ss. 4, 5.

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a demand of something due from the Plaintiff to the Defendant, otherwise there would be nothing to set off. If the claim against the Plaintiff were assigned or otherwise disposed of for value, the set-off would not arise at all; and the same principle applies in other cases where the legal demand is transferred or assigned. We have often had the well-known illustration of a bill of exchange indorsed over for value before it is due, so as no longer to be in the hands of the Defendant at the time of action brought. That being so, a question would immediately arise, if one of the parties became bankrupt, as to whether there was any set-off or not. In the case of bankruptcy the moneys due to the bankrupt before the bankruptcy would be distributable amongst the creditors and no longer payable to the bankrupt; and inasmuch as the Bankruptcy Acts enabled the assignee, who is now called a trustee, to sue in his own name—for he took under a legal assignment—of course, if he sued a Defendant, there was no debt due from him to the Defendant, although there might be a debt due from the bankrupt to the Defendant, and consequently, in terms, this form of set-off would not apply. It was to avoid that injustice that in the Bankruptcy Acts clauses of set-off were inserted, and which clauses are in fact rather wider than the Statutes of Set-off. I only observe upon that to shew that, in disposing of the bankrupt's rights as against his debtors, the Legislature found it necessary, in order to ascertain what should be included in the assets for the payment of creditors generally, to insert special provisions for set-off, otherwise there might be none.

So the law stood as regards individuals; and as regards companies there were several Acts of Parliament for winding them up, and finally the Act of 1862. Before going into the details of that Act, I may state the scheme of the Act as regards winding-up—which was this, that the assets of the company were to be collected by the liquidator and distributed among the creditors; and in the case of an insolvent company it was very like bankruptcy; but if the assets were to be so distributed, of course, if the liquidator sued in his own name, he would not be indebted at all to the man to whom the company was indebted, and there would be no strict right of set-off. Whether that was affected or not by the provisions of the Act that enabled him to sue in the name of the com-

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pany, I will consider further on. If he comes under those sections —notably the 138th section—in a voluntary winding-up, he comes in his own name as liquidator to enforce a call, and strictly speaking, there is no actual set-off, because he is not indebted.

If, therefore, you want a set-off at all, you must shew some provision in the Act itself giving the right of set-off, because in principle there is no such right. The debt due to the liquidator is distributable among the creditors, and the debt due to the individual from the company would only rank with the view of obtaining a dividend for the creditor for the amount due. The two debts are not applicable to the same purposes, and could not properly be made the subject of set-off. Therefore it appears to me that the onus lies upon the man who says that there is this right of set-off to point out the provisions in the Act of Parliament giving that right.

Now, when we look at the Act of Parliament, which is the next thing I have to consider, it is plain there is no such right. First of all, it must be remembered that the 38th section of the Act, which directs what is to be paid in the case of a winding-up by the shareholders of a limited company, creates new rights, and rights which did not exist before the passing of the *Companies Act*, 1862, and rights which do not exist till there is a winding-up. That point was decided by the House of Lords in the case of *Webb* v. *Whiffin* (1), that it was in fact a new right, or rather a new liability as regards the shareholders; and that section alone, for this purpose, regulates their liability.

When you come to look at the section you find that it applies to all kinds of winding-up; that is to say, to a winding-up by an order of the Court, to a winding-up voluntarily, and to a voluntary liquidation under the supervision of the Court; there is no distinction. The section says: "In the event of a company formed under this Act being wound up, every present and past member of such company shall be liable to contribute to the assets of the company to an amount sufficient for payment of the debts and liabilities of the company." That is a new liability; he is to contribute; it is a new contribution. It is a mistake to call that a debt due to the company. It is no such thing. It is not,

(1) Law Rep. 5 H. L. 711.

as has been supposed, in any shape or way a debt due to the company, but it is a liability to contribute to the assets of the company; and when we look further into the Act, it will be seen that it is a liability to contribution to be enforced by the liquidator. It is quite true that a call made before the winding-up—and in the case before me a call was made before the winding-up—is a debt due to the company, but that does not affect this new liability to contribution.

But there are certain limits to the liability. This being a limited company, the only limit which it is necessary to refer to is that stated in the 4th sub-section of the 38th section: "In the case of a company limited by shares, no contribution shall be required from any member exceeding the amount, if any, unpaid on the shares in respect of which he is liable as a present or past member." Now, first of all, as regards the calls made in the winding-up, they being calls for something unpaid on the shares, that is a contribution due by the member under the Act, and is not a debt due to the company. The contribution also under this section applies to the unpaid calls made before the winding-up; because, though that is a debt due to the company, it is not the less an amount unpaid on the shares in respect of which he is liable, and therefore he must be liable to contribute all that is unpaid on his shares. As I said before, it is as much unpaid if he had not paid the calls made before the winding-up, as it is in respect of the amount unpaid on the shares in respect of which no call has been made before the winding-up. It seems to me that the contributories' liability created by the 38th section being only limited to the amount unpaid, it is immaterial, for the purpose of this section, whether the call was made before or after the winding-up, provided the amount is unpaid. That being so, it is a liability to contribute which, in the case of an ordinary winding-up, is of course enforceable by the Court; but so it is in a voluntary winding-up.

Then the 138th section of the Act says that the liquidator may apply to the Court "to exercise, as respects the enforcing of calls, or in respect of any other matter, all or any of the powers which the Court might exercise if the company were being wound up by the Court;" and this summons is taken out under that section.

There is, therefore, no difference whatever; the liquidator may come to the Court in a voluntary winding-up, and say "Enforce the payment of the contributions due from the contributories under the 38th section."

It appears to me there is no possible distinction when you look at those two sections between the duty of the Court when applied to by a voluntary liquidator, and the duty of the Court when applied to by an official liquidator. If there is no debt due from the contributory to the company, how can he set off a debt due from the company to him against the contribution? It is a contribution to the assets enforceable by the liquidator, and not at all a debt. When you look at the Act there is really no question of set-off as between calls—that is, the amount unpaid on the shares —and a debt due by the company to the contributory.

Then there is one other section which I may refer to in addition to the sections that enable the liquidator to sue in the name of the company if he thinks fit. The 101st section—and I think it is the only section which deals in terms with this right of set-off—has an application to debts; but it does not at all interfere with the 38th section as to liability to contribution. The 101st section is this: "The Court may, at any time after making an order for winding up the company, make an order on any contributory for the time being settled on the list of contributories, directing payment to be made, in manner in the said order mentioned, of any moneys due from him or from the estate of the person whom he represents to the company, exclusive of any moneys which he or the estate of the person whom he represents may be liable to contribute by virtue of any call made or to be made by the Court in pursuance of this part of this Act." That excludes calls in the winding-up. It would include a call made before the winding-up. Then it goes on, "And it may, in making such order, when the company is not limited, allow to such contributory by way of set-off any moneys due to him or the estate which he represents from the company on any independent dealing or contract with the company, but not any moneys due to him as a member of the company in respect of any dividend or profit: Provided that when all the creditors of any company, whether limited or unlimited, are paid in full, any moneys due on any account whatever to any

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contributory from the company may be allowed to him by way of set-off against any subsequent call or calls."

Therefore this section empowers the Court to direct payment of any debt of the company, and it may allow, where the company is not limited, a set-off. Surely that does not allow the Court to do it where the company is limited. If there is any implication to be drawn from the section at all, it is that set-off is not to be allowed when the company is limited, though I do not think that is wanted, because, as I said before, I can see no ground on principle, on looking at the sections of the statute, for saying that there is a debt due from the contributory to the company, it being in fact the amount of his contribution to the assets for the benefit of the creditors.

So that when you look at the 101st section, so far as it goes it strengthens—if that was wanted—the proposition that there is no set-off to be allowed in the case of a limited company, for a sum of money due from the company to a person liable to the company. The proviso shews that when all the creditors are paid you may set off whether the company is limited or unlimited. Here, again, the inference is that you cannot do it before the creditors are paid. So that when you look at the wording of the 101st section, it is quite plain, as it appears to me, that, having regard to that section as well as the other sections of the Act, there is no ground for such a set-off as between the contribution under the 38th section, which includes calls made either before or after the winding-up—that is, anything unpaid on shares—and a debt due by the company to the contributory.

That being so on principle and on the construction of the Act, I must now look at the authorities, because they are somewhat difficult to deal with.

Now in the first case cited on behalf of the liquidator, *Grissell's Case* (1),—in which the company was being wound up under a supervision order—I cannot find any such distinction taken as was afterwards taken by the Court of Common Pleas between a winding-up under an order of the Court and a voluntary winding-up. It is laid down generally, that the shareholder who is also a creditor is not entitled to set off the debt due to him against the

(1) Law Rep. 1 Ch. 528.

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calls made in the winding-up; but I cannot find in Lord *Chelmsford's* judgment any notion that a distinction should be made between a voluntary winding-up and a compulsory winding-up.

Of course the question before the Court being a question of contribution, was treated by Lord *Chelmsford* as one of contribution. He says (1), "The 75th section of the Act enacts, that the liability of any person to contribute to the assets of a company, in the event of its being wound up, 'shall be deemed to create a debt accruing due from such person at the time when his liability commenced, but payable at the time or respective times when calls are made as hereinafter mentioned for enforcing such liability.' Until the call is made there is nothing more than a liability to contribute. This, indeed, creates a debt, but the debt does not accrue due till a call is made. The power to make calls is only to satisfy the debts and liabilities of the company, and the costs, charges, and expenses of winding it up, and for the adjustment of the rights of the contributories amongst themselves. But if the whole of the amount unpaid upon the shares were required to be paid up, more might be raised than would be requisite for these purposes." That shews the limit. The principle in *Grissell's Case* appears to me to cover the case of a voluntary winding-up as much as that of a compulsory winding-up.

The next case in order of date was *Calisher's Case* (2) which was decided a few days before the case before the Court of Common Pleas, and there Lord *Romilly* decided that you could not set off a debt due from the company to the contributory in the absence of special agreement. That latter part of the decision has been overruled, and it has been held that you cannot do so even by special agreement. But, subject to that, so far as the case before the Court went, Lord *Romilly* decided most distinctly that the Court could not, having regard to the terms of the 101st section and the decision of Lord *Chelmsford* in *Grissell's Case*, allow a contributory to set off a debt against a call.

The next case is the one which raises the whole difficulty; it is the case of the *Brighton Arcade Company* v. *Dowling* (3). The liquidator there brought an action for calls, and the full

(1) Law Rep. 1 Ch. 535. (2) Law Rep. 5 Eq. 214.
(3) Law Rep. 3 C. P. 175.

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Court of Common Pleas held that the debt due to the contributory from the company was to be set off against the call. The way in which it was put by the Court was this. Lord Chief Justice *Bovill* says (1): "Primâ facie there is a good debt disclosed by the declaration, and a good answer thereto by the fourth plea (of set-off). It lies therefore on the Plaintiffs to shew some law which prevents the application of the set-off."

Inasmuch as it appeared on the face of the action that it was a suit by the liquidator in the name of the company, it was not, as it appears to me, to be treated as if it was an action by the company whilst a going concern, and therefore the ground taken by the Court of Common Pleas fails, and under the provisions of the Act of 1862 there is no set-off—in other words, the obligation of proof is the other way. They assumed there was, under the statute, a right of set-off after the winding-up, unless you could shew it was taken away. There is no such right of set-off under the statute, where there is a contribution of this kind due to the assets of the company, and it is for those who allege set-off to shew it. His Lordship then proceeds to shew that there is an implication, if not an express prohibition, against such a plea, for he says, "If this had been the case of a company which was in course of being wound up by the Court or under the supervision of the Court, I should have had no hesitation in saying that the set-off could not be allowed." Therefore he does take the same view of the Act as I do, with one exception—that he thinks there is a difference in the case of a voluntary winding-up; but his attention was not called to the fact that you would then get this absurd consequence, namely, that under the 138th section the voluntary liquidator could apply for payment to the Court and the Court could exercise all the powers it could exercise under the winding-up; but the liquidator could not get the benefit of the Act, as regards payment by the contributory, in an action; and this extraordinary result would then follow, that he would get his demand, *minus* the set-off, in the action, and then come to the Court under the 138th section for the balance, namely, for that sum which the Court of Common Pleas say should be allowed by way of set-off—which would certainly be remarkable.

(1) Law Rep. 3 C. P. 179.

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It was never intended by the Legislature that the liquidator should, if he chose to proceed by action, amend his action by an order under the 138th section, nor could it be argued that, there being the right under the 38th section to get the whole amount of contribution without set-off, there could be a less right in an action.

That being so, all the argument of the Court of Common Pleas appears to me fallacious. The powers of the Act of Parliament are enforceable on the application of a liquidator. If a company is insolvent a voluntary winding-up is more likely to take place than where a company is solvent; and can there be any reason for such a distinction as is alleged? If there were, you would have this consequence, that every case would have to be brought into Court as to a right of set-off. That is a consideration which it seems to me was not dealt with by the Court of Common Pleas. The whole of the judgments of the Judges of the full Court of Common Pleas proceed, as I said before, on the assumption that the Statute of Set-off applies unless the other side can shew a negative. I think if you examine the Act you can shew the negative, but I do not think it is necessary to shew the negative.

I should have gone into this matter more fully had it not been for the elaborate discussion which the matter received from Lord *Selborne* in *Black & Co.'s Case* (1). That was the case in which the Court overruled the distinction which Lord *Romilly* thought might exist of a special contract, but in the course of it there is an elaborate discussion by Lord *Selborne* of the case of the *Brighton Arcade Company* v. *Dowling* (2), and he so clearly points out his reasons that it would be a work of supererogation on my part to repeat what he has indicated; and I need hardly say I entirely agree with what he says on the subject.

I have only one other case to notice, which is *Gibbs and West's Case* (3), before Vice-Chancellor *Malins;* and there is only one observation of the Vice-Chancellor in that case to which it is necessary for me to refer. After discussing (4) the decision in *Grissell's Case*, he refers (5) to the *Brighton Arcade Company* v.

(1) Law Rep. 8 Ch. 254.
(2) Ibid. 3 C. P. 175.
(3) Law Rep. 10 Eq. 312.
(4) Ibid. 327.
(5) Law Rep. 10 Eq. 330.

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Judgment.

Dowling (1). He says, "I have been referred to the case of the *Brighton Arcade Company* v. *Dowling*, with regard to which I confess, after all that has been said upon it, and after all that learned Judges have said, I am unable to see that it is not in conflict with *Grissell's Case*, which has settled that, where the liability is limited, the right to set-off cannot exist."

I merely cite that to shew that at least one other Judge has considered that there is a direct conflict between the authorities; but I am not by citing that case to be supposed to agree with the decision in other respects. Indeed, the observations I have made shew that I could not agree with it. I cite it merely with reference to that observation.

That being so, I am in this position, that there is a decision of the Court of Common Pleas ten years old which is directly in point, and that decision, as I read it, is in conflict with a prior decision of the Lord Chancellor in *Grissell's Case* (2), and emphatically disapproved of by another Lord Chancellor in *Black & Co.'s Case* (3), and in conflict with the true interpretation of the Act of Parliament. It appears to me that, having regard to the rules by which Courts are bound, I am entitled to say that I am not bound by the decision of the Court of Common Pleas, and that I have a right to decide the case according to my own view of the Act of Parliament, confirmed as it is by the high authority of the two Lord Chancellors in the cases I have cited, and also by the opinion of Vice-Chancellor *Malins* as to the conflict of the case in the Common Pleas with the case of *Grissell*.

That being so, I think that no set-off exists in the present case, and there will therefore be an order against the contributories for payment of the call, and they must pay the costs of the application.

Solicitors for all parties: *Duignan & Smiles*, agents for *Duignan & Co., Walsall.*

(1) Law Rep. 3 C. P. 175.
(2) Law Rep. 1 Ch. 528.
(3) Law Rep. 8 Ch. 254.

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***711 Francis Webb and Others, Trustees of the Briton Medical, &C. Association v George Whiffin and Others, Liquidators of the Accidental, &C. Insurance Corporation (Limited)**

House of Lords

Lord Chancellor Lord Hatherley, Lord Chelmsford, Lord Westbury, Lord Colonsay, and Lord Cairns

1872 July 8

Companies Act, 1862—B List of Contributories—No Special Application of their Contributions—"Assets"—Property.

In a winding-up, the funds contributed by the B list of shareholders become part of the general assets of the company, and are not to be applied, preferentially or exclusively, to the payment of those debts which were incurred before the B shareholders retired from the company.

The 38th section of the Companies Act, 1862 (25 & 26 Vict. c. 89), makes the "past members" (persons who have become so by retiring from the company within a year before the date of the winding-up order) liable to contribute to the assets of the company for the payment of the debts and liabilities of the company, but though they are not specifically liable to satisfy debts which have been contracted since they left the company, yet, when they have become liable to contribute to the assets of the company, and have so contributed, their contributions become part of the general assets, and cannot be appropriated exclusively to the payment of those debts which had been incurred before these members retired from the company.

The word "assets" in the 38th section of this statute means the same as the word "property" in the 133rd section, and both alike mean all the unpaid capital recoverable as well as the other property of the company.

Observations by Lord *Cairns* on the duty of the liquidators in making calls on the past members of a company.

THIS was an appeal against an order of Lord Justice *Giffard*, by which a previous order of Vice-Chancellor *Stuart* had been affirmed.

The *Accidental and Marine Insurance Corporation, Limited*, was formed of other companies originally established under other names, which had been duly registered and incorporated under the 7 & 8 Vict. c. 110. By these previous companies were issued on the 9th of March, 1858, and the 10th of May, 1859, two debentures, for the sums of £680 and £170 respectively, in favour of John Weston. The *Accidental and Marine Insurance Corporation* was itself registered on the 5th of August, 1865, under the 25 & 26 ***712** Vict. c. 89 (the Companies Act, 1862), and assumed the credits and liabilities of the former companies. The debentures held by *Weston* passed by assignment to *Webb* and others, as trustees of the Briton Medical and General Life Association.

On the 24th of October, 1866, resolutions were passed for a voluntary winding-up up the *Accidental and Maine Insurance Corporation*, and on the 3rd of November, 1866, an order was obtained that it should be wound up under the supervision of the Court.

Webb was admitted as creditor of the corporation for the sum of £850, the amount of the two debentures, and interest at the rate of 6 per cent. per annum from the 21st of September, 1867. Dividends of 2s., 1s. 6d., and 6d. in the pound respectively had since been paid by the liquidators, whereby the amount of the principal had been reduced to £680.

The existing members of the corporation were at the time when the corporation came to be wound up

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unable to satisfy the required contributions. The past members of the corporation were therefore put into a B list, and considerable sums had been received from them.

The debt, for the balance of which the Appellants are now creditors of the corporation, was contracted before the time at which any one of the "past members" ceased to be a member of the corporation.

On the 10th of March, 1870, Vice-Chancellor *Stuart* refused with costs a motion by the Appellants that the liquidators should divide the contributions received from past members amongst such of the creditors only who became so before the past members had ceased to be members of the corporation. On appeal, before Lord Justice *Giffard*, the decision of the Vice-Chancellor was affirmed[1] . The present appeal was thereon presented to this House.

Mr. *Greene*, Q.C., and Mr. *Holl*, for the Appellants:—

The question here is upon the construction to be put on the 38th section of the Companies Act, 1862. The words of the statute have been considered in other cases, but not precisely with the purpose of determining the question raised here. Those cases, however, point to the construction for which the Appellants contend. ***713** Here is a company which is the subject of a voluntary winding-up. The debts found to be due cannot be satisfied by the contributions of the "existing members," those who were members when the winding-up was resolved on. The liquidators have therefore, formed what is called a "B list," that is, a list composed of persons who had retired from the company, but had not retired more than a year before the winding-up. By the 38th section of the 25 & 26 Vict. c. 89, every present and past member of a company which is being wound up is declared liable to contribute to the assets of the company an amount sufficient for the payment of its debts and the costs, but that liability is to be subject to certain qualifications. These are contained in seven sub-sections, the first of which declares that no past member shall be liable if he has retired more than a year; the second that he shall not be liable to contribute in respect of "any debt or liability of the company contracted after the time at which he ceased to be a member:" the third says that "no past member shall be liable to contribute to the assets of the company unless the existing members are unable to satisfy the contributions required." On these enactments the contention of the Appellants is that the contributions of the past members are to be exclusively devoted to satisfy the debts to which the company was liable when these members retired from it. The existing members are to be liable in the first instance, for they have taken possession of the assets of the company; and having secured its advantages must support its burdens. But the Legislature desired to protect the creditors of the company, and therefore, intending, that men should not engage in speculations, thereby incur debts, and then suddenly abandon the speculations, and leave the creditors in the lurch, directed that unless they had retired for above a year they should be liable to contribute to the payment of the debts existing when they retired.

By the ordinary law of partnership a man who ceased to be a partner would be liable to the debts created while he was a partner, but to none created afterwards. The Legislature adopted that principle, but adopted it with modifications suited to the conduct of public companies. If a man quitted a company the man who succeeded him would be, in the first instance, liable to all the debts unpaid at the time when the company was declared to have failed, ***714** that is, when it was to be wound up. But he, the existing partner, might not be able to pay all the debts, so it was enacted, in favour of the creditor, that the partner who had quitted the concern within a certain limited period should be liable to contribute to the payment of the debts, but only of the debts which had been incurred while he was a partner. That was the chief object of the statute, and that was the interpretation which the Appellants contend that the statute ought to bear. The liability of past members, and the claims of what might be called past creditors, were in direct relationship

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with each other, and that relationship was exclusive. It did not and could not exist as to creditors who came in afterwards. On that principle Brett's Case 2 had been decided. *Brett* bought up all the past debts, that is, all those which existed when he ceased to be a shareholder, and it was held that no call could be made on him for any others. This case had then been decided3 , and was mentioned but not approved of there, or in Morris' Case 4 , which followed and adopted the principle in Brett's Case 5 . There Lord Justice *James* observed that "the liabilities of the ex-shareholders and the rights of the creditors who were creditors at the time when they ceased to be shareholders concerned only those two classes." The 102nd section of the Companies Act, 1862, is relied on by the other side. That gives the power to the Court to make calls before as well as after ascertaining the sufficiency of the assets of the company, but that has nothing to do with any particular classes of contributories, the contributions they are to make, or the special application of those contributions. The 133rd section is also relied on by the other side. That relates to the consequences ensuing on a voluntary winding-up. The 1st sub-section there says, that "the property of the company shall be applied in satisfaction of its liabilities pari passu." No doubt the contributions of each class are to be distributed among the creditors of that class *pari passu*, but not among all the classes of creditors. The 9th sub-section is plainly one which treats exclusively of the liabilities and contributions of those who are *primâ facie* liable, that is, the existing members, to satisfy the debts of the company, the last part of the sub-section ***715** expressly speaking of the liquidators taking into consideration the probability of the contributors being unable wholly or in part to pay, a consideration which, in the ordinary course of things, must be antecedent to the formation of a B list. The 98th section, which enacts that the Court shall cause the assets of the company to be collected and applied in discharge of its liabilities, only lays down a general proposition, but does not in any way say that the contributions of the old members, who have retired, shall be employed to relieve the liabilities of the existing members as to debts incurred since the retirement of the old members. A different rule from that which the Appellants contend for would be, in fact, making them contribute to the payment of liabilities from which the 38th section itself has expressly exempted them, whereas the plain meaning of the words is, if you are not liable to the debts you shall not contribute to the payment of them.

Mr. *J. N. Higgins*, Q.C., and Mr. *R. Romer*, for the Respondents:—

The point here is short and simple. The statute intended to afford protection to creditors, and therefore made not only all the existing members of a company liable to contribute to the assets of a company on its being wound up, but provided that if their contributions should not be sufficient to satisfy the debts, then that other and older members, their transferors in short, should be made liable to assist them. But the Legislature imposed this liability with a restriction. It was confined to members who had retired not more than one year before the winding-up. These recently retired members were made liable to contribute. But to contribute to what? To the assets of the company, not to any particular assets; not to assets which were to be employed in the payment of the particular claims of *A., B.*, and *C.*, but to the general claims of the creditors of the company, all of whom were to be paid *pari passu*. There was no selection by the statute of any particular creditors to be satisfied out of any particular fund. All the creditors were, if possible, to be satisfied, and all the members of the company who had been members within a certain date, before the period of the order for winding-up, were made liable to be called on to satisfy them.

The assets thus contributed are general assets. If not, what are ***716** they? There is nothing in the statute which assigns them to a particular purpose or directs them to be employed in a particular manner. The past member may not be required to contribute anything; but when the existing members are unable to pay the debts of the company, certain of the past members become liable to be called on to

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assist in doing so, and not for the purpose of satisfying any one class of creditors, but of contributing to the assets of the company to satisfy the liabilities of the company. Brett's Case 6 merely shews that if there were no debts at all when "past members" retired, such past members may not be called on to contribute to debts which have been wholly incurred since they retired; but it does not shew that if they are liable to be called on, what they do contribute shall be exclusively applied to debts contracted before they retired. In Andrews' Case 7 the principle was considered, but cannot be said to have been decided, nor was it decided when that case afterwards went before Lord Justice *Rolt*8 , except that he expressed an opinion against the idea of marshalling assets in such a case. In Helbert's Case 9 the Master of the Rolls expressly said that past members liable to contribute at all were liable to contribute to "all the debts and liabilities 'of the company and the costs,'" and his decision was affirmed in this House10 .

The case was ordered to be argued a second time before a larger Court, and it was again argued on July 8, and then before the Lord Chancellor (Lord *Hatherley*), Lord *Chelmsford*, Lord *Westbury*, Lord *Colonsay*, and Lord *Cairns*.

Mr. *Greene*, Q.C., and Mr. *Holl*, were again heard for the Appellants, and repeated the arguments which they had before addressed to the House, on the principles of construction to be applied to the statute, and on the cases already decided. They farther illustrated their arguments by reference to similar provisions in other statutes. The statute meant to say to past members, If you are not liable to debts you shall not contribute to them. They were not liable to debts contracted after they left the company, and therefore their ***717** contributions were not to be employed in the payment of debts so contracted. To make them liable would simply be to impose liability on them in order to relieve the existing members.

Mr. *Higgins*, Q.C., and Mr. *R. Romer*, for the Respondents, relied on the 133rd section of the statute, as presenting with regard to this case an essential difference between it and Brett's Case 11 . No principle applicable to a common law partnership applied here; this was a statutory liability, and could only be governed by the rules which the statute had created, and the statute made no separation of the fund into classes when the fund had once been constituted.

Mr. *Greene* replied.

THE LORD CHANCELLOR (Lord Hatherley):—

My Lords, this is an appeal from an order of the late Lord Justice *Giffard* affirming a decision of Vice-Chancellor *Stuart* with reference to the position of the claim of a certain class of creditors of a joint stock company which was being wound up. The claim of those creditors has been to be paid to the exclusion of the subsequent creditors of the company, by means of the sums which are recoverable from a class of shareholders who are ordinarily in these cases called B shareholders, namely, shareholders who, having retired within a year from the company, remain still liable in respect, at all events, of debts accrued anterior to the time of their ceasing to be members of the company. The question which the Appellants raise is this—they say that, by the true construction of the Act of 1862 with reference to joint stock companies, and especially with reference to the construction of the 38th section of that Act, inasmuch as the persons who have retired from the partnership are not to be called on to contribute to the debts which have accrued since their retirement, therefore the sums which they do contribute ought to be paid and applied in satisfaction of those debts which had accrued before their retirement in preference and priority to any payment to creditors who had become so subsequently.

The question arises entirely upon a clause, which is not very ***718** happily worded, in the 25 & 26 Vict. c. 89, the Companies Act of 1862. There are directions, in the first instance, that all the shareholders shall contribute to the assets of the company for the payment of the costs and of the debts of the com-

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pany. These directions are in the largest and most general terms. Then there are exceptions made by the 38th section with reference to that generality of expression. The first exception is that no person shall be a contributor who has ceased to be a partner for a year before the winding-up. That exception, in fact, takes the whole class of persons who have ceased to be shareholders for a year altogether out of the category of persons who are to pay. Then, secondly, in the case of limited companies, no persons are to pay more than the amount of the shares which they subscribed for. That exception, of course, one would expect to find from the nature of the company, it being a limited liability company. Then there is another provision, that none of those who have ceased to be members of the company within a year—that is to say, that none of those who are said to be on the B list—is to contribute until those who remained members of the co-partnership up to its expiration—that is, persons who constitute the A list—have been exhausted. Then, lastly, comes the provision which has occasioned such difficulty as has arisen in the present case, namely, that those who are on the B list shall not be called upon to contribute in respect of any debt accrued since their ceasing to be members of the company. Then, as regards the assets, when a fund has thus been formed, and there has been this general contribution to the assets, it is provided that the assets are to be distributed, first, in payment of the costs; and, secondly, in payment *pro ratâ* of the several creditors of the company, in which provision no distinction is made as to those who have been creditors at one particular period as distinguished from another particular period.

I have no doubt, that in making provision with respect to the assets of joint stock companies, and especially the assets of limited companies, many circumstances have to be considered which take the case out of the ordinary rule as to the distribution of the assets of a partnership. There is the circumstance that the members of the company have the power of parting with their shares, and ***719** thereby escaping, after a certain period, at least, from all liability; a state of things entirely contrary to that subsisting in an ordinary partnership. In an ordinary partnership, a person who has once become a partner cannot escape from any liability whatever for the debts by his ceasing to be a member of the co-partnership, except by payment of the debts. That was a point in which it was necessary to distinguish the members (sometimes called the partners) in a corporation or company of this kind from members of ordinary partnerships. The Legislature has been desirous from time to time of encouraging joint stock companies, by giving great facilities for the transfer of shares, which, of course, is a great encouragement to people to enter into companies of this kind, if they are disposed to enter into them at all. One encouragement the Legislature has given is, that of persons being able, on parting with their shares, to relieve themselves, as far as the Legislature allows, from liability in respect of those shares. In the several Joint Stock Companies Acts which preceded the Act of 1862, provisions seem to have been made which recognised, far more distinctly than this Act appears to do, or than the framers of it appear to have desired to do, the analogy of a member of a company to a member of a partnership, and which did make, as it appears to me, a more accurate provision for the distribution of the contributions of its members.

However, when we come to this Act we can only deal with it as we find it, and must act expressly according to the provisions which it contains. Some construction, of course, must be given to those words which say that the old members, the past members, the members classed in the B list, who have parted with their shares within a year anterior to the winding-up of the company, and who are therefore not placed upon the A list, although they have to contribute in some shape or way, yet are not to contribute until all the A list has been exhausted, and are not to contribute to the assets in respect of any debt which may have accrued since they ceased to be members. I apprehend that it is very difficult to give any construction to those words, and I shall be very cautious in all I say upon the subject, inas-

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much as I would rather confine myself to the express point we have before us, than enter into any speculation as to what may or may not be the construction of the ***720** Act in other respects. But with reference to Brett's Case 12 , which was brought before me sitting with the present Lords Justices, and upon which we pronounced an opinion, or a decision, I still continue of the same opinion as far as that is concerned, that you cannot, directly or indirectly, compel the B shareholders to make any contribution to the assets of the company in respect of, or on account of, any debts that may have accrued since they ceased to be members of the company. In other words you must, as regards them, in raising contributions from them to the assets of the company, whatever you may have to do as regards the costs of the winding-up (that is a matter to be considered hereafter), put wholly aside the amount of debt, whatever it may be, that has accrued since they ceased to be members. You have only to consider the debts that existed at the time of their being members, and if those debts are paid, then there is no liability upon them whatever, except as to any possible question that may arise as to the costs. And if they guarantee or secure the company against the debts owing when they ceased to be members (which was the case we had before us), by purchase or otherwise, then they remove out of the way the whole matter (subject to the question of costs) in respect of which they have at all to contribute.

But, my Lords, it does not appear to me at all to follow as a consequence from that, that because their contribution is limited, in the first place, to the extent of the unpaid money due upon the shares which they have transferred, after you have exhausted the means of their transferees and all other A shareholders, and they have to pay in to the fund only that which may be due from them in respect of debts owing at the time they ceased to be members, therefore, what they do so pay in is necessarily to be applied in payment of those debts only which existed at the time they were members. For although it may seem a somewhat singular provision that their liability shall be so limited, and yet that the money they pay in shall not be applied in the direction in which the limitation of their liability would seem to point; yet, on the other hand, looking to the clauses of the Act of Parliament carefully, you find that no mention is made of anything but the assets of the company in a general form. The assets of the company of course ***721** include all contributions which you are entitled to raise from the members, and these B members are liable to contribute in respect of all the shares they had parted with, in so far as those shares are not paid-up shares, or in so far as the A contributories have not been able to raise funds sufficient for the payment of all the debts of the company. When that is done, a common fund is formed, and you find no direction in the Act whatever, except for the distribution of the common fund so formed.

Then let us see what that distribution is. That distribution is only among all the creditors of the company, without any distinction of class between them. Of course reasons might be given for this, and one must assume that there were reasons for the Act being framed in this way. The Act was so framed as to say, You, the B contributors, shall stand as sureties, as it were, for the company to the public, that is, to those who are dealing and trading with this company; you shall stand as sureties for the formation of a fund towards the payment of the debts, by means of the payments required from you in respect of the shares which you have only parted with within a year. It shall be your business to see that you part with them only to persons of sufficient means to be able to meet the debts which may become due in the course of the year. If you do not do that you shall stand as sureties at least to the extent of making good what may be due upon those shares, or at least to the extent of making it good in respect of all debts that existed while you were a member. We shall not call upon you to remain liable for debts contracted after you parted with your shares, for that would very much indeed depreciate the advantage of being able to part with the shares. We will not call upon you to answer for all that happened after you ceased to have a control er the

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expenditure of the company; but we will say, to the extent of the debts owing at the time you left the company, you shall make good the payment as far as the shares you once held are concerned, and as far as the debts are concerned which you were liable for at the time you left the company. There may be reasons for saying that, without going on to say that the assets which you so pay are to be appropriated only to the payment of the particular debts due to those creditors who were creditors at the time you ceased to belong to the company. They have not chosen ***722** to call in those debts, they have taken their chance of the solvency of the company as long as it should continue to exist, and there is nothing irrational, at all events, in saying to them, You must come in for a share of the results of the calamities which have befallen the company in common with all the creditors of the company who were creditors at the time of the winding-up, without having any special preference given to you in respect of those sums which have been contributed by persons who were members of the company at the time you became creditors. There is no necessary reason why, unless it is expressly so stated in the Act, a distribution should be made to them from the fund contributed by the B shareholders in preference to the remaining creditors who became so subsequently to the retirement from the company of the B shareholders.

What has satisfied my mind most is, that there is no machinery provided for that purpose in the Act. I do not think that is so wholly conclusive as it appeared to be considered by the learned counsel in the course of the argument, for one reason, namely, that there must be some sort of machinery provided, I apprehend, in whatever way the Act is construed, with regard to the shareholders who cease to be shareholders at different times. Because shareholders of Class B, who cease at different times to be members of the company, are, each of them, to be exempted from contributing in respect of any debts that were contracted after they left—and you might go through all the letters of the alphabet, and say *X.* ceased to be a member at one time, *Y.* at another time, and *Z.*, again, at another time—there would be a different amount of debt due at the time of each of those persons ceasing to be a member, and there would, therefore, be a different amount in respect of which each of them respectively would have to contribute. That question may have to be disposed of hereafter. I cannot say that I think the Act extremely easy of construction under any circumstances whatever; but I think I can see my way to this, that there is no special charge given upon the particular assets contributed by the B shareholders to those who were creditors at the time the B shareholders were members of the company, but who continued to be creditors afterwards, and allowed their debts to remain unpaid until the common disaster came, and who, as it appears to me, can only dip into the common ***723** reservoir which is to satisfy the claims of all those creditors unpaid at the time of the winding-up. I think the mistake has been to consider that because, on the one hand, the liability of the B shareholders is limited by the debts owing by the company at the time of their ceasing to be shareholders, therefore, on the other hand, the amount which they contribute must be paid to those persons only who were creditors of the company at the time of their ceasing to be members of it, and who so continued until the winding-up.

I think, therefore, that the judgment of the Lords Justices, affirming the decision of the Vice-Chancellor, is correct, and that being so, that this appeal must be dismissed with costs.

LORD CHELMSFORD:—

My Lords, the question raised by this appeal is, whether the contributions received from contributories in Class B (that is, from persons who have not ceased to be members of the company for a period of one year prior to the commencement of the winding-up of the company) are to be appropriated exclusively to the satisfaction of the debts contracted whilst they were members of the company, or to form part of the assets of the company, to be applied generally in liquidation of all the debts due at

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the time when the winding-up commenced. This question cannot be determined upon any principles derived from the ordinary law of partnership; the answer to it is only to be found in the provisions of the Companies Act, 1862.

In examining the few sections of the Act which apply to the case, it will be seen that they do not deal with the rights of creditors, but regulate and limit the liabilities of shareholders of the company. It is necessary to advert to this, because it is the creditors who are here contending that the liquidators ought to be directed to divide the contributions received from the B contributories amongst such only of the unpaid creditors of the corporation whose debts were contracted before the respective times of such contributories ceasing to be members of the corporation. The 38th section of the Companies Act, 1862, enacts, that "in the event of a company formed under the Act being, wound up, every present and past member of the company shall be liable to contribute ***724** to the assets of the company to an amount sufficient for the payment of the debts and liabilities of the company, and the costs, charges, and expenses of the winding-up, and for the payment of such sums as may be required for the adjustment of the rights of the contributories amongst themselves." Nothing can be more general than these words, embracing, as they do, all present and past members, and rendering them all liable to contribute to the assets of the company, not to be applied differently with any reference to the two classes of shareholders, but, as to both past and present members, to the payment generally of the debts and liabilities of the company.

In the different sections which speak of the liability of the contributories, the expression used is, "to contribute to the assets of the company," as towards a common fund to be afterwards applied in the manner directed. The 133rd section enacts that the property of the company shall be applied in satisfaction of its liabilities *pari passu*. The word "property" means the same thing as "assets" of the company, and, as Lord Justice *James* says, in Morris's Case 13 , the company's assets include all the unpaid capital recoverable from the shareholders. The past shareholders, therefore, are liable to contribute to the assets of the company, to the extent of the amount due upon their shares, towards satisfaction of its liabilities *pari passu*.

But this liability of a past shareholder is limited in the 38th section of the Act by the three following (amongst other) qualifications: 1st, when he has ceased to be a member for a period of one year or upwards prior to the commencement of the winding-up; 2nd, he is not to be liable to contribute in respect of any debt or liability of the company contracted after the time at which he ceased to be a member; 3rd, nor unless it appears that the existing members are unable to satisfy the contributions required to be made by them in pursuance of the Act. The difficulty in the case arises upon the second qualification of a past member's liability. What is the meaning of his not being liable to contribute in respect of any debt or liability contracted after the time at which he ceased to be a member? By the preceding part of the 38th section a past as well as a present member is made liable to ***725** contribute to the assets of the company for payment of its debts and liabilities; and by the 133rd section the property (which we have seen includes the sums due from the shareholders) is to be applied in satisfaction of the liabilities *pari passu*.

There is no marshalling (as it has been improperly called), by the Act, of the contributions of the past members to the payment of the creditors who were such before they left the company, nor are the creditors distinguishable from the rest as creditors of the past members, but all the contributions of both the present and past members are to be carried to a common fund called the assets of the company, and to be applied in satisfaction of the debts and liabilities, not of the members, but of the company. The liability of a past member to be placed upon the list of contributories must be determined in the case of a voluntary winding-up at the time of the resolution authorizing such winding-up. If at that time there

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are any debts and liabilities existing which were contracted while he was a member, he appears to me to be made liable by the Act to contribute, not specifically to the payment of those debts and liabilities, but to the assets of the company, to be applied generally in payment of its debts and liabilities. If at the time of the commencement of the winding-up there were no debts or liabilities of the company but those contracted after the time at which he ceased to be a member, the past member would be free from liability to contribute to the assets of the company. But when once upon the list of contributories upon the ground of the existence of unsatisfied debts and liabilities which were contracted while he was a member, I confess that I am unable to see how any dealing with those debts and liabilities, even to the extent of extinguishing them, can discharge a liability to contribute to the assets of the company which had already attached upon him. The argument of the learned counsel for the Appellants failed to establish the analogy between the statutory liability of a shareholder in a company and of a partner in an ordinary partnership, and also the alleged right of the Appellants to have the past members' contributions applied to the payment of their debts in preference to the other creditors. The liability created by the Act is entirely different from that which exists amongst partners, either inter se or with relation to creditors; and the Act, in dealing ***726** with past members of a company, regulates only their liabilities, and makes no provision for the adjustment of the rights of the creditors of the company as to them.

With respect to the costs, charges, and expenses of the winding-up of the company, there appears to me to be no difficulty. These costs, charges, and expenses are to be payable out of the assets of the company in priority to all other claims. The official liquidator must make calls upon both classes of shareholders to an amount in his judgment sufficient for payment of all the liabilities. The calls upon the existing shareholders are to be first applied in payment of the costs, charges, and expenses of the winding-up. If the amount called for to the whole extent of the liability of this class of shareholders, or their ability to satisfy the calls, is insufficient for this purpose, then, and then only, the past members can be required to contribute, so that there can be no apportionment between these two classes of shareholders with respect to their liability upon this ground. In this case, and also with respect to the payment of the debts and liabilities, the past members of the company are liable only in the event of the existing members being unable to satisfy the contributions required to be made by them in pursuance of the Act.

I think the order appealed from must be affirmed, and the appeal dismissed with costs.

LORD WESTBURY:—

My Lords, this appeal is an attempt to derive from certain clauses in an Act of Parliament relating to joint stock companies (the Consolidating, Act of 1862), which are applicable only to the shareholders or partners in a company, and regulate the rights and liabilities inter se of those partners, a special conclusion, having the effect of appropriating a particular fund to the payment of a preferential class of creditors. Now that would be an entire abuse of the Act. The Act was not intended for any such purpose, nor is any such conclusion legitimately to be derived from it. The Act of Parliament was framed, not with reference to the creditors particularly, but with reference to the rights of the shareholders in partnerships of a more extended character.

By the ordinary law of partnership, as it existed previously to ***727** these Acts of Parliament, which originated, partially, a long time ago, but which are now consolidated in the existing Act of 1862, two things could not be done. In the first place, a partner could not transfer to another person his share in the partnership. Even if he attempted to do so with the consent of the other partners, it would not be a transfer of his share, it would be in effect the creation of a new partnership. Secondly, by the ordinary law of partnership a partner remains subject to the whole extent of his fortune to the liabilities con-

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tracted by the partnership. The Legislature thought that those difficulties in the way of company partnerships ought to be removed, and accordingly set to work in order to create conditions under which a partner in a company might have the power of transferring his share and making the transferee a member of the company or partnership in which he previously stood as a member. Thirdly, the Legislature desired to give the power of limiting the liability of partners, and that was done by one or the other of two or three modes, but ordinarily by making the liability of a partner extend only to the share that he took in the company or partnership which was formed under the Act. But then it became necessary to impose certain conditions upon the right of transfer; because of course it was felt that it would be impossible to permit a man to leave a company that was in a state of insolvency, and to exempt himself from all future liability.

The 38th section of the Act of 1862 is addressed entirely to the last named difficulty, and it is impossible, consistently with justice, to arrive at any conclusion that it is to be applied to a purpose which it did not at all contemplate or think of; and which would be repugnant to other parts of the Act, namely, the purpose of creating, by the rules given touching the liability of past members, a peculiar fund that should be applied exclusively in favour of those creditors who were creditors at the time when each transferring partner left the partnership. The limitations which the Legislature imposed were these:—A man making a transfer at a time which does not precede by a twelvemonth the order for winding up, or the voluntary agreement to wind up the company, shall remain to a certain extent liable; but, then, the extent of that liability can only be measured with reference to the general ***728** enactment that the existing members of the company (that is, the members of the company *minus* the retiring and transferring partners) shall be first resorted to for the payment of the debts. I apprehend there is no difficulty about the matter, if you will only take the 3rd sub-section of the 38th section, and apply it first, before you come to the second sub-section, which is not happily worded, and which ought to be read as an affirmative proposition, instead of being expressed, as it is now, in negative words.

The 3rd sub-section directs that the existing members shall be first exhausted. Now, exhausted for the benefit of whom? Exhausted for the benefit of all the existing creditors of the partnership. Now, all the existing creditors are creditors whose debts remain unsatisfied, no matter at what time they were contracted. The existing creditors, therefore, who are thus to be regarded with reference to the liability of the existing partners, will be those creditors who remain unpaid, whatever may be the date of their debts, whether they are debts contracted within the last year, or whether they are debts contracted many years ago. The consequences of that direction must be attended to, and they appear to me to remove all possible difficulty. The direction is this:—You will apply all that you can get from the existing members in payment of the existing debts, no matter of what date. If, after you have done that, there remain debts unsatisfied, so that you have to resort to the members who have passed away from the company within a year, then you will be compelled to classify the residuum of the debts so remaining, and ascertain what part of that residuum is to be attributed to past debts; that is, to debts which pre-existed the transfer made by past members, and what portion is to be attributed to the new debts which have arisen subsequently to the date of the last transfer. When you have ascertained the proportion which is attributable to debts which existed when the transfers were made,—then, if there have been several transfers within the year, you will be compelled of necessity to subdivide that portion of the residuum into several portions, according as you find that transfers have been made within the past year. It would be impossible to escape from that difficulty. It is not a difficulty, I think, which, in practice will be found to be of any ***729** magnitude. It exists only in words, when you have, in an abstract form, to express the rule of distribution.

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Now, my Lords, that renders the matter perfectly clear, and it is impossible to give to the older creditors any preferential claim, for this plain reason, that they have, with the new creditors, all been admitted to share and to take a portion of the contributions to the uttermost that were obtainable from the existing members. First of all there is a joint stock fund created out of the contributions of the existing members, and that is divided pari passu among all the creditors without regard at all to the date of their debts. The older creditors of the partnership having come in to participate in that fund, it is impossible for them afterwards to claim the benefit of any rule of distribution which would give them anything like a preferential right to a particular portion of the assets remaining still to be distributed.

The whole of this misapprehension and mistake appears to have arisen from the construction put by the Appellants upon the second sub-section, which says: "No past member shall be liable to contribute in respect of any debt or liability of the company contracted after the time at which he ceased to be a member." The Appellants have read that in this way—they say it provides that the fund that shall be created by the contributions of past members shall be limited only to the amount of the debt existing at the time when the transfer was made by them; and then they say that excludes all the new creditors, and if the fund is to be created with the exclusion of the new or subsequent creditors, of necessity that fund must belong to the older creditors who existed when the B shareholders left the company. But it is in reality only a limitation of the liability of the past members to contribute. The Act of Parliament has the effect of creating two limits of liability. The limit of the liability of the existing members will be the full extent of the shares held by those members in the partnership. The limit of the liability of the past members is the amount of the debts existing at the time of the transfer made by each, subject, of course, to this, that no past member shall be bound to contribute more than to the extent of the shares held by him and transferred by him. The effect of the Act, therefore, is to create two classes of contributories by a minor subdivision, namely, those who ***730** contribute to the full extent of the shares held by them, and who, under clause 3, must be first exhausted, and those who are bound to contribute to the extent of (for that is the effect of the words "in respect of") the debts or liabilities of the company existing at the time of the transfer. If you convert the negative proposition contained in the second sub-section into an affirmative proposition, which is the result of the whole of the enactments, although I think it might have been much more happily expressed, there is no difficulty at all in the working of the rule given by this 38th section.

But, as I said repeatedly during the argument, all that we have judicially to do now is to declare whether we can or cannot assent to the proposition of the Appellants. They applied to Vice-Chancellor *Stuart* that it might be declared that the contributions received from persons who were past members, should be divided, exclusively, amongst those creditors of the company only whose debts were contracted before the times of such past members ceasing to be members; that is to say, among creditors claiming, *proprio jure*, under the words of the Act, a right to have that portion of the common fund appropriated exclusively to the payment of their debts. Now, there is nothing in the language of the Act to give a *locus standi* to any creditors for the purpose of maintaining such a proposition. There is nothing in the Act which, either expressly or by any kind of implication, gives them that right. There is nothing either in the Act, or in the machinery for distribution which it creates, that would enure to give this class of creditors any such right. It would be impossible for this class of creditors, who have been compelled to come in and participate in the first fund, which is created by calls on the existing members, to insist, after they have had that participation, that still there shall be appropriated to them alone this second portion of the fund, and that they shall be entitled to claim payment of their own debts out of it to the exclusion of the other creditors.

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The object of the Act of Parliament was to give a limit to the liability of members who had transferred their shares within a definite time, and that liability takes the place of the old liability, which would be a liability limited to the amount of their shares only. Therefore there are now two sets of contributories, one called Class A—that is, all the existing members the limit of ***731** whose liability is the amount payable upon their shares—and another class, which is to be resorted to only in the event of the contributions of the existing members not being sufficient to answer all the purposes; and if they are resorted to, they are bound to contribute, but with a different limit of liability, namely, the amount required to satisfy the debts existing at the time when they retired from the partnership.

Under these circumstances, my Lords, I think the appeal has been founded altogether upon a groundless misinterpretation of the Act of Parliament, and that the appeal, therefore, must be dismissed with costs.

LORD COLONSAY:—

My Lords, I am of opinion that the contention of the Appellants here, the B creditors, is not supported by the provisions of the Act of 1862, whether read by itself or read in the light of the previous enactments regarding joint stock companies; and in particular I am of opinion that the 38th section, upon which the argument was mainly founded, is a section which is intended to regulate the measure of liability of those members of the company who have retired within a year. The difficulty which arises upon that section seems to me to centre in the words of the 2nd sub-section. Those words are not happily expressed, but I think they are not words from which the Appellants can deduce the inference which they seek to deduce from them; for I think that that sub-section, like the other portions of sect. 38, is intended to give one of the measures of the liability of the members who have retired. There is a difficulty in understanding it, for it is not very accurately expressed; but I think it gives no support to the contention of the Appellants. I am far from saying that there may not arise under it practical difficulties in regard to the sums obtained from the several members who have retired at different periods, in measuring the amount of the debts due at the periods when each of them retired. That is a practical difficulty, but it is altogether away from the question we are now considering, which is, whether the B creditors constitute a preferential set of creditors, entitled to take to themselves the money derived from the B members of the company. I am of opinion that the ***732** judgment appealed from ought to be affirmed, and that the appeal should be dismissed with costs.

LORD CAIRNS:—

My Lords, it is peculiarly necessary in this case to bear in mind what is the precise point which is brought before your Lordships for decision. The Appellants state it in this way. They seek that the liquidators of the company may be directed to divide the contributions received from persons settled on the B list of contributories among those of the unpaid creditors of the company only, whose debts were contracted before the respective times of such contributories ceasing to be members of the corporation. Your Lordships, therefore, observe at once, that there is no controversy as to the settlement of the list which is called the A list of contributories, namely, the existing members of the company. There is no controversy as to the settlement of the list which is called the B list, namely, the ex-members of the company. There is no controversy as to the inability of the contributories on the A list to satisfy the demands which were justly made upon them, and there is no controversy that the call which has been made upon the ex-members on the B list has been the proper amount or quantum of call. These matters are all removed out of the range of controversy or dispute.

The only question which your Lordships have to determine is, what is to be done with the money which has been levied as contribution from the ex-members on the B list? Is that money to go into the common fund of the company, or is it to be segreg-

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ated and set apart for the purpose of paying the particular class or classes of creditors who existed as creditors at the time or times of the retirement of the ex-members?

Now, my Lords, in approaching the consideration of that question, the first observation which naturally occurs upon the contest of the Appellants is this: If they are entitled to the advantage which they desire, namely, to have these contributions from the B list applied in payment of their debts in particular, that advantage has arisen from a simple accident; the accident, namely, that the contributories upon the A list have been unable to satisfy the whole of the contribution which was required of them. The advantage ***733** has not arisen by contract, or by stipulation of any kind. If the contributories on the A list had been able to satisfy the full amount of the contribution which was required of them, it is not denied by the Appellants that those contributions must have been divided rateably among all the creditors of the company, old and new, without any distinction whatever.

The second observation, which occurs at the outset, as proper to be made upon the contest of the Appellants, is this: It is not in dispute but that the Appellants are entitled to receive, and possibly have received, a rateable dividend along with all other creditors out of the fund which has been contributed by the members upon the A list. What they ask for, therefore, is something over and above that dividend which they and all the other creditors have received; they ask to have that other and greater dividend in preference to all whom I may term the modern creditors of the company. They, therefore, contend that the effect of the liquidation, the effect of the circumstance that the company is now being wound up, is such that it has given to the Appellants a preferential debt, whereas before the winding-up most clearly their debt was in no sense a preferential debt against the company. Before the winding-up the Appellants could not have affirmed of their debt that they had taken any particular security for it, or that they had contracted that, as between various portions of the capital of the company, their debt should stand in a better position than any other debt. So long as the company was going on up to the time of the winding-up order, beyond all doubt the debts would have been paid *pari passu*, and no creditor would have been able to affirm that he was in a better position than another creditor.

Your Lordships are quite familiar with the fact, that in many cases where you have to administer assets upon an insolvency, or upon a liquidation, claims which before the administration of the assets were preferential are cut down and deprived of their preferential quality or attribute. But I own that it is entirely new to me to hear an argument that the effect of liquidation, which is ordinarily to cut down preferential claims, is to make a claim, which before liquidation was not preferential, emerge into a preferential claim, and assume a quality which it never possessed before. This is a result of the argument of the Appellants, which is so startling ***734** that it would induce your Lordships, I think, to pause, before that argument could be admitted.

It appears to me that the argument of the Appellants, which was urged with great ability and force, is founded altogether upon a fallacy, the statement of which removes every difficulty out of the case. The Appellants proceed upon the assumption that they are entitled to establish a direct relation of creditor and debtor between themselves and certain members of the company. Now, I understand the whole scheme of the Act of 1862 to be entirely at variance with any theory of that kind. As I understand that Act, the relation of creditor and debtor which is established by the Act is established only with regard to that which is the common fund or capital of the company. It was always the habit in ordinary partnerships, and it was the habit in previous Acts, or in almost all previous Acts of Parliament, to constitute more or less of a direct relation between the creditor and the debtor, between the creditor and the particular individual shareholder in the company. In some of the former Joint Stock

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Companies Acts, even although the process had to be taken in the first instance against the company, the creditor was afterwards allowed to take out execution under certain qualifications against an individual shareholder, and in that way, to constitute a direct relation between himself and the individual shareholder. But by the Act of 1862 that state of things is entirely swept away. A capital is created, sometimes limited, sometimes without a limit; but that capital is to be made good in the shape of a common fund, and that common fund it is which is to be the source of the payment of every creditor of the company. And although it is quite true that members and ex-members of the company are placed by the Act under liability, that liability is a liability, not to make payments to creditors, but it is a liability to contribute to and make good what should be the proper amount of the common fund. Then, having got into the common fund every sum which ought to be contributed to it by every person whomsoever, the Legislature takes possession of that common fund, and proceeds to distribute it amongst the creditors of the company.

My Lords, this would be made very clear, I think, by merely reading the 133rd section of the Act of Parliament. It is quite ***735** true, as has been observed, that that 133rd section applies to the case of a voluntary winding-up only; but your Lordships will observe, in looking at this Act of Parliament, that it has been thought, and very naturally thought, important in the case of voluntary windings-up to make specific provisions, and to give specific directions as to matters which were supposed to be so plain, and so necessarily consequential upon the general scheme of the Act, that in a winding-up under the order of the Court it was not thought necessary to give express directions upon these matters of detail. An illustration of that might be found in the way in which the provision to be made for costs is dealt with by the same Act of Parliament. In the case of a voluntary winding-up there is an express direction that the costs shall be paid, in the first instance, out of the moneys contributed, that is out of the common fund. In the case of a winding-up under the order of the Court there is no such provision, it being, I suppose, presumed that the Court would see that the justice of the case required that, in the first instance, the costs of winding-up ought to be paid. So, also, with regard to the distribution of the assets, we have this direction given to the liquidators under a voluntary winding-up, who were not, therefore, acting directly and constantly under the orders of Court (and the company now before your Lordships is a company under voluntary liquidation):

“The following consequences shall ensue upon the voluntary winding-up of a company: The property of the company shall be applied in satisfaction of its liabilities *pari passu.”*

Now, I ask the question, are the contributions to be made by the ex-members the property of the company or are they not? Can it be contended for a moment that they are not? Whose property are they, if they are not the property of the company? Is there anything in this Act of Parliament which makes them the property of any other person but the company? It appears to me, my Lords, beyond all doubt, that all unpaid calls, whether from members or from ex-members, are part of the property and the assets of the company; and I certainly cannot read this section as we were told it had been read, as meaning by “the property of the company” the property in specie in the office, or the warehouses, or the stores of the company, at the time of the winding-up, as ***736** distinguished from the credits of the company, or the funds coming to the company in respect of unpaid capital. The 133rd section, therefore, my Lords, entirely supports the general theory which I have ventured to submit to your Lordships as the theory upon which the Act of Parliament is framed.

But, then, we were told that the argument of the Appellants was to be supported upon the 38th section of the Act. Now it is necessary to observe that the 38th section consists of two parts. The first part is the affirmative part of the section, which lays down the general principle, that contributions shall

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come, so far as is necessary, both from members and from ex-members of the company. And it is worth while observing, although it is by no means an observation which is conclusive of the argument, that this 38th section is headed as a separate division of the Act by the words, "Liability of Members," as if its entire object was to define the amount of liability of members; whereas the *fasciculus* of clauses which commence with the following section, the 39th, is headed in a manner altogether different, namely, "Provisions for Protection of Creditors." It is under these provisions that you would expect to find arrangements made for the special protection of creditors, and not under the 38th section.

Now, the 38th section, applying itself to the liability of members of companies, says: "In the event of a company formed under this Act being wound up, every present and past member of such company shall be liable to contribute to the assets of the company to an amount sufficient for payment of the debts and liabilities of the company, and the costs, charges, and expenses of the winding-up, and for the payment of such sums as may be required for the adjustment of the rights of the contributories amongst themselves, with the qualifications following." Now the observations which naturally arise in one's mind upon that part of the section are these: In the first place, the contribution here spoken of, which is to be a contribution not merely by present, but by ex-members, is to be a contribution not to particular creditors, but to the assets of the company. The second observation is this, that the contribution is not to be merely a contribution for payment of debts and liabilities, but it is also to be a contribution for payment of the costs, charges, and expenses of the winding-up. And the third ***737** observation is this: that all the subsidiary enactments which occur in the latter part of the clause are here described as "qualifications," namely, qualifications upon the general liability which is here established, that is to say, some enactments which are to be in diminution or restriction of that general liability, and not enactments for the purpose of creating new and separate rights in creditors.

My Lords, I do not dwell upon these qualifications, the meaning of which is perfectly obvious. There is a period of a year, during which alone an ex-member is to be liable. There is a protection to ex-members in this, that it must be first ascertained that the existing members are unable to satisfy the contributions required to be made by them. I only observe upon that, that it is not that you are to wait until the assets raised from the existing members are exhausted, but you are entitled to act the moment it appears to the Court that the existing members are unable to satisfy the contributions required of them. There is also the qualification that in a limited liability company there is no contribution to be required either from a present member or an ex-member exceeding the amount of capital unpaid upon his share. Upon these qualifications no question can arise.

The second qualification, which is supposed to have created the difficulty, is this: "No past member shall be liable to contribute in respect of any debt or liability of the company contracted after the time at which he ceased to be a member." Now, there I ask the question, contribute to what? For upon the answer to that question it appears to me the solution of the whole difficulty depends. Does it mean contribute to the payment of a particular creditor, or a particular class of creditors? Surely not. "Contribute" there is used without the words that follow it in the general enactment at the commencement of the section, namely, to contribute to the assets of the company. Therefore I read the second sub-division of the section as if it stood thus: No past member shall be liable to contribute to the assets of the company in respect of any debt or liability of the company contracted after the time at which he ceased to be a member. Then I find the whole section is harmonious. There are series of limitations upon liability. The liability is a liability to contribute to the assets or the common ***738** fund of the company. To that fund the contributions must be made. The contribution is to be governed by

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these qualifications. No new destination is given to the money to be contributed, but that money is to be applied under the 133rd section pari passu amongst all the creditors of the company.

Now, we were pressed very much with this question: but how is the official manager to adjust and define the sum he is to call for from the ex-members of the company? My Lords, I think it is important that it should be borne in mind that any opinion that your Lordships, or any of your Lordships, might express upon this subject, cannot upon this appeal become the order of the House, and cannot, therefore, have the effect of a decision of that question; and in many respects I should have desired not to express even a passing opinion upon the subject, because if it should ever hereafter come in controversy, and be brought before your Lordships, I desire that it should come perfectly unaffected as regards any decision of this Mouse by any extra-judicial expression of opinion which may now take place. I own that, as at present advised (but I repeat that it is entirely open to a reconsideration of the question), I see little or no difficulty in the matter. It appears to me that where the official liquidator, acting under the Court, has ascertained that the existing members are unable to satisfy the contributions required of them, he has then to make a call upon the ex-members, but in making that call he must observe and pay attention to the debts which were in existence at the time each particular ex-member ceased to be a member, and he must disregard the debts which were incurred after that time. Of course the debts to which he must have regard would be old debts continuing to be debts up to the time and at the time of the winding-up.

It was said that this view of the Act of Parliament would be at variance with two decisions of the Court of Chancery, the decision in Brett's Case 14 , and the decision in Morris's Case 15 . Now Brett's Case was a case of great peculiarity. The circumstances in it probably had never occurred before, and possibly may never occur again. I should be unwilling to express any opinion as to whether; having regard to the peculiarity of those circumstances, that decision could or could not be made to agree with the view which ***739** I understand the majority or all of your Lordships to entertain on the present appeal. I will only say this about it. It appears to me that there were two points which did not receive, either in the argument, or in the judgment in Brett's Case 16 , the consideration to which I think they were entitled. One of those points was the liability of ex-members to provide for the costs of the winding-up, whether they were past debts, old debts, in respect of which they were liable, or not. The other matter to which I think sufficient attention was not paid was the question whether the debts in respect of which contributions could be called for from ex-members are not what I have called "old debts," subsisting at the date of the winding-up, and whether anything done with regard to those debts after the date of the winding-up could affect or diminish the liability which had once accrued upon the ex-members.

My Lords, with regard to Morris's Case 17 , I own I think the determination of that case cannot subsist with the determination at which your Lordships seem now likely to arrive on the present appeal, and I myself think that the decision in Morris's Case proceeded upon a construction of this Act of Parliament which I am unable to accept.

I therefore concur with your Lordships in thinking that this appeal should be dismissed. In a case of considerable difficulty there might be, under other circumstances, some ground for submitting to your Lordships that the general rule of dismissing an appeal with costs should not apply; but I own that I think that in the present case these Appellants have had at least as much favour shewn to them in the matter of costs as they are entitled to, because I find that the decision of the Vice Chancellor was against them, and the decision of Lord Justice *Giffard* was against them, and yet in both of those Courts their costs were paid out of the assets of the company. They then obtained, after the time for appealing had elapsed, a special leave to appeal, and they appear

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also to have obtained an order restraining the payment of any farther dividends to the creditors of the company (although a farther dividend had been declared, and was ready to be paid) until the result of this appeal should be ascertained. They have, therefore, I should think, been the cause of very considerable ***740** inconvenience and expense in the liquidation of this company, and I think, having had upon two occasions decisions against them, and yet having had on each occasion their costs allowed them out of the assets of the company, there is no course now open to your Lordships but to dismiss this appeal with costs.

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1. Law Rep. 5 Ch. Ap. 428, nom. Re Accidental and Marine Insurance Corporation.

2. Law Rep. 6 Ch. Ap. 800.

3. Law Rep. 5 Ch. Ap. 428.

4. Law Rep. 7 Ch. Ap. 200.

5. Law Rep. 6 Ch. Ap. 800.

6. Law Rep. 6 Ch. Ap. 800.

7. Law Rep. 4 Eq. 458.

8. Law Rep. 3 Ch. Ap. 161.

9. Law Rep. 6 Eq. 509–511.

10. Law Rep. 5 H. L. 31.

11. Law Rep. 6 Ch. Ap. 800.

12. Law Rep. 6 Ch. Ap. 800.

13. Law Rep. 7 Ch. Ap. 204.

14. Law Rep. 6 Ch. Ap. 800.

15. Law Rep. 7 Ch. Ap. 206.

16. Law Rep. 6 Ch. Ap. 800.

17. Law Rep. 7 Ch. Ap. 200.

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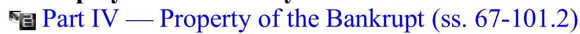
Index No. 14

Canada Federal Statutes
Bankruptcy and **Insolvency Act**

Part IV — Property of the Bankrupt (ss. 67-101.2)

General Provisions
s 77.

Federal English Statutes reflect amendments current to June 6, 2012

Federal English Regulations are current to Gazette Vol. 146:13 (June 20, 2012)

77.
77(1) Contributory shareholders
Every shareholder or member of a bankrupt corporation is liable to contribute the amount unpaid on his shares of the capital or on his liability to the corporation, its members or creditors, as the case may be, under the Act, charter or instrument of incorporation of the company or otherwise.

77(2) Liability of contributory an asset
The amount that the contributory is liable to contribute under subsection (1) shall be deemed an asset of the corporation and a debt payable to the trustee forthwith on the bankruptcy of the corporation.

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Index No. 15

Westlaw

1967 CarswellOnt 144, [1967] 2 O.R. 565, 64 D.L.R. (2d) 457

Clarkson Co. v. Zhelka

Clarkson Co. Ltd. v. Zhelka et al.

Ontario High Court of Justice

Thompson, J.

Judgment: August 22, 1967

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Counsel: *R. S. Joy, Q.C.*, and *W. D. Lessmann*, for plaintiff.

J. R. Denny, Q.C., and *J. H. Gardner*, for defendant Zhelka.

W. J. Smith, Q.C., for defendant, Industrial Sites & Locations Ltd.

Subject: Corporate and Commercial

Corporations --- Nature of corporation — Distinct existence — From owner

Nature of corporation — Distinct existence — From owner — General — One man company — Whether alter ego or agent for incorporator — Liability of incorporator.

Plaintiff, trustee in bankruptcy of S., sought a declaration that certain land was held by defendants as trustee for plaintiff. I. was a private company organized by S., and had conveyed the land to defendant Z., a sister of S. living with him. She mortgaged it back to I. for a large amount on which no advances were in fact made. Plaintiff claimed that I. was a mere sham or alter ego for S. and it or Z. held the land as trustee for S. Held, the action should be dismissed. The evidence fell short of proving fraud or that I., although owned by S., was his mere alter ego. A controlling share interest did not in itself establish that the company was only an agent. In questions of property, of acts done, rights acquired or liabilities assumed, the company was an entity distinct from its incorporators. The company had not been formed for the express purpose of doing an illegal act nor had those in control expressly directed a wrongful thing to be done, so they were not personally liable.

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***Thompson, J.*:**

1 In this action the plaintiff as trustee of George Alexander Selkirk, a bankrupt (to whom for the sake of brevity, I shall refer as Selkirk), seeks a declaration that certain lands in the Township of North York in the Province of Ontario, described in the statement of claim, are held by the defendants, or one of them, as trustee for the plaintiff and that a certain mortgage thereupon from the defendant Zhelka to the defendant Industrial Sites and Locations Limited as mortgagee, bearing date May 2, 1960, does not constitute a valid charge. The plaintiff prays for consequential judgment vesting the lands in it as such trustee in bankruptcy, free and clear of encumbrance.

2 The determination of the issues involved revolves principally around a conveyance of the lands in question, which are of substantial value, by the corporate defendant to the individual defendant, dated May 2, 1960, and registered September 15, 1960, as No. 399806 for the Township of North York (ex. 5).

3 The defendant, Zhelka, is a sister of Selkirk, the bankrupt, and resides with him, his wife and his family of four children, at 299 Russell Hill Rd. in the City of Toronto. In fact the title to this residential property is in her name.

4 The plaintiff alleges that the corporate defendant, a private company incorporated under the laws of Ontario and promoted and organized by Selkirk, was and is to all intents and purposes, not an independent trading unit, but is and has been the mere agent of Selkirk and particularly with respect to the conveyance to Miss Zhelka.

5 It is urged in the alternative that the company, which for the purposes of convenience I refer to as "Industrial", is a mere sham, cloak, or front for or the *alter ego* of Selkirk, kept alive and operated by him for his own personal purposes and whose shareholders and directors, other than himself, are and have been his nominees and merely tools in his hands. The plaintiff goes further and argues that Industrial is but one of a group of some several similar corporations which constitute a Selkirk corporate family and whose business operations, interchange of assets, and interrelated dealings, are wholly controlled and directed by him personally to the prejudice and confusion of his personal creditors.

6 In essence, the Court is asked to rend the corporate veil, to pass beyond the line which separates Industrial as an artificial person from its creator and controller Selkirk, and to declare it to be in reality Selkirk or his mere agent and without legal entity as distinct from him, at least with relation to the lands involved.

7 The facts are complex and are made more so by the welter of contradiction throughout the evidence and the consistently inconsistent conduct of the bankrupt and the individual defendant.

8 It was said of Selkirk in the case of *Selkirk v. M.N.R.*, 63 D.T.C. 108 at p. 110 that:

> ... just about everyone who became associated with, or worked for, him suffered financially and would have been better off never to have met him.

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9 In the instant case, had he deliberately set out on a course of perplexity, he could not have done better than he in fact has. Be that as it may, the plaintiff's allegations are akin to those of fraud and the onus of proof lies heavily upon it.

10 The resolution of the present issues, in my view, can be arrived at only by a detailed consideration of the circumstances surrounding the attacked transaction between the defendants and the background facts relating to the relationship of Mr. Selkirk to Industrial.

11 The plaintiff's allegations or theories with respect to the conveyance to Miss Zhelka are that the lands were conveyed to her to hold in trust for her brother and there thus is a resulting trust in him; that the mortgage back from her is not genuine and a mere pretence; and that the whole transaction was voluntary and without consideration and was entered into with a view to preventing the property from falling into the bankrupt's estate and as a scheme between Selkirk and the defendants to that end.

12 As previously intimated, the plaintiff contends that for the purposes of the impeached transaction, the grantor, although nominally Industrial, is in reality Selkirk, or alternatively, that Industrial was merely his agent therein acting upon his direction.

13 In order to trace the relationship of Selkirk to Industrial one must go back some years.

14 Selkirk, sometimes known as Zhelka, alias George Alexander, according to his wife, is a promoter of land development. I prefer to call him simply a land trader.

15 For the purposes of carrying on such business he became a corporator of several companies. Statistically, the following appears from the evidence:

16 On August 18, 1952, Langstaff Land Development Limited was formed. This is referred to in the case of *Selkirk v. M.N.R., supra*, as being wholly owned by Selkirk, although his name does not appear as a director in the corporate returns made to the Government, the last of which was made or filed in 1958.

17 In March, 1956, Fidelity Real Estate Limited was incorporated, and, although not originally a director, the last return which was made in 1958 showed Selkirk, his father Fred Zhelka, and the defendant Cecile Zhelka, to be the directors.

18 On April 19, 1956, he promoted the incorporation of Britannia Memorial Gardens Limited. The original directors were Roy A. Dunn, John N. Dunn and Marilyn McIntyre. No departmental returns have been filed.

19 He was instrumental in the incorporation of St. George Developments Limited on August 2, 1957. Marilyn Edith Wooding (now his wife), Fedor Zhelka (apparently his father) and himself were named as the original directors. This company too has filed no annual returns.

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20 Industrial was incorporated on August 6, 1958. The petition for incorporation was presented by St. George Developments Ltd. which paid the incorporation fee. The first directors named were Joseph Daniel McNab, solicitor, Margaret de Jean and Anne Heron. No annual returns under the *Corporations Information Act*, 1953 (Ont.), c. 21 [now R.S.O. 1960, c. 72], have been filed and thus no change in directors indicated to the Government.

21 Despite the lack of information available from the public records, due to default in making returns, certain additional facts with respect to Selkirk's relationship to these companies do appear from the evidence of certain of their officers from time to time, including Mrs. Selkirk, the defendant Zhelka and three solicitors Mr. McIlwain, Mr. Mortimer and Mr. W. Scott Burrill, employed by Selkirk at different times to administer the companies, two of whom held offices therein.

22 In addition to the companies above named, Selkirk is said to have incorporated two or three other private corporations, including one operating in Nassau and one known as Concord Sand and Gravel Limited.

23 This action, as originally framed, was against the defendant Zhelka alone, and when the trial had substantially progressed, I deemed it necessary, by reason of the nature of the relief claimed, to add Industrial as a party defendant pursuant to Rule 136. Upon resuming, after the addition of Industrial as a defendant, it appeared that a good many of its books and records were not available for production; they were, for some undisclosed reason, under seizure by the Department of the Provincial Treasurer. This was so of the original minute book of the company and apparently of the share register, which Burrill said he at one time had prepared. Exhibit 44, purporting to be a minute book, is said to be only a partial duplicate copy of the original minute book and not at all complete.

24 Minutes of the meetings of directors of December 26, 1959, and of February 6, 1960, indicate that Selkirk was then president of the defendant company. Other evidence discloses that he never held or owned more than one qualifying share of stock.

25 The minutes of December 26, 1959, further indicate that stock was allotted to the following persons in consideration of past services during the years 1958 and 1959:

To Marilyn Selkirk, 100 shares, of the value of $200;

To Edna Heron [a secretary in the employ of Selkirk],

10 shares, of the value of $20; and

To Cecile Zhelka, 125 shares, of the value of $250.

26 The company never had money in its treasury by way of subscribed capital. Its one and only asset was a tract of some 86 acres of land on Steeles Ave. between Dufferin and Keele Sts. in the Township of North York, a portion of which are the lands now called into question.

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27 This it acquired through the negotiations of Selkirk, by grant from one Rosati on January 6, 1959 (ex. 39). An option to purchase had originally been taken in the name of the secretary, Miss Heron, and which was assigned by her to Industrial.

28 The affidavit of land transfer tax appended to the Rosati deed, indicates that the consideration for the transfer was $342,122.26, of which $90,000 was paid in cash, $121,075 by way of the assumption of existing encumbrances and the balance by way of mortgage back to the vendor. Industrial, being without money or other assets at the time of the purchase, the moneys paid for the option and the extensions thereof were advanced by the associate company St. George Developments Ltd. This was applied upon the purchase price and the balance of cash paid on closing of $60,000 was advanced by another of the associated companies, Langstaff Land Developments Ltd. Promissory notes or agreements for repayment (ex. 17), were given by Industrial to these associates and signed by Selkirk.

29 A further advance by another of the Selkirk companies, Britannia Memorial Gardens Ltd., in the sum of $21,000 was made in March, 1960, to Industrial to assist it in its operations (ex. 18).

30 There is no indication that any of these advances were repaid as such, although Mrs. Selkirk testifies that the Langstaff company did receive approximately $60,000 from Industrial in the year 1961, which was used by it in the reduction of a mortgage to one Gotfrid upon lands in the Township of Markham, upon which mortgage he had commenced foreclosure proceedings. These moneys were the proceeds of a mortgage upon the lands in question made by the defendant Zhelka to one Max Gelberg (ex. 6).

31 In the meantime, in March, 1960, through the offices of Selkirk, Industrial sold and conveyed to the Municipality of Metropolitan Toronto some 45 acres of the 85-acre parcel (ex. 3). The proceeds of this sale, some $260,000, was used in discharging the existing encumbrances upon the land and in paying off a lien to the Province of Ontario for arrears under the *Corporations Tax Act*, R.S.O. 1960, c. 73.

32 Then followed the conveyance from Industrial to Miss Zhelka on May 2, 1960 (ex. 5).

33 The property retained remained clear of encumbrance until the Gelberg mortgage was given by her on January 21, 1961 (ex. 6).

34 Subsequently, Mr. Gelberg in an action for redemption by Miss Zhelka, took foreclosure proceedings upon his mortgage by way of counterclaim. That action was settled, following a sale to the Sun Oil Company Limited, negotiated by Selkirk and approved of by the Court, of a 20-acre parcel of the lands for $150,000. This money was paid into Court. The Gelberg mortgage and a further lien for corporation taxes to the Province of Ontario were satisfied. The sum of $9,249.32 by way of adjustment of interest was paid to the defendant Zhelka. This in some unexplained manner found its way into the general bank account of Fidelity Real Estate Ltd. (ex. 20).

35 I presume that the balance of the Sun Oil purchase price remains in Court. The parties to this action were all parties in the Gelberg action (ex. 21).

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36 The defendant Zhelka pleads that the lands in question were conveyed to her as a trustee by her co-defendant and in consideration of the sum of $120,000 as evidenced by a promissory note dated May 2, 1960, given by her to Industrial. Her co-defendant, Industrial, pleads that the lands were conveyed to her in consideration of the mortgage for $120,000 from her and a further promissory note made by her in its favour for $120,000. The corporate defendant further pleads, in the alternative, that she holds the lands for it as trustee.

37 It is admitted that no moneys were advanced under the mortgage and from the evidence it appears that no moneys have been paid upon the promissory note which is said to have been drawn for two years.

38 The mortgage document, ex. 7, bears date May 2, 1960, but was not registered until January 15, 1963. It first came to light, apart from what knowledge the immediate parties to it may have theretofore had of it, if any, when Industrial sought to prove a claim upon it as second mortgagee in the Master's Office in the Gelberg action in February, 1963. This claim was supported by the affidavit of Mrs. Selkirk who purported to be president of Industrial at that time.

39 Strenuous attacks are made upon this instrument by the plaintiff. Its authenticity is called into question, the plaintiff contending that the signatures of the Commissioner taking the affidavits endorsed thereupon or appended thereto, Mr. Scott Burrill, are simulated or feigned. Considerable evidence of handwriting experts was adduced in this respect with a not uncommon contradictory result. Mr. Burrill, however, swears that the signatures are his and are genuine. Both he and Mrs. Selkirk testify that the mortgage was not sooner registered as efforts were being made to raise money upon the land by way of mortgage elsewhere and it was desired that no prior encumbrance should appear upon the title. This is consistent of course with the fact that the mortgage was a mere pretence.

40 While I entertain some skepticism about this document, I am not prepared, in the light of the contradictory evidence presented, to hold that it was not genuinely executed or that it was an afterthought.

41 However that may be, I am convinced from the evidence which I accept that this instrument was never intended to operate as a mortgage or as a genuine security upon the lands for any sum of money whatsoever.

42 I am satisfied that it was intended as a mere device, as was also the promissory note of the individual defendant, to be used in case of necessity for the purpose of defeating, hindering or delaying the creditors or prospective creditors of Industrial from recovery of their claims.

43 Mrs. Selkirk, who became president of the company shortly thereafter, and Burrill, who became the secretary, both testify that Industrial was involved in extensive litigation and that as a result of this, it was determined to convey the lands to Miss Zhelka and that she holds them for the company as a trustee. Miss Zhelka herself states, in one instance, that her brother informed her that this was the reason these lands were being transferred to her.

44 I unhesitatingly conclude that the conveyance to Miss Zhelka and the entire transaction with her was without consideration and voluntary and entered into with the intention of protecting the lands against resort thereto by the creditors and others having claims against Industrial. Undoubtedly, Selkirk was the moving factor behind the whole plan.

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45 The weak attempt of Mrs. Selkirk to explain the reason for the mortgage and promissory note was deplorable in view of her previous affidavit in support of Industrial's claim.

46 Miss Zhelka's many contradictory assertions as to the reason for the conveyance and as to the capacity in which she holds the lands served only to convince me that she had little idea of what the entire matter was about, but that she was prepared to go to any length to do her brother's bidding and to meet what she considered to be his convenience or advantage.

47 No doubt her statement upon cross-examination in the Gotfrid action to the effect that she held the lands in question for her brother has sparked this entire litigation (ex. 11). She, of course, now states at trial that she holds as a trustee for Industrial.

48 It is significant that the instrument of conveyance itself (ex. 5) is absolute in form and that the expressed consideration is nominal. The affidavit of land transfer tax is made by Selkirk; no mortgage back is mentioned; and the explanation therein given is that the grantor has held the lands as trustee for the grantee and is now transferring title. Mr. Burrill states that he drew the affidavit and that this explanation was inserted by him at Selkirk's dictation, but that he, Burrill, made an error in that he reversed or transposed the terms "grantor" and "grantee". I do not accept this statement. To give effect to it would render the explanation unintelligible. As it stands it is consistent with the avowed purpose of the transaction so that it might be indicated to others that Industrial held only as trustee and had no beneficial interest in the lands which might be exigible.

49 It is my view that there is a resulting trust in Industrial and that it never was intended that Miss Zhelka should take any beneficial interest in the property conveyed; and that despite the fact that she subsequently mortgaged the lands to Gelberg for the convenience of one of the associated companies.

50 I have no doubt that the conveyance is open to attack by the creditors of Industrial under the Statute of Elizabeth, 13 Eliz., c. 5, now the *Fraudulent Conveyances Act*, R.S.O. 1960, c. 154. The Court would not lend its assistance, however, to the grantor in the recovery of the property, were it sought by Industrial upon the principle of the maxim *in pari delicto, potior est conditio possidentis: Mundell v. Tinkis* (1883), 6 O.R 625; *Scheuerman v. Scheuerman* (1915), 10 W.W.R. 379, 52 S.C.R. 625, 28 D.L.R. 223.

51 Even if the plaintiff were successful in its contention that Industrial is merely the agent or the *alter ego* of Selkirk, it is doubtful whether the plaintiff claiming through Selkirk, the bankrupt, could acquire any greater rights than he could in the face of the maxim quoted. It is also questionable as to whether, in that event, it could avoid the transaction under the general policy of the bankruptcy law or as a "settlement" within the meaning of s. 60 of the *Bankruptcy Act*, R.S.C. 1952, c. 14. It would, however in such event, be open to attack by the trustee as a conveyance fraudulent as against creditors of the debtor.

52 These considerations, however, become academic by reason of the fact that the plaintiff does not attack the transaction as a settlement or otherwise under the *Bankruptcy Act*, nor as a conveyance fraudulent against the debtor's creditors. The case is framed upon the premise that the property is held by the defendants or one of them as agent or

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trustee for the debtor and that it constitutes part of his estate or property passing to the plaintiff upon bankruptcy.

53 Such considerations become still more academic in the light of the view I ultimately adopt as to the relationship between the debtor Selkirk and Industrial.

54 There can be little doubt that the companies forming Selkirk's corporate structure were interrelated in the sense that there were transfers of assets from one to another or advances of money as between them, although none of them was a subsidiary of another in the true sense of the word.

55 It equally appears from the evidence that the only person to benefit financially from or to receive moneys arising from their operation was Selkirk himself.

56 The picture as to their procedures, however, is not altogether clear. The absence of records leaves substantial gaps in the evidence. Selkirk, himself, the one who, if he would, could have thrown much light upon the scene, was not called as a witness. Too much has been left to unsafe conjecture and frequently that which might have developed into proof has become arrested on the border of suspicion.

57 It does appear that Selkirk resigned as president of Industrial on May 31, 1960. His resignation was accepted at a meeting of the shareholders on June 2, 1960, the minutes of which recite that his qualifying share had been turned in for cancellation and had been transferred to W. Scott Burrill in order to maintain the required minimum number of shareholders.

58 Burrill states that there was no consideration passing for the transfer. Selkirk was adjudged a bankrupt on September 29, 1960, upon a petition filed on June 21, 1960. It may well be that this transfer of his share is void as against the trustee, the plaintiff, and that Selkirk's interest in the company, whatever it may be passes as part of his property to his trustee.

59 After his resignation as president, the defendant Zhelka, already a shareholder, was elected a director. Following his resignation, Selkirk was named as manager of the company and a resolution of the directors of October 20, 1961 purports to confer upon him wide powers with relation to the company's business and even goes so far as to purport to reinstate him as a director and officer in the event that he should be successful in a pending appeal from the receiving order against him.

60 He is even found, despite his resignation and his disqualification as a director by reason of his bankruptcy, signing the Gelberg mortgage in January, 1961, as president of the company.

61 With respect to the associated companies, Selkirk appears as a director of St. George Developments Ltd. in 1957 and as a director of Fidelity Real Estate Ltd. in 1958. His interest by way of stock in any of the other companies, except Industrial, is not disclosed by the evidence. There is some indication that he was at times the sole signing officer of Langstaff Land Development Ltd. and St. George Developments Ltd.

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62 It would appear from the report of the decision in *Selkirk v. M.N.R., supra*, that in 1952, the Langstaff company was wholly owned by him and that he conveyed a portion of the Markham Township land acquired by him to it, for a consideration, a large part of which had not been paid by April, 1960. It is there stated that in 1952 Langstaff had no money. This, however, was not the situation by the year 1959, for at that time Langstaff advanced to Industrial some $60,000 to enable it to purchase the Steeles Ave. property.

63 While the reported reasons for judgment of the Tax Appeal Board in that case indicate that Langstaff, for the purposes of the matters there being considered, was but the agent of Selkirk rather than functioning as a separate entity, this was not one of the issues raised nor was it argued as such and is mere *obiter*. As appears from the evidence in the instant case, and as already stated, that situation, in any event, had been altered by the year 1959. In fact the witness Mr. Lloyd A. May, a solicitor who acted in the Gotfrid action, states that by the year 1961, the Markham Township property, which had been originally owned by Selkirk, had found its way into the hands of St. George Developments Ltd., not Langstaff, with the exception of two lots which were then owned by the defendant Zhelka.

64 The evidence clearly demonstrates that George A. Selkirk always had and retained in fact complete control over all these companies upon which the evidence touches. He dictated the corporate policy in each case and was the moving and directing force in all of their business operations. The directors and officers, and particularly in the case of Industrial, were his nominees, including members of his immediate household and family, and were subject to his influence and I have no doubt to his domination. To all intents and purposes Industrial and its associated companies were one-man companies.

65 In reaching such conclusions, I am, I may say, quite uninfluenced by any alleged admissions or statements said to have been made by Selkirk. There are instances throughout the evidence of statements alleged to have been made to others by him. He is not a party to the action and such could not form admissible evidence for the plaintiff. Either one must consider them as entirely hearsay or as self-serving statements.

66 We are here, of course, primarily concerned only with Selkirk's relationship to Industrial. His connection with the other companies and their interconnection with Industrial is only of importance in so far as it may tend to establish a pattern of conduct. Industrial, despite its default in Government returns and irregularity in its proceedings, was regularly incorporated and has been kept alive as a corporate entity. Its charter has not been revoked under s. 326 of the *Corporations Act*, R.S.O. 1960, c. 71, although, apparently, it has been under departmental investigation. In 1963, it was still being taxed and some $14,000 levied against it under the *Corporations Tax Act* (ex. 21).

67 There is no evidence to indicate that when Industrial was incorporated in 1958, that Selkirk was insolvent; and nowhere is evidence to be found tracing any of Selkirk's personal assets into the hands of Industrial. The only indication that any of his personal assets passed into any of his companies is in the dictum in *Selkirk v. M.N.R.* earlier referred to. There is no intimation that at that time Selkirk was insolvent or that the transfer was in any way irregular or questionable. It does appear that later the Langstaff company advanced moneys to Industrial, but by the same token, it appears that Industrial still later advanced or repaid to Langstaff an approximately equal sum. I can see nothing unlawful or illegal *per se*, as against the personal creditors of Selkirk, in these interchanges of funds between companies. Even if there were an unlawful element, the only persons who were injured or damnified would be the shareholders or creditors of the companies involved. It is true that Selkirk has benefited personally from activities of his companies in

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dealings or transactions of questionable validity.

68 Industrial seldom had a bank account. Rental from the buildings upon the lands in question was received by his nominee or nominees rather than by Industrial. None of it, however, has been traced into his own hands, although one might suspect that some of it at least did reach him. In any event, only a small portion of it accrued due and was paid before his bankruptcy.

69 Fidelity Real Estate Ltd. appears recently to be the only one of the companies operating with a bank account and Industrial was indirectly the recipient of some of its funds.

70 The moneys paid to Miss Zhelka upon the settlement of the Gelberg action, some $9,249, went into the Fidelity bank account. These were really the funds of Industrial. Out of that account were paid some of Selkirk's personal bills for clothing, a retaining fee to a solicitor acting for him upon a criminal charge or charges of fraud pending against him and a sum offered by him by way of restitution in connection with such charge.

71 Whether Selkirk was entitled to moneys by way of salary or otherwise from Fidelity does not appear. If he was, at the time of such payments, a director of Fidelity as he once was, and the moneys were merely a loan or an advance to him, the transaction of course would fall within the prohibition of the *Corporations Act* respecting loans to shareholders.

72 The sum and substance of all this is that Selkirk has received some comparatively minor benefits from the operation of his companies and at times in a manner which, so far as regularity is concerned, is questionable. An aura of suspicion has been cast about him. I have no doubt that where his personal advantage is concerned he would go a long way.

73 But the question remains, in what way has his association with his corporate offspring injured, defeated or prejudiced his personal creditors? Apart from a small portion of the rents which he may have received, if any, from the buildings on the Steeles Ave. lands, it would appear that all benefits have accrued since his bankruptcy and really fall into the category of after-acquired property, to which recourse by the trustee is under the provisions of the *Bankruptcy Act*.

74 This is not a case where a debtor or a prospective debtor has transferred his own assets to a corporation of his making for the purpose of avoiding existing personal liabilities or obligations; nor is it a case where he has personally made a secret or clandestine profit by such a transfer.

75 There is here no claim or complaint by any creditor, if such there now be, of Industrial or its associated companies, nor by any director or shareholder.

76 In a critical analysis of the situation, one asks oneself just where is any fraud upon Selkirk's personal creditors being perpetrated by the operation of his companies and his conduct with relation thereto? To me the evidence falls short of establishing that.

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77 No doubt his creditors are disappointed at their inability to have access to his corporate assets and particularly where he himself is reaping some financial benefit therefrom. But that must of necessity be, so long as the Legislature provides for and encourages the formation of private corporations. Without such, of course, enterprise and business adventure would be stifled. Limited liability is one of the landmarks of incorporation.

78 The plaintiff as trustee in bankruptcy for some reason apparently has not seen fit to follow any funds reaching the hands of his debtor as after-acquired property nor to intervene with respect thereto.

79 The cases in which the Courts, both in this Province and in England, have seen fit to disregard the corporate entity or personality, and instead to consider the economic realities behind the legal facade, fall within a narrow compass. The Legislature, in the fields of revenue and taxation, and particularly with respect to true subsidiaries, has made much greater departure in this respect. Such cases as there are, illustrate no consistent principle. The only principle laid down is that in the leading case of *Salomon v. Salomon & Co., Ltd.*, [1897] A.C. 22; and in general such principle has been rigidly applied. Briefly stated, it is that the legal *persona* created by incorporation is an entity distinct from its shareholders and directors and that even in the case of a one-man company, the company is not an alias for the owner.

80 The exceptions would appear to represent refusals to apply the logic of the *Salomon* case where it would be flagrantly opposed to justice.

81 Counsel have presented me with an exhaustive review of these authorities. I can see no useful purpose in here reiterating it. The conclusions to be drawn from the cases as a whole were well stated by Mr. Justice Masten in his article on "'One Man Companies' and their Controlling Shareholders" at 14 *Can. Bar Rev.* 663 (1936), where he discusses the authorities.

82 In questions of property and capacity, of acts done and rights acquired or liabilities assumed, the company is always an entity distinct from its corporators. It is not an alias or a sham and the principle of the *Salomon* case stands unimpaired.

83 If a company is formed for the express purpose of doing a wrongful or unlawful act, or, if when formed, those in control expressly direct a wrongful thing to be done, the individuals as well as the company are responsible to those to whom liability is legally owed.

84 In such cases, or where the company is the mere agent of a controlling corporator, it may be said that the company is a sham, cloak or *alter ego*, but otherwise it should not be so termed.

85 Whether an individual has constituted the company his agent is a question of fact in each case. A controlling or total share interest does not in itself establish such agency. Due regard must be had to law of principal and agent relating to the formation of the relationship.

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86 Although the instant case may be close to the line, the plaintiff has failed to satisfy me that I should declare Industrial to be his *alter ego* or his mere agent for the conduct of his personal business or for the purposes of the conveyance in question to the defendant Zhelka. In the result, the action must be dismissed.

87 As I have previously intimated, I think the defendant Zhelka has invited these proceedings. I fail to see how the plaintiff, as trustee for the creditors of Selkirk, could afford to stand idly by in the face of her earlier statement in the Gotfrid action that she was holding the lands in question for her brother. It was, as events have proven, a false statement, or at least a totally irresponsible one; but the plaintiff in my view on the strength of it was justified in seeking judicial investigation of the whole matter.

88 In view of the relationship between the defendants and of the fact that the alternative plea by the corporate defendant that Miss Zhelka holds the lands in trust for it is virtually a plea asserting its own fraud against its creditors, I do not feel that it should have costs.

89 Under the circumstances there will be no order as to costs and the action will therefore be dismissed without costs.

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Transamerica Life Insurance Co. of Canada v. Canada Life Assurance Co.

Transamerica Life Insurance Company of Canada (plaintiff / respondent) and The Canada Life Assurance Company and Canada Life Mortgage Services Ltd. (defendants / moving party)

Ontario Court of Justice (General Division)

Sharpe J.

Judgment: May 1, 1996
Docket: Toronto 92-CQ-27566

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Counsel: *Earl Cherniak, Q.C., Paul Bates* and *Simon Clements*, for plaintiff / respondent.

Robert Armstrong, Q.C., Robert Rueter and *Stephanie Willson*, for defendants / moving party.

Subject: Civil Practice and Procedure

Corporations --- Nature of corporation — Distinct existence — Lifting the corporate veil

Corporations — Nature of corporation — Distinct existence — Lifting the corporate veil — Defendant parent and wholly-owned subsidiary being completely separate entities — Parent company not having any control over subsidiary nor involved in any way with plaintiff's dealing with subsidiary — No basis existing for piercing corporate veil.

The plaintiff made 54 mortgage loans between 1983 to 1989 which had been arranged by the defendant. A number of those mortgages had fallen into default in an alleged loss of approximately $60 million. The plaintiff alleged that the defendants owed it a duty to do the underwriting for the loans and that it failed to do so. The plaintiff sued the defendants for damags for breach of contract, breach of fiduciary duty, fraud, misrepresentation and negligence. One of the defendants was the wholly owned subsidiary of the other. The plaintiff asserted that the parent company is liable for the wrongs of its subsidiary. The parent company moved for summary judgment dismissing the action against it on the basis that there was no triable issue as to its liability to the plaintiff. The plaintiff contended that there existed a

basis for piercing the corporate veil, and for holding the parent company liable as an accessory to a breach of fiduciary duty of its subsidiary and liable as an accesory for the alleged misrepresentation of the subsidiary.

Held:

The motion was granted.

The parent company satisfied the onus of demonstrating that there was no genuine issues for trial respecting its liability to the plaintiff. The subsidiary and parent companies had their own head offices and branch offices, their own bank accounts and were managed and operated independently of one another. There was an arm's length relationship between the defendants. There was no evidence that any officer, employee or agent of the parent company was in any way involved with the dealings between the plaintiff and the subsidiary. There was no basis for piercing the corporate veil as there existed no principal-agent relationship between the two defendants. The parent did not control the subsidiary and there was no evidence to indicate any involvement in the impugned transactions between the plaintiff and the parent company. The plaintiff failed to demonstrate that there existed any triable issues with respect to the parent company's liability on the basis of its being an accessory to a breach of fiduciary duty or a misrepresentation.

Cases considered:

Air Canada v. M & L Travel Ltd. (1993), 50 E.T.R. 225, 159 N.R. 1, [1993] 3 S.C.R. 787, 67 O.A.C. 1, 15 O.R. (3d) 804 (note), 108 D.L.R. (4th) 592 — *considered*

Aluminum Co. of Canada v. Toronto (City), [1944] S.C.R. 267, [1944] 3 D.L.R. 609 — *referred to*

Australian Securities Commission v. A.S. Nominees Ltd. (1995), 133 A.L.R. 1 — *referred to*

B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd. (1989), 4 R.P.R. (2d) 74, 37 B.C.L.R. (2d) 258, 43 B.L.R. 67, (sub nom. *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Developments Ltd.)* 60 D.L.R. (4th) 30 (C.A.) — *applied*

Bank of Montreal v. Canadian Westgrowth Ltd. (1990), 102 A.R. 391, 72 Alta. L.R. (2d) 319 (Q.B.) [affirmed (1992), 2 Alta. L.R. (3d) 221, 135 A.R. 49, 33 W.A.C. 49 (C.A.)] — *referred to*

Barnes v. Addy (1874), 9 Ch. App. 244 (C.A.) — *referred to*

Clarkson Co. v. Zhelka, [1967] 2 O.R. 565, 64 D.L.R. (2d) 457 (H.C.) — *distinguished*

Covert v. Nova Scotia (Minister of Finance), [1980] 2 S.C.R. 774, 8 E.T.R. 69, (sub nom. *Jodrey Estate v. Nova Scotia)* 41 N.S.R. (2d) 181, 32 N.R. 275, (sub nom. *Jodrey v. Nova Scotia (Minister of Finance))* [1980] C.T.C. 437 — *distinguished*

Gold v. Rosenberg (1995), 9 E.T.R. (2d) 93, 129 D.L.R. (4th) 152, 86 O.A.C. 116, 25 O.R. (3d) 601 (C.A.) —

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considered

Gregorio v. Intrans-Corp. (1994), 4 M.V.R. (3d) 140, 18 O.R. (3d) 527, 72 O.A.C. 51, 115 D.L.R. (4th) 200, 15 B.L.R. (2d) 109 (C.A.) [additional reasons at (1994), 15 B.L.R. (2d) 109n (Ont. C.A.)] — *considered*

Kosmopoulos v. Constitution Insurance Co., 22 C.C.L.I. 296, [1987] 1 S.C.R. 2, (sub nom. *Kosmopoulos v. Constitution Insurance Co. of Can.)* [1987] I.L.R. 1-2147, 74 N.R. 360, 21 O.A.C. 4, (sub nom. *Constitution Insurance Co. of Can. v. Kosmopoulos)* 34 D.L.R. (4th) 208, (sub nom. *Kosmopoulos v. Constitution Insurance Co.)* 36 B.L.R. 233 — *considered*

Pizza Pizza Ltd. v. Gillespie (1990), 75 O.R. (2d) 225, 45 C.P.C. (2d) 168, 33 C.P.R. (3d) 515 (Gen. Div.) — *referred to*

Royal Brunei Airlines Sdn Bhd v. Tan, [1995] 3 W.L.R. 64 (P.C.) — *referred to*

Salomon v. Salomon & Co., [1897] A.C. 22, [1895-99] All E.R. Rep. 33, 4 Mans. 89 (H.L.) — *applied*

W.D. Latimer Co. v. Dijon Investments Ltd. (1992), 12 O.R. (3d) 415 (Gen. Div.) — *referred to*

801962 Ontario Inc. v. MacKenzie Trust Trust Co., [1994] O.J. 2105 [unreported] — *considered*

1061590 Ontario Ltd. v. Ontario Jockey Club (1995), 43 R.P.R. (2d) 161, 16 C.E.L.R. (N.S.) 1, 21 O.R. (3d) 547, 77 O.A.C. 196 (C.A.) — *referred to*

Statutes considered:

Competition Act, R.S.C. 1985, c. C-34

s. 36(4)*referred to*

s. 52(1)*considered*

MOTION for summary judgment dismissing action against moving party for disclosing no genuine triable issue.

***Sharpe J.*:**

Introduction

1 In the period 1983 to 1989, the plaintiff, Transamerica Life Insurance Company of Canada, made fifty-four mortgage loans which were arranged by the defendant Canada Life Mortgage Services Ltd. ("CLMS"). A number of

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the mortgages have fallen into default, resulting in an alleged loss of some $60 million. Transamerica asserts that CLMS owed it a duty to do the underwriting (due diligence, risk assessment and analysis) for these loans, that CLMS failed in that regard, and that Transamerica has suffered loss as a consequence. In its claim against CLMS, Transamerica pleads breach of contract, breach of fiduciary duty, fraud, misrepresentation and negligence. CLMS denies that it owed Transamerica any duty to underwrite the loans, asserts that it acted throughout simply as a mortgage broker, and contends that it was for Transamerica to do its own underwriting and due diligence with respect to the loans in question.

2 CLMS is the wholly owned subsidiary of The Canada Life Assurance Company. Transamerica asserts that Canada Life liable for the wrongs of CLMS on a variety of grounds and has joined Canada Life as a defendant to this lawsuit. Canada Life asserts that it had nothing to do with the mortgages in question and that there is no basis for the claim that it is legally responsible for the alleged wrongs of its wholly-owned subsidiary, CLMS. Canada Life brings this motion for summary judgment on the grounds that Transamerica had failed to show that there is a triable issue as to Canada Life's liability and asks that the action against it be dismissed.

Issues

3 Transamerica bases its claim against Canada Life on three grounds which, it asserts, permit the court to look behind the separate corporate existence of CLMS and attach liability to its sole shareholder, Canada Life. These assertions give rise to the following issues on this motion for summary judgment.

1. Is there a basis for "piercing the corporate veil" and holding Canada Life liable for the acts of its wholly owned subsidiary, CLMS?

2. Is there a basis for holding Canada Life liable as an accessory to a breach of fiduciary duty by CLMS?

3. Is there a basis for holding Canada Life liable for the alleged misrepresentations of CLMS either at common law, or under the *Competition Act*?

Facts

4 CLMS was incorporated in 1974 to carry on business as a mortgage correspondent and general financial agent. Before the creation of CLMS, Canada Life had regularly invested in mortgages originated by its branch offices. The branches produced more mortgage investment opportunities than Canada Life could handle and Canada Life decided to incorporate CLMS to carry on the business of mortgage correspondent and to deal with both Canada Life and other institutional investors. As CLMS was to be a wholly owned subsidiary, governing legislation required Canada Life to obtain the consent of the Department of Insurance, now Office of the Superintendent of Financial Institutions ("OFSI"), to its incorporation. The Department of Insurance was satisfied that the proposed business of CLMS was ancillary to the business of insurance as required by s. 65 of the Canadian and British Insurance Companies Act. Henry Heft, the employee of the Department of Insurance who dealt with the CLMS matter, testified that under the legislation, the Department was not interested in the way in which CLMS carried on its business, but only that it was ancillary to the business of insurance, that Canada Life's investment was not unreasonable and properly accounted for,

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and that CLMS did not exceed the powers it was given under its letters patent. It was Heft's understanding that the activity of a mortgage correspondent was to "be there for the service of people wanting to invest funds, and also for the service of people looking for the funds." The Department took no interest in whether the borrower or the lender paid CLMS a fee and knew that CLMS would be dealing with borrowers in all aspects of the proposed mortgage business. Para. (a)(ii) of the CLMS objects provides:

> to assist in the development, financing, construction and promotion of various real and immoveable properties, including research and feasibility studies relating to commercial, industrial, residential and public and private undertakings.

Heft understood this to refer to providing or obtaining financing for owners of real estate, in other words, borrowers.

5 It was Heft's evidence that the Department was not concerned about CLMS engaging in the business of assisting borrowers. Heft also testified that the Department did not address the particular matter of whether the due diligence review, analysis and risk assessment was the function of the insurance company lender or CLMS as mortgage broker. It was, however, his own personal understanding that this would be the responsibility of the lender.

6 In March 1981, Transamerica and CLMS established a "Master Agreement" to govern their relationship, and in the period to 1989, Transamerica invested in 54 mortgages originated by CLMS pursuant to this agreement. The terms of this agreement do not specifically provide that CLMS is to perform any underwriting function on Transamerica's behalf. CLMS takes the position that the agreement excludes this duty and asserts that is does not engage in the business of underwriting mortgage loan proposals for any lender. CLMS has an agreement with Canada Life in terms virtually identical to the Transamerica agreement and Canada Life does its own due diligence, review and risk assessment of proposed loans and does not look to CLMS to perform this function. The interpretation of the agreement and the nature of the relationship between CLMS and Transamerica is hotly disputed as Transamerica takes the position that CLMS was responsible for the underwriting function with respect to the loans it made.

7 The relationship between CLMS and Canada Life is as follows. CLMS has its own head office and branch offices distinct from those of Canada Life. CLMS has its own bank accounts. It is and was managed and operated independently of Canada Life. CLMS management exercises independent discretion in conducting the business of CLMS. Apart from the president, the senior management of CLMS is independent of Canada Life. Two vice-presidents have overall responsibility for the affairs of CLMS. The president of CLMS is a Canada Life employee. He spends a very small percentage of his time on CLMS business and he plays no role on the day to day management of CLMS. While his salary is paid by Canada Life, the portion of it attributable to the time he spends on CLMS business is charged back to CLMS. Canada Life does provide CLMS with certain administrative services, including payroll, salary records and legal services. The cost of these services is billed to CLMS by Canada Life, and responsibility for hiring, promotion and remuneration of CLMS employees remains that of CLMS management. All members of the CLMS board of directors and the president of CLMS are senior executives of Canada Life.

8 Canada Life and CLMS take the position that the exigencies of the market required there to be an arm's length relationship between the two companies. They contend that prospective lenders, including Transamerica, were concerned that Canada Life would be in a favoured position and "cherry-pick" the best investments, and for that reason,

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CLMS was operated as a business entirely separate and independent of Canada Life.

9 The individual who dealt directly with Transamerica during the relevant period, Stuart Pearson, was the branch manager of the Toronto Regional Branch. He reported to Tom Deegan, one of the two vice-presidents. Pearson and Deegan were both employees of CLMS and neither had any duties or responsibilities to Canada Life. The affidavit of J. Gordon Fleming, President and Chairman of the Board of CLMS from 1984 to 1994 describes the involvement, or lack thereof, of Canada Life in the dealings between CLMS and Transamerica:

> All business dealings between CLMS and Transamerica were conducted by CLMS employees directly with Transamerica employees. There has been absolutely no involvement in the business dealings between CLMS and Transamerica by directors, officers or employees of Canada Life other than the presence of representatives of Canada Life in discussion with Transamerica about this litigation commencing in 1992. There was never any involvement in the actual business dealings between CLMS and Transamerica that gives rise to this litigation by the directors, officers or employees of Canada Life not indeed was there even any knowledge of it by them.

10 There is no evidence, subject to what follows relating to certain meetings in 1989, that Mr. Fleming or any other Canada Life officer or employee were involved in any way in the dealings between CLMS and Transamerica. The relationship between CLMS and Transamerica was not discussed by the Board of Directors of CLMS. Apart form six letters from the legal department of Canada Life, acting in the capacity of solicitors for CLMS, there is no evidence of any communication whatsoever between Canada Life and Transamerica in relation to the transactions at issue in this suit prior to the initiation of proceedings.

11 As noted already, the president of CLMS, Mr. Fleming and his predecessor, R.D. Radford, were the only officers of CLMS who were also officers of Canada Life. There is no evidence to suggest that Mr. Radford was aware of or involved with Transamerica. Fleming's involvement prior to the initiation of proceedings was as follows. In 1989, senior officers from Transamerica's parent came to Toronto to conduct a review of the mortgage investment practices and procedures of Transamerica. The inferences to be drawn from this review is a matter of dispute between CLMS and Transamerica. Transamerica takes the position that this review should have made it apparent to CLMS that Transamerica was relying on CLMS for underwriting advise in relation to the mortgages in which it was investing. CLMS takes the position that the review suggested otherwise and points to the fact that a report of the review recognized that Transamerica should not be relying on CLMS for underwriting but rather should ensure it had internal capacity to perform that function. The significance of this review will be an issue for trial as between CLMS and Transamerica. For the purposes of this motion, Transamerica argues that there is evidence that Fleming became aware of the review and that his failure to set the record straight as to the nature of the service being provided by CLMS to Transamerica is sufficient to fix liability on Canada Life. The only evidence of Fleming's awareness is as follows. The defendants have produced an extract from a minute of a CLMS management meeting of June 28, 1989, of Fleming and the two vice-presidents, Curtin and Deegan:

> Mr. Fleming was advised of a visit from the Senior Vice-President of Transamerica who was conducting an "underwriting audit" of their mortgage dealings in Canada. Attending the meetings were Joseph Barbieri, Bob Clarke and myself.

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> Transamerica was interested in mortgage financing in Canada and their questions were mainly directed to types of financings, building construction, appraisals, etc. There was no criticism or our services either from the branch or head office.

12 Transamerica takes the position that this is sufficient to fix Fleming, and through Fleming, Canada Life, with knowledge of the breach of contract, breach of fiduciary duty, and misrepresentations alleged against CLMS. In my view, this assertion reads far more into the minute than is warranted by the minute itself and by the balance of the evidence surrounding the meetings of the visiting Transamerica executives. Fleming denies that he was told that Transamerica thought that CLMS was doing the underwriting. It was his evidence that during the course of a meeting that lasted about two minutes, he was told that CLMS had had a visit from Transamerica. He stated that he is almost certain that this was the first time he learned that CLMS was doing business with Transamerica and that he considered it to be a routine matter for an investor to come to learn more about the mortgage market in Canada. He agreed that if he had been made aware that Transamerica was operating under the mistaken impression that CLMS was doing the underwriting for the loans, he would have instructed the CLMS staff to set the matter straight, but the information he was given did not convey that information.

Analysis

1. Is there a basis for "piercing the corporate veil" and holding Canada Life liable for the acts of its wholly owned subsidiary, CLMS?

13 On behalf of Transamerica, Mr. Bates submits that the applicable legal test for piercing the corporate veil can be stated no more precisely that this: the corporate veil will be pierced when it is "just and equitable" to do so. As authority for that proposition, reliance is placed on the following passage from the judgment of Wilson J. in *Constitution Insurance Co. v. Kosmopolous*, [1987] 1 S.C.R. 2 at pp. 10-11:

> As a general rule a corporation is a legal entity distinct from its shareholders: Salomon v. Salomon & Co. [1897] A.C. 22 (H.L.). The law on when a court may disregard this principle by "lifting the corporate veil" and regarding the company as a mere "agent" or "puppet" of its controlling shareholder or parent corporation follows no consistent principle. The best that can be said is that the "separate entities" principle is not enforced when it would yield a result "too flagrantly opposed to justice, convenience or the interests of the Revenue": L.C.B. Gower, Modern Company Law (4th ed. 1979) at p. 112. I have no doubt that theoretically the veil could be lifted in this case to do justice ... But a number of factors lead me to think it would be unwise to do so.

14 If accepted, the argument advanced by Transamerica would represent a significant departure from the principle established in *Salomon v. Salomon & Co.*, [1897] A.C. 22 (U.K. H.L.) at 51 per Lord Macnaughten:

> The company is at law a different person altogether from the subscribers to the memorandum; and, though it may be that after incorporation the business is precisely the same as it was before, and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided by the Act.

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15 In my view, the argument advanced by Transamerica reads far too much into a dictum plainly not intended to constitute an in depth analysis of an important area of the law or to reverse a legal principle which, for almost 100 years, has served as a cornerstone of corporate law.

16 It was conceded in argument that no case since Kosmopolous has applied the preferred "just and equitable" test. In Kosmopolous itself, the Supreme Court, including Wilson J., rejected the submission that the corporate veil be lifted. Moreover, it will be noted that Wilson J. does not use the phrase "just and equitable" but rather quotes a passage from an English text which describes the test in must more stringent terms.

17 Two recent judgments of this court have refused to read the Kosmopolous dictum as granting carte blanche to lift the corporate veil absent fraudulent or improper conduct: *W.D. Latimer Co. v. Dijon Investments Ltd.* (1992), 12 O.R. (3d) 415 (Gen. Div.); *801962 Ontario Inc. v. MacKenzie Trust Co.*, [1994] O.J. No. 2105 [unreported]. In the MacKenzie case, Spence J. reviewed the case-law in detail and concluded:

> These decisions do not support a claim that the test in Salomon v. Salomon has been superseded by a new "business entity" or "single business entity" test. They merely illustrate the principle that, in particular fact situations, where the nature of the legal issue in dispute makes it appropriate to have regard to the larger business entity, the court is not precluded by Salomon v. Salomon from doing so. In a few cases, there are statements that the court will lift the corporate veil "where injustice would otherwise result." I am not able to conclude that such statements are intended to remove the authority of the Salomon principle. I think they may be more in the nature of a shorthand formulation reflecting the approach of the courts in the cases discussed above.

18 The proposition that the dictum of Wilson J in Kosmopolous suggests a fundamental shift in the law was also rejected by the British Columbia Court of Appeal in *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd.* (1989), 37 B.C.L.R. (2d) 258 (C.A.). Seaton J. observed (at 267) that the passage quoted in Kosmopolous from Gower, Modern Company Law, concluded with a passage which disapproved of the free-wheeling "just and equitable" approach:

> The most that can be said is that the courts' policy is to lift the veil if they think that justice demands it and they are not constrained by contrary binding authority. The results in individual cases may be commendable, but it smacks of palm-tree justice rather than the application of legal rules.

Seaton J.A. went on to quote a Canadian text, Welling, Corporate Law in Canada (1984) at p. 129, which disapproved of the approach of some American cases to adopt a general fairness test:

> Little need be said about this rationale, other than that it simply will not do. There are, so far as we know, no such broadly enforceable standards of "fair play and good conscience," at least in Canadian corporate law.

19 It should also be noted that the most recent edition of Gower, Modern Company Law, (5th ed., 1992) puts the test for lifting the corporate veil in much more stringent terms. The authors review the decision of the English Court of

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Appeal in Adams v. Cape Industries plc, [1991] 1 All E.R. 433 which, they state (at p. 125) "subjected lifting the veil to the most exhaustive treatment that it has yet received in the English (or Scottish) courts." The authors conclude that the Adams decision significantly attenuates the grounds for lifting the veil, and they make no suggestion, as they did in the earlier edition cited in Kosmopolous, that the test is anything like a "just and equitable standard: (at 132-133)

> There seem to be three circumstances only in which the courts can do so. These are:
>
> (1) When the court is construing a statute, contract or other document.
>
> (2) When the court is satisfied that a company is a "mere facade" concealing the true facts.
>
> (3) When it can be established that the company is an authorized agent of its controllers or its members, corporate or human.

20 In a recent judgment of the Ontario Court of Appeal, *Gregorio v. Intrans-Corp.* (1994), 18 O.R. (3d) 527 (C.A.) at 536, Laskin J.A. restated the legal principles relating to the liability of a parent company for the acts of its subsidiary as follows:

> Generally, a subsidiary, even a wholly owned subsidiary, will not be found to be the alter ego of its parent unless the subsidiary is under the complete control of the parent and is nothing more that a conduit used by the parent to avoid liability. The alter ego principle is applied to prevent conduct akin to fraud that would otherwise unjustly deprive claimants of their rights.

21 There are undoubtedly situations where justice requires that the corporate veil be lifted. The cases and authorities already cited indicate that it will be difficult to define precisely when lifting the corporate veil is to be lifted, but that lack of a precise test does not mean that a court is free to act as it pleases on some loosely defined "just and equitable" standard. There may be a principal-agent relationship between two related corporations which leads to liability despite separate legal personalities: see *Gower, supra*; *Clarkson Co. v. Zhelka*, [1967] 2 O.R. 565 (H.C.) at 578. It is also the case that the courts will look behind corporate structures where necessary to give effect to legislation, especially taxation statutes: see *Gower, supra*; *Covert v. Nova Scotia (Minister of Finance)*, [1980] 2 S.C.R. 774. Neither of these two exceptions applies to the situation of the case at bar.

22 As just indicated, the courts will disregard the separate legal personality of a corporate entity where it is completely dominated and controlled and being used as a shield for fraudulent or improper conduct. The first element, "complete control", requires more than ownership. It must be shown that there is complete domination and that the subsidiary company does not, in fact, function independently: *Aluminum Co. of Canada v. Toronto (City)*, [1944] S.C.R. 267 at 271; *Bank of Montreal v. Canadian Westgrowth Ltd.* (1990), 72 Alta. R. (2d) 319 (Q.B.). The evidence before me indicates that the relationship between Canada Life and CLMS was that of a typical parent and subsidiary. While CLMS is wholly owned by Canada Life and its board of directors is comprised of Canada Life executives, I have found that it does have an independent management and conducts a business separate and distinct from that of its parent. There is, in my opinion, no evidence sufficient to give rise to a triable issue that CLMS is the mere puppet of Canada Life.

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23 The second element relates to the nature of the conduct: is there "conduct akin to fraud that would otherwise unjustly deprive claimants of their rights?" In my view, while Transamerica has alleged fraud against CLMS, there is no evidence to suggest that Canada Life has any involvement in that alleged fraud, apart form the fact that CLMS is its wholly-owned subsidiary. The officers and employees of Canada Life were not involved in the dealings between CLMS and Transamerica, and no evidence has been advanced sufficient to give rise to a triable issue that Canada Life is somehow using CLMS as a shield for some nefarious purpose.

24 It is submitted that this is a developing area of the law, and that it would be wrong for me to grant summary judgment and thereby preclude having the issue fully considered at trial in light of all the evidence. As I have already indicated, it is my view that the law in this area is not developing at anything close to the extent submitted by Mr. Bates. Moreover, there is nothing in the facts of this case to suggest that this would be a case where the court might be tempted to lift the corporate veil in the interest of doing justice between the parties. Transamerica has simply not been able to make out a triable issue or arguable case that the court should look behind the corporate veil. There has been extensive discovery, cross-examination on affidavits and this motion has been pending for almost an entire year. Transamerica has had the fullest possible opportunity to advance its case. It is clearly established that on a motion for summary judgment, a party is no longer entitled to sit back and rely on the possibility that more favourable facts may develop at trial. To avoid summary judgment, a party is required to put its best foot forward. The onus remains on the moving party to show that there is no genuine issue for trial, but the responding party must "lead trump or risk losing": *Pizza Pizza Ltd. v. Gillespie* (1990), 75 O.R. (2d) 225 (Gen. Div.); *1061590 Ontario Ltd. v. Ontario Jockey Club* (1995), 21 O.R. (3d) 547 (C.A.). In my view, Transamerica has failed to present evidence to indicate that there is a triable issue on this point and Canada Life has met the onus of showing that it should be granted summary judgment on this issue.

2. Is there a basis for holding Canada Life liable as an accessory to a breach of fiduciary duty by CLMS?

25 In my view, Transamerica has failed to demonstrate that there is a triable issue on the claim that Canada Life is liable as an accessory to a breach of fiduciary duty.

26 This area of the law was canvassed at length in the recent decision of the Supreme Court of Canada, *Air Canada v. M. & L. Travel Ltd.*, [1993] 3 S.C.R. 787. That case affirms the principle that a stranger to a trust may become personally liable for a breach of trust committed by the trustee. It involved the liability of directors of a closely held corporation for a breach of trust committed by the corporation. On the surface, this is analogous to the case at bar where Transamerica alleges that Canada Life should be held to account for a breach of fiduciary duty committed by its wholly owned subsidiary, CLMS. However, it should be noted that in the Air Canada case, the directors were directly and personally involved in the misappropriation of trust funds. The Supreme Court of Canada found that to support a claim against an accessory, the plaintiff must show a breach of trust of a fraudulent or dishonest nature. An innocent breach of trust will not suffice. The opinion of Iacobucci J. also makes it clear that the stranger to the trust must be involved in the breach with actual knowledge, recklessness or wilful blindness. Iacobucci J. expressly excludes the possibility of liability on the basis of constructive knowledge (knowledge of circumstances which would indicate the facts to an honest person or put an honest person on inquiry). This conclusion is consistent with a long line of authority with respect to accessorial liability for breach of trust. In an early leading case, cited with approval by Iacobucci J., it

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was stated that persons who "assist with knowledge in a dishonest and fraudulent design on the part of the trustees" will be held liable: *Barnes v. Addy* (1874), 9 Ch. App. 244 (U.K. C.A.) at 252. The statement of the principle cited by Transamerica is that from the judgment of Finn J. in *Australian Securities Commission v. A.S. Nominees Ltd.* (1995), 133 A.L.R. 1 at 19:

> For present purposes, that liability rule can be formulated (conservatively) as one which exposes a third party to the full range of equitable remedy available against the trustee if that person knowingly or recklessly assists in or procures a breach of trust or of fiduciary duty by a trustee.

27 The recent judgment of the Privy Council in *Royal Brunei Airlines Sdn Bhd v. Tan*, [1995] 3 W.L.R. 64 (P.C.) describes the level of misconduct required as "dishonesty": "A liability in equity to make good resulting loss attaches to person who dishonestly procures or assists in a breach of trust or fiduciary obligation" (at 76 per Lord Nicholls). The Ontario Court of Appeal has also recently had occasion to review the law in this area. In *Gold v. Rosenberg* (1995), 25 O.R. (3d) 601 (C.A.), Laskin J.A. held that the Supreme Court of Canada's decision in the *Air Canada* case, supra, had "settled" two crucial questions in this area, first, whether the trustee's breach had to be fraudulent and dishonest, and second, whether the agent must have actual knowledge to be held liable or whether constructive knowledge is sufficient. As Laskin J.A. observed, the judgment of Iacobucci J. *Air Canada* makes it clear that the breach of trust must be fraudulent or dishonest and the agent must have actual knowledge of the breach.

28 The nature of the breach alleged against CLMS is essentially an allegation that CLMS had a contractual obligation to perform certain duties with respect to underwriting the loans and that it breached those contractual duties by failing to perform as it had promised. Mr. Cherniak submits that where the contract is such as to give rise to a fiduciary duty, the party complaining of the breach is clearly entitled to ground its claim in equity if that is more beneficial. Accepting that proposition still leaves Transamerica well short of a fraudulent or dishonest breach of trust of the kind contemplated by *Air Canada* and *Gold v. Rosenberg* as being necessary to support a claim for the liability if the accessory. But even if the claim of Transamerica against Canada Life could survive that first hurdle, there is no evidence to support the allegation that Canada Life knowingly assisting CLMS in committing a breach of trust or breach or fiduciary duty. Certainly, there is no evidence of "dishonesty" (said to be necessary by the Privy Council in *Royal Brunei Airlines Sdn Bhd v. Tan*) on the part of Canada Life. As indicated above, until 1989, no Canada Life officer or employee knew that CLMS had dealings with Transamerica, let alone that CLMS was acting in breach of trust or breach of fiduciary duty. Transamerica relies on the undertaking given to OSFI at the time of CLMS's incorporation. That undertaking was not given to or even known by Transamerica and the evidence of Heft, the party who received the undertaking, is clear that there is no basis to support the very specific meaning and significance Transamerica seeks to attribute to it. The information conveyed to Fleming in relation to the visit from the senior executives of Transamerica's parent in 1989 falls well short of evidence capable of grounding a triable issue on this point. In my view, the contentions of Transamerica on this point are wholly unsupported by the evidence and there is no triable issue of liability of Canada Life. It is apparent that this argument amounts to an attempt to overcome the limitation of liability created by the separate corporate existence of Canada Life and CLMS. It is also apparent from the *Air Canada* case and the other authorities already cited that without proof of knowing involvement in the breach of trust, the law does not impose equitable liability simply on the basis that the targeted defendant is the owner of the corporate entity which committed the equitable wrong.

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3. Is there a basis for holding Canada Life liable for the alleged misrepresentations of CLMS either at common law or under the Competition Act?

29 In the statement of claim, Transamerica contends that CLMS represented to it that Canada Life "would stand behind CLMS and ensure that it discharge its obligations to Transamerica" and that "CLMS' business for Transamerica was that of a mortgage correspondent acting on behalf of Transamerica in the acquisition and servicing of the mortgage investments." With respect to Canada Life, it is pleaded:

> Canada Life knew or ought to have known that the [above] representations ... were made by CLMS to Transamerica for the purpose of inducing Transamerica to do business with, and to continue to do business with, CLMS pursuant to the Mortgage Correspondent Agreement. Canada Life caused, and consented to, the making of these representations for the purpose of realizing economic gain conducted by CLMS with Transamerica.

In response to a demand for particulars of these allegations against Canada Life, Transamerica was unable to specify any communication from Canada Life. On this motion for summary judgment, no evidence has been offered that Canada Life "caused" any misrepresentation to be made to Transamerica. Nor has any evidence been offered to support the allegation that Canada Life "consented to" any such misrepresentation if, indeed, "consenting" to such a statement would give rise to liability.

30 Transamerica submits that it is entitled to succeed against Canada Life on the theory that it must have known of certain misrepresentations made by CLMS. It is submitted that these alleged misrepresentations give rise to a common law cause of action and to an action under the *Competition Act* s. 52(1):

> 52(1) No person shall, for the purpose of promoting, directly or indirectly, the supply or use of a product or for the purpose of promoting, directly or indirectly, any business interest, by any means whatever,
>
> (a) make any representation to the public that is false or misleading in a material respect.

31 This argument was essentially based upon three marketing brochures which describe the activities of CLMS and its relationship to Canada Life. In addition, reliance was placed on the fact that the CLMS financial statements are consolidated with those of Canada Life.

32 The first of the marketing brochures relied upon was in use for 1976 to 1978, well before Transamerica had any dealings with CLMS and Transamerica has been unable to produce a copy of this brochure from its records. Transamerica does state, however, that its officers saw and relied upon certain statements in the brochure, in particular, that CLMS would act as "the investor's own Mortgage and Real Estate Department" and that CLMS was a "Canada Life company". The second brochure was in use for the period 1982-85 and the third was released in 1989. All the brochures clearly indicate that CLMS provides services to both borrowers and lenders. They also refer to the fact that CLMS in a wholly owned subsidiary of Canada Life.

33 Radford saw the first brochure, signed a letter contained in the second as "Chairman of the Board and Presi-

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dent" of CLMS, and Fleming saw the third brochure. Apart from that, there is no evidence that any officer or employee of Canada Life had any involvement with the writing, printing or distribution of these brochures.

34 In my view, the allegations based on these brochures fail to give rise to a triable issue against Canada Life. I will deal first with the issue of the definition of the role of CLMS. The language of the brochures is, at best, ambiguous with respect to the role of CLMS. It is difficult to give credence to the suggestion that at the relevant time, Transamerica attached to these brochures the significance it now does for the purposes of this action. Transamerica was investing millions of dollars in mortgages and had a detailed written agreement with CLMS to govern their dealings. It strains credibility to imagine that a sophisticated institutional investor would rely on marketing materials of this nature as the basis for defining the legal obligations of CLMS and Canada Life.

35 However, assuming for present purposes that the brochures contain statements which are capable of grounding a claim for deceit, misrepresentation or breach of the provisions of the *Competition Act*, is there evidence to suggest a triable issues that liability should attach to Canada Life? In my view, there is not. They were prepared, printed and distributed by CLMS. In cross-examination, Fleming stated that the authority to put forward marketing materials

> existed within the subsidiary itself. This was their brochure, not Canada Life's. So there would be no need for approval from Canada Life. They wouldn't know it existed. So it was a CLMS document. And they produced it and had the authority to produce it themselves for their own corporate purpose.

This is entirely consistent with the rest of the evidence as to the independent management of CLMS and there is no evidence to suggest that Canada Life had any greater involvement in the preparation of the brochures. As indicated, the only involvement of any Canada Life officer or employees was that 1) Radford saw the first brochure; 2) in his capacity as Chairman of the Board and President of CLMS, Radford signed the second brochure; and 3) Fleming saw the third brochure. In my view, this minimal involvement by these two individuals, acting in their capacity with CLMS, falls well short of a factual basis for finding liability on the part of Canada Life.

36 The second issue is the claim that the brochures represent Canada Life as being legally responsible for the acts of CLMS. In addition to the brochures, it is submitted that the consolidated financial statements of Canada Life and CLMS and led Transamerica to believe that Canada Life would "stand behind" CLMS. The evidence with respect to the financial statements is as follows. In June, 1989, as part of its review of the mortgage investment procedures of its subsidiary, a representative of the parent of Transamerica asked CLMS to provide its financial statements. This request was answered by letter from RF Clarke of CLMS dated June 27, 1989:

> As you requested in your recent visit to our office, I have enclosed a copy of the Financial Statements of the Canada Life Assurance Company (which includes Canada Life Mortgage Services in its consolidation).

The consolidation of CLMS' financial statements with those of its parent corporation is in accordance with accepted accounting principles, a matter well known to Transamerica as it follows precisely the same practice with respect to its statements.

37 In my view, the evidence advanced to support this claim is insufficient to give rise to a triable issue. The

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brochures accurately state that CLMS is a wholly owned subsidiary of Canada Life and the financial statements reflect accepted accounting practice. While from a business perspective, the relationship between CLMS and Canada Life was undoubtedly significant to Transamerica, it is inconceivable that a sophisticated corporate entity such as Transamerica would read such statements in a marketing brochure to amount to a representation that Canada Life would be legally liable for any wrongs committed by CLMS. The affidavit of James Roszak is carefully crafted. His statement that Transamerica "understood that Canada Life would stand behind CLMS and ensure that it discharged its obligations" falls well short of a sworn statement that he or anyone else at Transamerica actually thought that when Transamerica dealt with CLMS, that from a legal perspective, it was dealing with Canada Life or that legal liability would attach to Canada Life for the acts of CLMS.

38 In argument, Mr Armstrong placed particular emphasis with respect to this area of the case on the fact Transamerica has failed to adduce any evidence from Ken Hennessy, the officer of Transamerica who was responsible for the day to day dealings with CLMS. In view of the failure of Transamerica to come forward with evidence from Hennessy to say that when he was dealing with Pearson and CLMS, he thought he was really dealing with Canada Life, Mr. Armstrong submits that an adverse inference can be drawn.

39 Mr. Cherniak resists this point on the basis that the Roszak affidavit is based in part upon information from Hennessy. It was also argued that as Hennessy is now a party to the action, having been added as a third party by Canada Life, Transamerica cannot be expected to adduce his evidence.

40 In my view, the failure of Transamerica to provide any evidence on this motion from Hennessy is telling. He is without question the individual with the most direct and immediate knowledge of the dealings between CLMS and Transamerica. It is difficult to imagine how Transamerica could make out its case at trial that when it dealt with CLMS, it honestly thought it was dealing with Canada Life, without strong evidence from this individual. While he has recently been made a third party, this motion for summary judgment has been pending for over one year, and his involvement as a third party does not explain why his evidence was not adduced. I have already indicated the significant weakness in the evidence adduced by Transamerica on the misrepresentation issue. The failure of Transamerica to lead any evidence from Hennessy or to provide an adequate explanation for the fact that no such evidence has been adduced provides a further basis for granting summary judgment on this point.

41 A further point was raised by the defendants, namely, that the claim under the *Competition Act* is statute barred in light of s. 36(4) which requires that any action be brought within "two years from the day on which the conduct was engaged in". This matter was raised in reply argument, and as the limitation defence had not been pleaded, a motion was made to amend the statement of defence. In view of my finding with respect to the misrepresentation claim, it is not necessary for me to deal with this point in relation to the summary judgment motion brought by Canada Life. However, as the action is proceeding against CLMS and the plaintiff asserts a cause of action under the *Competition Act*, I grant leave to amend the statement of defence to plead the limitation defence.

Conclusion

42 For the foregoing reasons, I conclude that the moving party, Canada Life, has met the onus of demonstrating that there is no genuine issue for trial. The responding party, Transamerica, has had full opportunity to come forward

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with evidence to show that there is a genuine issue for trial but has failed to do so. Accordingly, Canada Life is entitled to summary judgment dismissing the action against it. The remaining defendant CLMS is hereby granted leave to amend the statement of defence to plead the limitation defence pursuant to s. 36(4) of the *Competition Act*. I may be spoken to with respect to costs.

Motion allowed.

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Index No. 17

***679 In re European Society Arbitration Acts v**

Court of Appeal

L. James, Baggallay, and Thesiger

1878 Jan 28, 29; Feb. 1, 4, 26

Ultrà Vires—Purchase of Business by Company—Transfer to purchasing Company of Shares of selling Company.

The *B. N. Company* was an insurance company established with £10 shares, under a deed of settlement which provided that every instrument whereby the company became liable to pay money should contain a clause limiting the liability of shareholders to the amount payable on their shares. The deed contained a power to the company, with the sanction of an extraordinary general meeting, to purchase the business of any other company of a similar nature, upon such terms as the meeting should think fit. The company resolved to purchase the business of the *B. C. Company* , an insurance company whose capital was divided into £50 shares, on each of which £5 had been paid, and whose deed of settlement contained no power to sell the business. The transaction was completed by purchasing the shares of the *B. C. Company* , which were transferred to various officers of the *B. N. Company* . Subsequently a deed was executed by which those transferees transferred their shares to the *B. N. Company* , and thereupon that company was entered On the register of shareholders of the B. C. Company, and remained so registered for some years. This deed was never sanctioned by a general meeting of the *B. N.* shareholders. An order having been made for winding up the *B. C. Company* :—

that the transfer of the shares to the *B. N. Company* was ultrà ***680** vires and invalid, and that the *B. N. Company* could not be placed on the list of contributories of the *B. C. Company* . By the European Arbitration Act, 1875 , it was enacted that as regards any determination or order given or made before the passing of the Act, no appeal should lie therefrom unless the arbitrator expressly certified in writing that by reason of differences between previous decisions on matters of principle it was desirable that an appeal should be brought:—

that a formal certificate from the arbitrator, and not a mere expression of opinion, was necessary to give the Court of Appeal jurisdiction; and that differences between previous decisions referred to decisions before the passing of the Act.

THIS was an appeal by the liquidators of the British Nation Life Assurance Association (hereinafter called the *British Nation*) against the decision of Mr. *F. S. Reilly* , the arbitrator appointed under the *European Assurance Society Arbitration Acts* , 1872, 1873, and 1875, to the effect that the *British Nation* should be put on the list of contributories of *British Commercial Insurance Company* , and should be ordered to pay such call as might be necessary to discharge the *British Commercial* liabilities and the costs of the *British Commercial* liquidation; and that the liability of the *British Nation* in respect of such an call was unlimited, except so far as it was limited by the terms of the *British Commercial* policies and other contracts.

The *British Commercial* was established by a deed of settlement dated the 1st May, 1821, with a nominal capital of £1,000,000, divided into 200,000 shares of £50 each. 12,000 of those shares were subscribed for, and calls to the amount of £5 a share were made thereon. It was an unregistered company within Part VIII. of the Companies Act, 1862 . The deed of settlement contained the common clause providing for the insertion in its policies and other contracts of a provision that the contracting party should only look to the funds and uncalled capital of the company. And it did not contain any power enabling the company to transfer its business to another company.

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The *British Nation* was established by a deed of settlement dated the 28th of February, 1855, with a nominal capital of £300,000, in shares of £1 each, subsequently altered to shares of £10 each. Its objects included all the usual business of a fire and life insurance company. It was completely registered under 7 & 8 Vict. c. 110 , and on the 3rd of November, 1862, was registered ***681** under the Companies Act, 1862 . The provisions to which notice was called during the argument were the following:—

"44.That two extraordinary general meetings shall have full power to extend the objects of the association to the making or effecting insurances on ships or vessels and their cargoes against loss or damage by fire, and against capture and other sea risks, and to the undertaking of any other such business as is usually undertaken by underwriters, and to make new laws, regulations, and provisions for the association, or to amend, alter, or repeal, either wholly or in part, all or any of the existing laws, regulations, and provisions of the association, provided that such extensions of the objects of the association, and such new, amended, or altered laws and provisions shall have been previously recommended by the board, and do not extend to, amend, alter, or repeal any provisions hereby expressly declared to be unalterable, or any of the laws, regulations, or provisions hereby established for limiting the individual responsibility of shareholders, and subject in all cases to the provisions and regulations of 7 & 8 Vict. c. 110 , and these presents.

"45.That an extraordinary general meeting may accept or take a transfer of or purchase or acquire the business of any other associations, companies, or societies of a similar nature (wholly or in part) with the association hereby established, upon and under such terms, conditions, stipulations, and agreements as such meeting shall think fit."

"91.That the board shall, as respects every life policy and other policy issued by the association, and every grant of annuity by the association, and every other instrument whereby a liability to pay any sum or sums exceeding in the whole the sum of £5 shall be incurred by the association (except in the cases specially provided for in clause 187, and except in the case of the lease of any house or offices rented by the association), cause to be inserted therein, either in express words or by reference to this present clause, a declaration that the capital, stock, and funds of the association shall alone be liable to answer and make good all claims under such policy, grant of annuity, or other instrument (as the case may be), and all other claims whatsoever against the said association, and that no director, proprietor, or member of ***682** the association shall in any manner be personally liable or subject to any such claims, or be bound by reason thereof to do anything more than (as respects a proprietor) to pay to the proper officers the association the amount (if any) due from him to the association in respect of instalments upon his share or shares in the capital of the association."

Clause 187 prohibited making or issuing promissory notes or bills of exchange in the name or on the behalf of the association, and it also forbade the acceptance of bills by the association, except bills drawn by persons abroad for moneys payable in respect of claims under policies. Such last mentioned bills were not to be subject to clause 91.

Clause 119 gave extensive powers of investing the moneys in hand which were not required to satisfy immediate claims, and, inter alia, it was provided that the board, with the consent of not less than three directors present, might invest "in the purchase of shares in any docks, canals, rivers, navigations, waterworks, bridges, piers, railways, or turnpike roads established by Act of Parliament … or in the purchase of any personal property of any nature or kind whatsoever, or of any debts, claims, and demands, or interests whatsoever, and of what nature or kind soever.

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On the 17th of November, 1859, Henry Lake, the manager and secretary of the *British Nation* , in accordance with a resolution of the *British Nation* board of directors, passed on the same day, addressed the following letter to the directors of the *British Commercial* :—

"Gentlemen,—It has been suggested to the directors of this association and to myself that a union of the business of the *British Commercial Insurance Company* with this association would be advantageous to both institutions, and for the following reasons:

"First. The proprietary of the *British Commercial* might, if they so desired, be paid off at a price to be agreed upon—say 25s. per share, and transfer of such shares be taken by trustees to be appointed by this association.

"Second. This association having a business of nearly £30,000 ***683** a year at present arising from policies of an average of under three years would supply the older policies of the *British Commercial* , the element which alone is necessary to give force and value to its business. For the increased amount of the annual premium income would be better enabled to bear the certain claims which must arise from the older business of the British Commercial without, for many years to come, entrenching upon the assets reserved, thus protecting the company from the disastrous effects of a disturbed rate of mortality. A further negotiation for young life business, which, as your directors may be aware, carries with it invariably a large amount of future profit combined with greatly increased security, is pending, and on the very eve of completion, by which an addition of £20,000 a year will be made to the income of this association, forming a gross income of £50,000 per annum.

"Third. This association possesses a staff of nearly 1000 agents, now producing a large amount of new business, which is rapidly increasing, and all anxious to co-operate with the directors of this association in the effort to obtain an increased connection, and it may be fairly urged that with the business of the *British Commercial* in union with this association the agents of that company will be more likely to work with vigour for the combined institutions and to obtain more business in consequence than could be expected under existing circumstances from the agents of the *British Commercial* alone.

"Fourthly. The shareholders in this association are upwards of 300 in number, and they are prepared in every possible way to co-operate in the endeavour to increase the business of the institution, and from this circumstance also the *British Commercial* connection will derive an increased advantage, there being a reserve of actually subscribed capital amounting to £92,500.

"Under these circumstances the directors of this association would be glad if the directors of the *British Commercial* would consider this letter as a basis of a proposition for a union of the business of the *British Commercial* and *British Nation Companies* upon the following understanding:—

"The shareholders of the *British Commercial* should be paid off at the rate of 25s. per share, and their shares transferred.***684**

"That the directors of the *British Commercial* , with the consent of the shareholders, be paid a compensation of £1000 by this association.

"That the staff of the *British Commercial* be retained by the *British Nation* , and that the directors of the *British Nation* be at liberty to apply to any director or officer of the *British Commercial* to assist this association in the completion of such proposed arrangement after the shareholders have decided upon its adoption.

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"That the trustees should be appointed to hold the assets of the *British Commercial* pending the completion of the proposed arrangement.

"That an Act of Parliament should be forthwith applied for if agreed to be necessary to consolidate the proposed union.

"Thus a strong company may be formed, to the permanent benefit of all interested."

By a resolution passed on the 2nd of January, 1860, the directors of the *British Commercial* resolved that the directors of the *British Nation* should be informed that the board accepted the offer contained in the foregoing letter, subject to the approval of their shareholders, and also resolved that a special extraordinary meeting of the shareholders should be called on the 21st instant, to consider the offer of the *British Nation* , for its adoption or otherwise, and that the meeting should be advertised as therein mentioned. The meeting was advertised accordingly, and on the 6th of January, 1860, a circular was issued to the shareholders of the *British Commercial* as follows:—

"Sir,—Herewith you will receive a formal notice convening an extraordinary or special meeting of the proprietary for the 21st inst. The object of the meeting is to consider a proposal for the union with or transfer of the business liabilities and assets of this company to another company.

"I am instructed to inform you that the proposition above referred to has been under the consideration of the directors of this company for some time past, and after careful investigation they have arrived at the unanimous resolution to adopt and accept the same, subject to the approval and confirmation of the ***685** shareholders. I may add that the proposition contains an offer of 25s. per share to the shareholders of the *British Commercial* , who will also be relieved of their liabilities in respect of such shares."

The notice referred to in this circular was for an extraordinary meeting on the 21st, for the following purposes, viz.:—

"1st.For the purpose of considering a proposal for the union or 're-assurance' with or transfer of the business liabilities and assets of this company to another company.

"2nd.For the purpose of adopting and accepting or otherwise the offer contained in the proposal for union or transfer above referred to.

"3rd.For the purposes of investing the directors with necessary powers to enable them to complete and forthwith to carry out such union or transfer, and for the purpose of dissolving the said *British Commercial Life Insurance Company* , should that course be deemed expedient."

At the meeting, of the *British Commercial* , held accordingly on the 21st of January, 1860, it was (amongst other things) resolved:—

"1st.That the proposal of the British Nation Life Assurance Association as contained in their letter of the 17th of November last, now read, be and is hereby adopted and accepted.

"2nd.That with a view of carrying out the last resolution for the union of the two companies, the shareholders of this company present at this meeting do approve of and accept the proposal made on behalf of certain members of the British Nation Life Assurance Association for the purchase of shares in this company at the price of 25s. per share.

"3rd.That the directors be and are hereby authorized and empowered to take such steps in accordance with the provisions of the deed of settlement of this company as may be necessary to carry such proposal into

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effect on behalf of the shareholders."

An extraordinary general meeting of the *British Nation* shareholders was convened for the 20th of January, 1860, by a notice stating that the meeting was to be held for the purpose of investing ***686** the directors under the 45th clause of the deed of settlement with the necessary powers for taking to the business of another life assurance company, and for the purpose of making certain alterations in the deed of settlement, namely, as to the time of holding ordinary general meetings; as to voting by ballot; as to remuneration of auditors; as to the calling of general meetings; &c. The meeting was accordingly held on the 20th of January, and the notice convening it, and the *British Nation* manager's letter of the 17th of November, 1859, and the *British Commercial* directors' resolution of the 2nd of January, 1860, were read, and it was resolved:—

"[I.]That this meeting having heard the terms of the proposed arrangement with the *British Commercial Company* approves of the same, and hereby authorizes and empowers the directors of this company to take such steps as they may consider necessary for carrying the same into effect, and to issue in lieu of the payment of 25s. per share to such proprietors of the British Commercial Insurance Company as may elect to receive the same shares in this association either wholly or in part paid up to the extent of 30s. for each *British Commercial Insurance Company's* share so held by such proprietors as aforesaid.

"[II.]That George Bermingham, the chairman of this association, and the manager, *Henry Lake* , be and they are hereby appointed trustees of this association, with such trustee as may be named on the part of the *British Commercial Insurance Company* , for the purpose of holding the assets, &c., in trust of the British Commercial Insurance Company, and for other arrangements pending the complete transfer of that company to this association.

"[III.]That pending the completion of the arrangements with the *British Commercial Insurance Company* with this association the manager and secretary, Mr. *Lake* , be and he is hereby permitted and allowed to accept the appointment of manager to the *British Commercial Insurance Company* .

"[IV.]That the directors of this association be and they are hereby empowered to appoint from time to time such trustees, whether shareholders or others, as may in their discretion be necessary for holding such shares of the British Commercial Insurance Company as in the arrangements contemplated may be ***687** required to be transferred, and that such trustees be and they are hereby indemnified from any liability in respect of the British Commercial shares so transferred save in their capacity of shareholders in this association."

These resolutions were confirmed at a second meeting on the 4th of February, 1860.

Two deeds, dated respectively the 8th of February and the 7th of June, 1860, were executed for carrying into effect the arrangement authorized by the foregoing resolutions;

The deed of the 8th of February, 1860, was an indenture expressed to be made between *Bermingham* and *Lake* of the first part, the persons named in the first part of the schedule thereto (being individual shareholders in the *British Commercial*) of the second part, and the persons named in the second part of the schedule being joint owners of shares in the *British Commercial* of the third part. It recited that *Bermingham* and *Lake* had agreed to purchase from the parties of the second and third parts their respective shares at 25s. per share; and by the witnessing part the parties of the second and third parts covenanted, on payment of that price for their respective shares, to transfer them to *Bermingham* and *Lake* , or their nominees; and *Bermingham* and *Lake* covenanted that

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they would, by themselves or their nominees, accept transfer of the shares, and would before the 1st of July, 1860, concur in all acts requisite to cause the shares purchased to be transferred out of the names of the persons in whose names they were standing into the names of some other persons, and would pay the purchase-money in manner therein mentioned. The deed contained a proviso for avoiding it if the holders of five-sixths of the shares in the *British Commercial* did not enter into it before the 25th of March then next.

The deed of the 8th of February, 1860, was executed, between the 10th of February and the 23rd of June, 1860, by 174 shareholders of the *British Commercial* , holding in the aggregate 11,014 shares. Of these 174 shareholders, seven, who held in all seventy-nine shares, did not at any time execute any transfer of any of their shares in pursuance of that deed or of the amalgamation arrangement, but 167, holding in all 10,135 shares, executed between the 17th of December, 1859, and the 23rd of February, ***688** 1865, under the amalgamation arrangement, transfers of their shares in the *British Commercial* , either to *Bermingham* and *Lake* , or one of them, or to persons nominated for that purpose by *Bermingham* and *Lake* .

After the execution of the deed of the 8th of February, 1860, but before the 21st of April, 1865, seventeen shareholders of the *British Commercial* who did not execute the deed of the 8th of February, 1860, holding in the aggregate 776 shares, executed, under the amalgamation arrangement, transfers of those shares to *Bermingham* and *Lake* , or one of them, or to other persons nominated for that purpose by the *British Nation* .

All the transfers mentioned above were in the common form, and nearly all the transferees were officers or servants of the *British Nation* , and executed the deed of the 7th of June, 1860. This latter deed was an indenture expressed to be made between the parties executing in the schedule, including *Bermingham* and *Lake* of the first part, *Bermingham* and *Lake* of the second part, and the *British Nation* of the third part. This deed recited the deed of the 8th of February, 1860, and that in further pursuance of the above arrangements the persons named in the first column of the schedule had transferred their shares in the *British Commercial* to *Bermingham* and *Lake* , or to the other parties thereto of the first part as their nominees. The parties of the first part then declared that they would stand possessed of the shares so transferred to them in trust for the *British Nation* . And by the same indenture the *British Nation* covenanted with each of the parties of the first part that the *British Nation* would indemnify them, their heirs, executors, and administrators, from all liability in respect of the shares so transferred to them. This deed was not submitted to or approved by the *British Nation* shareholders in general meeting. None of the *British Commercial* shareholders who executed, under the amalgamation arrangement, transfers of their shares gave the directors any such notice of transfer as was required by the *British Commercial* deed of settlement, nor did any of their transferees execute such deeds of covenant as were required to be executed by purchasers of shares binding them to observe the stipulations of the deed of settlement.

Twenty-three shareholders of the *British Commercial* , holding ***689** in the aggregate 210 shares, executed neither the deed of the 8th of February, 1860, nor any transfer of their shares.

On the 30th of January, 1860, the secretary of the *British Commercial* issued a circular to the shareholders therein, informing them of the result of the meeting of the 21st of January, 1860, and inclosing a copy of the resolutions passed at it.

On the 23rd of March, 1860, the *British Nation* manager issued a circular to the *British Commercial* shareholders in which he appointed a day for the payment of the first two-fifths of the price of the *British Commercial* shares, and inclosed two alternative forms for signature, by one of which the share-

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holder signing would agree to take the price of his shares in cash, and by the other of which the shareholder signing would agree to take the price of his shares in shares of the *British Nation* . Fourteen *British Commercial* shareholders holding 1020 shares took British Nation shares under the amalgamation arrangement. All the *British Commercial* shareholders who executed, under the amalgamation arrangement, transfers of their shares, received the consideration for them according to that arrangement.

After the deed of the 8th of February, 1860, the business of the *British Commercial* continued for some time to be carried on as a separate business, and that company issued new policies down to the 29th of May, 1862, after which day no contract was made or fresh liability incurred by it. It paid claims down to the 19th of March, 1863. After April, 1863, it had no office separate from the office of the *British Nation* . On the amalgamation arrangement, *Lake* , the manager and secretary of the *British Nation* , became also the manager of the *British Commercial* , and the secretary of the *British Commercial* was employed in the office of the *British Nation* , and attended to any matters connected with the *British Commercial* .

After the 1st of January, 1860, only two general meetings of the *British Commercial* shareholders were held, namely, on the 12th of March and the 22nd of May, 1861, at the former of which new directors were appointed. The last memorial of the names of *British Commercial* directors inrolled under the *British Commercial* Act of Parliament was inrolled on the 13th of February, 1865. The company, however, was never dissolved. ***690**

On the 22nd of December, 1864, an extraordinary court of directors of the *British Commercial* was held, when it was resolved:

"That the existing amalgamation of the business of this company with the business of the *British Nation Life Assurance Association* be adopted and confirmed, and that the trustees of this company be directed to take such steps and do such acts and execute such instruments as might be considered necessary with a view to perfecting such amalgamation and legally vesting the assets of this company in the said association.

On the 29th of December, 1864, the *British Nation* board of directors resolved:

"That the existing amalgamation of the business of the *British Commercial Insurance Company* with the business of this association be adopted and confirmed, and that the deed, a copy of which has been submitted to and approved of by this board, is a proper deed for carrying the said amalgamation into effect, and that the seal of this association be accordingly affixed thereto."

These resolutions were carried into effect by a deed of the 31st of December, 1864, indorsed—Deed of Amalgamation. By this deed the holders of 9892 shares, which had been transferred to them as trustees for the *British Nation* , purported to transfer them to the *British Nation* , and the *British Nation* covenanted to indemnify the transferors from all debts in respect of the engagements of the *British Commercial* , subject to a proviso that only the subscribed capital of the *British Nation* should be liable under the covenant. This deed of amalgamation was not submitted to or approved by the *British Nation* shareholders in general meeting.

The transfers of *British Commercial* shares made under the amalgamation arrangement, and the general assignment of British Commercial shares made by the deed of the 31st of December, 1864, were from time to time entered in the share ledger of the *British Commercial* . The form of entry as to shares assigned by the latter deed was, "By deed dated the 31st of December, 1864, the above shares were assigned by the

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above-named to the British Nation Life Assurance Association, their successors and assigns."

Memorials of the names of the assignees under the last-mentioned transfers and assignment were from time to time inrolled ***691** in the Court of Chancery, the inrolments being expressed to be made pursuant to the *British Commercial* Act of Parliament. The last of those memorials was inrolled on the 1st of September, 1865, and gave the *British Nation* as the assignee of the bulk of the shares.

The *British Nation* went into voluntary liquidation under a resolution passed on the 18th of January, 1872; and that liquidation was by order dated the 29th of January, 1872, continued under the supervision of the Court under the provisions of the Companies Acts. On the 19th of July, 1872, the *British Commercial* was, on the petition of a creditor, ordered to be wound up under the Companies Acts. These liquidations went on under the European Society's Arbitration Acts. The whole of the subscribed share capital of the *British Nation* was called up, and a further call of £4 a share was made for costs and expenses of the liquidation of that company.

In Rivington's Case it was decided that *William Rivington* , who was a holder at the date of the amalgamation of 200 shares in the *British Commercial* , and who executed the deed of the 8th of February, 1860, and a transfer of his shares thereunder to *Bermingham* , was not to be settled on the list of contributories of the *British Commercial* in respect of those 200 shares, for any purpose whatever, even as regarded liabilities of the *British Commercial* incurred before he executed the transfer, or as regarded the costs of winding up that company.

In Lawson's Case , Lord *Romilly* decided that *Lawson* , to whom, as one of the nominees of the *British Nation* , shares in the British Commercial had been transferred as part of the amalgamation arrangement, and who had executed a declaration of trust of those shares for the *British Nation* , was not a contributory of the British Commercial in respect of those shares.

In Chatteris' Case , Lord *Romilly* decided that *Chatteris* , one of the seven shareholders of the *British Commercial* , who executed the deed of the 8th of February, 1860, but did not execute transfers of their *British Commercial* shares under the amalgamation arrangement, was not a contributory of the *British Commercial* .

In Edwards' Case , Lord *Romilly* decided that *Edwards* , one of the twenty-three shareholders of the *British Commercial* , who did ***692** not execute the deed of the 8th of February, 1860, or any transfer of their shares under the amalgamation arrangement, was not a contributory of the *British Commercial* .

The result of the above decisions was that none of the shareholders of the *British Commercial* were liable to be put on the list of contributories of that company, and that persons to whom shares had been transferred in trust for the *British Nation* were not contributories. Unless, therefore, the *British Nation* could be put on the list of contributories there was no contributory at all.

The case before the arbitrator sought to make the British Nation, and also *Lawson, Chatteris* , and *Edwards* , liable as contributories of the *British Commercial* , and the case as against these three persons was reheard, notwithstanding Lord *Romilly's* previous decisions in their favour. The arbitrator held the *British Nation* liable and the other Respondents not liable.

The arbitrator certified for an appeal, but did not give the special certificate applicable to the case of previous conflicting decisions.

An appeal was at the same time brought from the decisions in the cases of *Chatteris, Lawson* , and

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Edwards , although the arbitrator had not given a written certificate as required by the Arbitration Act, 1875 . The appeal was heard on the 28th and 29th of January, and the 1st and 4th of February, 1878.

Bagshawe , Q.C., *Cookson* , Q.C., and *Lemon* , for the British Nation, in support of this appeal:—

It is made a fundamental principle of the constitution of the *British Nation* by sect. 91 that no contracts shall be entered into on behalf of the company which impose on the shareholders unlimited liability. It is quite against this that the company should become a shareholder in another company, and indeed it is quite beyond the scope of a joint stock company to become a shareholder in another company unless authority is expressly given for that purpose. We say, then, that the deed of the 31st of December, 1864, by which it is alleged that the *British Nation* became legal holders of shares, is ultrà vires and invalid, and that the British Nation never became a shareholder. The shares no doubt were held by trustees for the *British Nation* , but that does not make ***693** the *British Nation* a contributory, and it cannot be held such. In Peek's Case 1 there was a complete contract to take shares, and this is necessary: King's Case 2 . The trustee, not the cestui que trust, must be on the list: Williams Case 3 . If a man is not liable to creditors he cannot be a contributory: Bright v. Hutton 4 . The arbitrator thought that sect. 200 of the Companies Act, 1862 , made a person liable to be put on the list of contributories through having agreed to take shares without putting forward his own name, and no doubt in many cases this is so; but if shares are duly vested in a trustee for *A. B.* , that does not make A. B. a contributory. He is liable to indemnify his trustee, but that does not enable you to take the short cut of making him a contributory. None of the *British Commercial* shareholders can complain on the ground of the *British Nation* not being put on the list. They are of three classes: first, those who under the arrangement covenanted to transfer, and did transfer, to trustees for the *British Nation* . They are released from liability. *Rivington* is a type of that class. Then there are those who did not covenant, but did transfer; they are free from all liability. Then there are those who neither covenanted to transfer nor transferred; they were strangers to the transaction, and cannot have any complaint to make. In order to make out the *British Nation* to be a contributory, it must be shewn, 1, that it became a shareholder at law; or, 2, that it contracted to become such so as to be a shareholder in equity; or, 3, that, under the Companies Act, 1862, s. 200 , it is liable to be settled as a contributory by reason of being liable at law or in equity to contribute to pay off the debts of the *British Commercial* . Now, did the *British Nation* contract to become a shareholder? One company registered under the Act of 1862 can take shares in another: In re Barned's Banking Company 5 , but only if authorized by its articles to do so; and here the *British Nation* had no such power. Its deed being completely registered, was notice to all the world. Now, clause 119, which is the only clause authorizing the taking shares of any kind, does not authorize the taking shares in a limited company. Clause 45 ***694** does not authorize it, for taking shares is quite different from taking to a business. The deed of the 8th of February, 1860, is a deed to which the *British Nation* was not a party; it could not be bound by that to become a shareholder. The deed of the 7th of June, 1860, was never approved by the company in general meeting, nor does it follow from any resolution of a general meeting, it therefore cannot bind the company. The transfer was made when the *Commercial* company was virtually dissolved, and is therefore void: Chappell's Case 6 ; Lankester's Case 7 ; Allin's Case 8 . The arbitrator seems to have been influenced by the view that a cestui que trust can be put on the list in place of the trustee by reason of his obligation to indemnify him; and Hemming v. Maddick 9 was referred to as establishing this, but rightly understood the case goes quite the other way. The authorities are clear that the trustee must be on the list, not the cestui que trust: Chapman and Barker's Case 10 ; Ex parte Challis 11 .

Sir *H. Jackson* , Q.C., and *Whitehorne* , for the Eu-

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ropean Society, took no part in the argument.

Higgins , Q.C., and *Romer* , for the liquidators of the British Commercial:—

The claims established against the *British Commercial* amount to about £180,000, and if this appeal be simply allowed they will be worthless. There must be a liability to contribute somewhere. It has been decided that the transferors of the *Commercial* shares are not liable, nor the transferees who transferred to the British Nation, and it necessarily follows that the *British Nation* must be. Now, as to the objection that any contract imposing an unlimited liability on the shareholders was ultrà vires , we contend that it was perfectly competent to the shareholders by mutual consent to annul the clause imposing this restriction on contracts, and that the shareholders did so. At the commencement of the winding-up of the *Commercial* the *British Nation* was on the publicly inrolled list of members, and had been there for years. ***695**

The process of this amalgamation was unique. No attempt was made to produce a novation. The policy-holders were not consulted. The *Commercial Company* was kept alive. The Bank of London Case 12 has no application. The amalgamation in our case, as it was effected, was quite intrà vires . In the Albert Case the clause limiting the powers of the company to alter the rules was stronger than in our case. There was no power to amalgamate at all: the *British Nation* deed gives power to amalgamate. But in truth no power is necessary. There is nothing that a general meeting cannot alter if all the shareholders consent. Even if limited liability be a fundamental principle of the company, the shareholders may consent to alter it. If all the shareholders can alter the laws as they please, a majority may do so, if the minority acquiesce. If the minority protest, it may be different; but if they acquiesce, they must be taken as consenting. Our positions are—1. At the commencement of the winding-up of the *Commercial* in 1872, the *Nation* was on the list of shareholders, and had been there for seven or eight years, and their name was put on by their own consent, without any intervention of the Commercial, by which the creditors of the *Commercial* cannot be prejudiced. 2. The onus is on the *British Nation* to have its name removed from the list of members, and it cannot now get the register rectified. Even if there were no formal difficulty, It has no equity to do so. The Appellants say, first, that the *British Nation* had no power to take shares, and, secondly, that it did not take any. We say that it had power to take, and did take, shares. 3. We rely on the effect of the 200th section. There was a contract to take shares, and the company became equitable shareholders. 4. We rely on the authorities as to the effect of acquiescence Assuming that there was an informality, the acts of the British Nation render it impossible for them to take advantage of it. As to the first and second propositions, Oakes v. Turquand 13 shews that there are many cases where persons who are on the register at the time of the winding-up cannot get their names taken off, although they might have done so before the winding-up. There is nothing in the nature of a company which in itself prevents it from holding shares in another company. The Act of 1862 ***696** assumes that it may be done: In re Barned's Banking Company 14 ; Royal Bank of India's Case 15 . It is not for us to shew a special power in the articles of the *British Nation* to take shares, provided it is in accordance with the general objects of the company; and even if there was anything against it in the articles of the company, a general meeting had power to alter it, and did alter it. Power is given by clauses 44 and 45. Clause 91, which says that the liability is to be limited in all contracts, only applies to acts done by the directors, and the reservation in clause 44 means that no alteration may be made which shall give power to the directors to pledge the unlimited liability of the shareholders, but a general meeting had power to do what has been done: Greenwood's Case 16 ; Agar v. Athenæum Assurance Society 17 ; Prince of Wales Assurance Society v. Athenæum Assurance Society 18 ; Ernest v. Nicholls 19 . This was an unregistered company, and therefore the constitution could be altered with the consent of all the shareholders, ex-

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press or implied: *Lindley* on Partnership 20 ; Webb v. Herne Bay Commsssioners 21 ; Lane's Case 22 .

3. As to the effect of sect. 200 of the Companies Act, 1862 , there was a bargain between the two companies that the *Commercial* shares should be bought up on behalf of the *Nation* ; that the *Nation* should be liable for the debts of the *Commercial* , and that the *Nation* should take the shares and should indemnify the trustees. The *Nation Company* was therefore the real owner of the shales, and a contributory of the *Commercial Company* under sect. 200 : Williams' Case 23 .

4. As to the acquiescence of the shareholders of the British Nation, we say that the shareholders confirmed the transaction, even if it was ultrà vires : Re Era Company 24 ; Evans v. Smallcombe 25 ; Phosphate of Lime Company v. Green 26 . The Court will not interfere to stop acts which are ultrà vires, if there has been acquiescence on the part of the body of the shareholders, ***697** unless they are contrary to the fundamental purposes of the company: Anglo-Australian Assurance Company v. British Provident Life Assurance Society 27 . In this case the *British Nation Company* has enjoyed the benefit of the agreement. They have taken all the premiums since 1860: Re Phoenix Life Assurance Company 28 ; Re Sea, Fire, and Life Assurance Company 29 . A third party is not bound to examine into the question whether a company has observed all the conditions imposed by its articles: Royal British Bank v. Turquand 30 . Sect. 47 gives power to purchase on such terms as the directors think fit.

[JAMES, L.J.:—That would not authorize anything which in substance altered the constitution of the company.]

Taking shares must have been contemplated, for in no other way could the business be acquired.

[JAMES, L.J.:—Buying shares is quite a different thing from buying a business. The shares are not the property of the selling company.]

The power was created before the *Companies Acts* , and must be taken to authorize the acquiring the business of a private partnership, which could only be acquired by transfer of the shares of the partners.

[JAMES, L.J.:—No. The partners together would convey the entire property.]

There is power to invest in the purchase of personal property.

[JAMES, L.J.:—How could such a power authorize becoming a partner in a business?]

The provision as to limited liability is merely a regulation for the shareholders inter se, and does not affect third parties: Greenwood's Case 31 . Where there is a direct contract between the company whose shares are held and the beneficiary, the beneficiary is the person responsible: Reaveley's Case 32 .

On the appeals in the cases of *Chatteris, Lawson* , and *Edwards* , being opened, ***698**

Hemming , Q.C., and *Millar* , for *Chatteris* , took a preliminary objection:—

The decision in Chatteris' Case was made by Lord *Romilly* under the European Arbitration Act of 1872 . By the 16th section of that Act, after directing how applications are to be made to the arbitrator, it was enacted “that the opinion or decision of the arbitrator on any such application, or with respect to the costs thereof, or on any matter or thing within his jurisdiction, shall not be subject to any review or appeal.” Then the European Arbitration Amendment Act, 1875, sect. 3 , provides that the Court of Appeal in Chancery shall have jurisdiction and power to entertain an appeal from any determination or order of the

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arbitrator given or made before or after the passing of this Act. And then it goes on to enact that, "An appeal shall lie from any determination or order of the arbitrator accordingly, subject to the foregoing provisions (among others): "(1)As regards any determination or order given or made before the passing of this Act, an appeal shall not lie therefrom unless the arbitrator expressly certifies in writing that by reason of differences between previous decisions on matters of principle relating to cases of novation or of liability of contributories, it is desirable that an appeal be brought."

In the present case, Mr. *Reilly* , the present arbitrator, has not given any certificate that it is desirable that there should be an appeal. The Court, therefore, has no jurisdiction to hear the appeal. The fact that the arbitrator has made these persons Respondents to the special case is not sufficient without a formal certificate.

Bevir , Q.C., and *Bissell* , for *Lawson* , and *J. Pearson* , Q.C., and *Millar* , for *Edwards* , took similar objections.

Higgins , Q.C., and *Romer* , for the Appellants:—

These Respondents are not in the same position as if a final award had been made before the passing of the Act of 1875. Although Lord *Romilly* had given his decision upon their cases, it was open to him or his successor to reconsider those decisions at any time before the final award. That was the view that Lord ***699** Cairns took in the *Albert Arbitration* . And *Lord Romilly* , in this arbitration, reheard a case which had been decided by Lord *Westbury* . The words "previous decisions" mean decisions before the appeal is brought, not necessarily before the passing of the Act of 1875. And there cannot be a doubt that, in the words of this Act, there have been "differences between previous decisions on matters of principle" relating to the questions now before the Court. If, therefore, the arbitrator has not given a certificate, it is only the omission of a form, which we could get rectified. But, in fact, the form of the special case to which these Respondents are made parties, and in which the judgment of the Court of Appeal is asked, "What other decision should be given either as between the Appellants and Respondents, or any of them, or as among the several Respondents," amounts in itself to a certificate that the appeal in the case of these Respondents is desirable.

Feb. 1. JAMES, L.J.:—

The absence of the certificate is to my mind conclusive. The arbitrator has not given the certificate required by the Act of Parliament. We have heard a very long argument to shew that if he had not given the certificate in words he had done so in effect, and that he meant to say there had been that difference of opinion. As at present advised, I see no ground for that contention. I think it right to say that the 16th section of the first Act of Parliament is one to which effect must be given according to its plain meaning. Nobody can doubt that that 16th section says that application shall be made to the arbitrator in such manner and form, and shall be heard and disposed of as the arbitrator shall direct, and every decision of the arbitrator upon any such application, shall not be subject to review or appeal. Then Messrs. *Chatteris, Lawson* , and *Edwards* say: "We have a decision by the arbitrator in our favour, and that decision was by the Act of Parliament made final." The further clause in the *Amendment Act* , which has been relied upon, must be construed very strictly in favour of the gentlemen who rely on the 16th section of the old Act. The Amendment Act, after a recital that, in some cases of great importance as affecting the liquidations of ***700** the companies subject to the arbitration, the second arbitrator had differed in opinion from and varied the determinations and orders of the first arbitrator, and difficulty had ensued therefrom in the conduct of the administrative business of the arbitration, contains a clause that, in certain cases, an appeal shall lie from

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any determination or order of the arbitrator, subject to the following provisions, the first being: "As regards any determination or order given or made before the passing of this Act an appeal shall not lie therefrom unless the arbitrator expressly certifies in writing that by reason of differences between previous decisions on matters of principle relating to cases of novation or of liability of contributories it is desirable that an appeal be brought." Now, the meaning of these words "between previous decisions" must be decisions previously acted upon. I think, therefore, that the arbitrator purposely abstained from giving a certificate.

BAGGALLAY, L.J.:—

I am of the same opinion. We are bound to come to a decision on the objections raised on behalf of these gentlemen to the hearing of an application in the nature of an appeal against the former decisions in this case, and as far as they are concerned we are bound to deal with that objection irrespective of any inconveniences that may be occasioned to other parties by reason of the mode in which we deal with it. Each of these three gentlemen has had a determination in his favour by one of the previous arbitrators. At the time when those determinations were arrived at, an Act of Parliament was in force which declared that they should be final and conclusive, and not open to review or appeal, and before the Act of 1875 was passed, these gentlemen were entitled to rely upon these determinations as being final and conclusive. When the Act of 1875 was passed, it recited, as was the fact, that in the course of the liquidations of these companies by the two preceding arbitrators there had been differences of opinion on matters of principle, and it went on to recite, that, though there was an imperative provision in the former Act of Parliament that their decisions should be without appeal, it was proper that in certain cases there should be a power of appeal, but the enacting ***701** part limits the right of appeal, as far as regards any determination or order given or made before the passing of the Act of 1875, to cases in which the arbitrator expressly certifies in writing that it is desirable that an appeal should be brought by reason of differences between the previous decisions. No language could be more clear, having regard to the previous recital, though I should have thought it sufficiently clear without it, to express that the conflict of principle must have been in connection with some determination or order arrived at before the Act of 1875 was passed. It would be convenient, no doubt—I do not mean to say that the arbitrator is bound to do so, but it would be convenient—if he did expressly certify, in each particular case, that by reason of such differences in principle an appeal should be brought, and that he should specify himself; on the certificate, what those differences in principle are on which he thinks it desirable that there should be an appeal. However, I say no more on that. With regard to its being desirable that such an appeal should be brought, I feel quite clear that we are hound to have, on his responsibility, a distinct statement in writing that he considers there is a proper case for appeal. We have here no such clear case and no such certificate. Now, it has been suggested that though the certificate does not exist, there may be the means and the opportunity of procuring it. I am far from saying that in no possible case would this Court give the opportunity for a certificate being obtained after the appeal was lodged, but it must certainly be an extreme case to justify it. At the present moment I see no reason for giving that leave, or allowing the matter to stand over in order that such certificate should be obtained. As far as I am able to trace the decisions arrived at by Lord *Westbury* in *Rivington's Case* , and Lord *Romilly* in the cases which are represented before us to-day, I can see no difference in matter of principle. It is possible, and it may be so urged, that a principle applied in an earlier case was applied also in a later to which it was not properly applicable, but that is not a difference in principle. It may be at the outside an error of judgment as regards the application of a recognised principle. I think, therefore, that the objections that are taken on behalf of Messrs. *Edwards, Chatteris* , and *Lawson* , are well founded. ***702**

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THESIGER, L.J.:—

I am also of opinion that the preliminary objection that is taken is well founded. I ground my judgment on the absence of the certificate by the arbitrator. At the same time I may say that nothing which I have heard has satisfied me that there has been any difference of principle between the decisions of Lord Romilly and Lord *Westbury* on the point which we have to deal with. Also, I am not satisfied that there has been any difference between the decision of Mr. *Reilly* , in point of principle, and the previous decisions of Lord *Romilly* and Lord *Westbury* . And, although I was very much struck with the ingenuity of the argument of Mr. *Romer* , founded on the meaning of the words "between previous decisions," I am not satisfied that, even if we were to give any decisions which were contrary to the previous decisions of Lord *Romilly* and Lord *Westbury* , that that would enable those decisions, given, as they were, before the passing of the Act, to be reviewed on appeal, even if a certificate were given.

On the appeal of the *British Nation* their Lordships reserved their judgment.

Feb. 26. JAMES, L.J., now delivered the judgment of the Court (*James, Baggallay* , and *Thesiger* , L.JJ.):—

The circumstances under which this appeal has been brought, and the facts on which it has to be decided, are sufficiently stated on the special case, settled by the arbitrator, and the appendix thereto.

In some respects, by reason of the decisions of former arbitrators, the question has assumed a very peculiar aspect. The question immediately before us is whether the British Nation Association, in its quasi corporate character, is or is not liable to be placed on the list of contributories of the British Commercial Company. That company, at the commencement of the transactions out of which this question has arisen, consisted of 174 shareholders, holding 11,014 shares, seventeen other shareholders holding 776 shares, and twenty-three other shareholders holding 210 shares. The differences in the position of these several classes of shareholders ***703** appear in the special case. By decisions in the arbitration all these several persons were declared not to be liable as contributories.

In the course of the transactions 184 shareholders executed transfers of, in the aggregate, 11,711 shares to persons who were directors, officers, servants, or other nominees of the *British Nation* as its trustees, and by a deed, dated the 31st of December, 1864, shares, amounting in the aggregate to 9892, were expressed to be assigned to the *British Nation* itself by the persons to whom they had previously been transferred as such trustees.

In Lawson's Case it was decided by Lord *Romilly* , as arbitrator, that such last-mentioned persons were not liable to be put on the list of contributories. And it was contended before us that it followed logically from those decisions that the *British Nation* was, as the ultimate transferee, the shareholder in respect of those shares. The original shareholders were, it was said, exonerated by reason of their having got rid of their shares, and the intermediate transferees were in like manner exonerated by reason of their having transferred their shares to the *British Nation* . Either, therefore, it was urged, the previous decisions, or one of them, were or was wrong, or the *British Nation* must be liable as transferee. And in this view of the case the persons who had obtained the decisions in their favour were made respondents to this appeal with the view, if possible, of having the whole matter determined by this Court as to who ought to have been, and who ought to be, placed on the list of contributories. But it was contended by such respondents, and we decided, that under the Acts regulating the arbitration no such appeal was competent, and that the decision in their favour was absolute and final. And, on the other hand, it was contended by the shareholders of the *British Nation* that they were no parties

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to the previous decisions, that there was, so far as they were concerned, no *res judicata* , and that they were entitled to have their case decided wholly unprejudiced by the former decisions. This contention is, we think, not to be gainsayed. Their argument on the merits may be very shortly stated. The deed by which their officers and trustees affected to divest themselves of their shares, and to vest them in the association, is, they say, ultrà vires and void. ***704**

The association was formed for the purposes mentioned in Article 3 of their deed of settlement, such purposes to be carried into effect and the business to be managed by boards of directors and by general meetings in manner there prescribed. Primâ facie there is nothing more inconsistent with the whole scope and character of such a body than that it should enter into a contract of partnership with any other person or persons in any other business whatever. It would require very clear powers to enable a man's partner or partners, or, in a joint stock company, his delegated officers, or the majority of his co-shareholders, to make him a partner with any other person or a shareholder in any other society. But if the society, in its *quasi* corporate character. could take shares in another partnership or body, it would in effect be to make every shareholder a partner or shareholder in such partnership or body. In the deed of settlement in this case there is express power to invest the funds of the society not immediately required in shares. But the language of that clause goes far to negative any such power to invest generally in shares or in a partnership. It is only as an investment of surplus funds that it is permitted to purchase shares, and shares only in docks, &c., things that are mentioned in the articles, established by Act of Parliament, in substance, interests in real estate; nothing, in fact, like a partnership in some other business speculation or adventure. It was put to counsel in the course of the argument whether it could possibly be contended that such a society as this could take shares, or become a partner in a society or partnership for brewing or mining, or buying and selling of merchandise, and it was admitted that it would be difficult so to contend. But in truth, the more or less similarity of the objects, or even absolute identity of the objects, does not affect the principle. It is the entering into a new contract of partnership with new persons under a new constitution, which is absolutely ultrà vires and void, unless specially provided for and authorized.

But it is suggested that there is such special provision and authority in this case. By the 45th article of the deed of settlement it is provided, “that an extraordinary general meeting may accept or take a transfer of or purchase or acquire the business of any other associations, companies, or societies of a similar nature ***705** wholly or in part with the association hereby established, upon and under such terms, conditions, stipulations, and agreements as such meeting shall think fit.”

It is said that it was, and in truth it appears to have been, competent for the society to purchase the business of the *Commercial* , and that it vas a proper term and condition of the purchase of an entire business, that the purchasing company should take the shares of the selling company. It would probably be sufficient to say that it was not one of the terms and conditions of the agreement that the association should take, itself, a transfer of the shares.

Neither the selling company nor the buying company nor the transferring shareholders contemplated such a mode of dealing with the matter. The latter, probably, would have been advised to have nothing to do with such an attempt. What was done was to find individual transferees capable clearly of accepting and holding the shares. And the latter were the officers and managers of the society and their friends, who were anxious to promote the scheme, and were willing to take what they probably then thought an inappreciable risk, having the indemnity of their own association. That was the transaction as it was arranged, and as it was carried out.

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But it must be held, we think, that the power to take a transfer of or to purchase a business on such terms, conditions, stipulations, and agreements as the meeting should think fit, could not, under the guise of a condition or stipulation, sanction every dealing and transaction that it might be thought fit to enter into contemporaneously with it. It could not under that guise sanction something so entirely at variance with the whole constitution and principle of the association as to make those shareholders who had carefully limited their liability so far as they could do it to £10 per share, shareholders in another society with a liability to £50 a share. By their constitution it was stipulated that every document binding them shall contain certain express reference to the provision making the funds and property and subscribed capital of the society alone liable, and declaring that the shareholders should only be in fact liable to pay calls on their subscribed capital. Even the power given to two successive general meetings to ***706** amend the laws was carefully guarded so as not to extend to any alteration enlarging the individual responsibility of the shareholders. And it would be against all reason to hold that a general meeting purchasing a business from another society should have the power to accept, either in terms, or by implication, a condition or stipulation that in respect of such purchased business the shareholders should be liable to a totally different extent, and on a totally different principle, from the liability under which they stood on business of the same kind originally entered by their own officers. If such a condition were expressed in terms it would at once shock the mind of any person to whom it was submitted.

The transaction as it was carried out was reasonable enough. The purchasing company was to the whole extent of its funds and property liable to discharge the liabilities of the selling company, just as it was liable to satisfy its own similar contracts, and there being no novation, the mode in which it assumed that liability was by giving an indemnity to the selling company and its shareholders.

As part of the same indemnity, it became liable to save harmless its own nominees who took transfers of shares in order to facilitate the purchase. But that was only the same liability in another form, namely, the liability to discharge the contracts connected with the transferred business out of the same funds, property and capital, out of which all their other contracts were to be satisfied. That was how things stood when the deed of 1864 was made, and when it was attempted thereby to vest the shares in the association itself. Where was there any authority for that deed? The expressed object of the deed was in fact not to vest the shares, qua existing and continuing shares in the association, but to merge and extinguish the shares, and it is not unworthy of notice that in that very deed the covenant to indemnify such transferring shareholders is expressly limited to the funds and property of the association. It is beyond all question that the trustees, directors, and managers of the association could not by their own act, by means merely of their own physical possession of the common seal, alter their position towards their cestui que trust . The deed of 1864 was an entirely internal matter. Before the execution of that ***707** deed the shareholders, parties thereto, were liable as such, with an indemnity out of the funds. They had no power, as between them and the association, to transfer their own liability to the latter. And no other person or body of persons could be prejudiced or benefited or affected by an instrument to which they were absolutely strangers, such instrument being void as between the parties to it.

It was argued, however, that this transaction became binding by reason of the entry of the association as owners of the shares in the books of the *Commercial* , and by the inrolment in Chancery of a memorial of the assignment to the association and the acquiescence of the *British Nation* shareholders therein. It was said that this was like Peek's Case 33 , that the *British Nation* were at the time of winding-up de facto the shareholders, and that, whatever equity they might have had before the winding-up to be relieved from

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their shares, they could not, after the winding-up, assert such equity.

That case, however, has no application if the preceding reasoning is sound; this is not the case of a person induced to become a shareholder, and who had become a shareholder by fraud—but of persons who say truly they never were shareholders.

They never accepted their shares, and if that be so, the entries in the books of the company and the inrolment of the memorial in Chancery were wholly inoperative as to them.

Such entries and memorial are as void as the transaction itself. It is not unimportant to observe that the entries in the books are without date; and that the memorial was not inrolled until the 1st of September, 1865, several months after both the *Commercial* and the *British Nation* had practically ceased to exist, the latter having on the 16th of March, 1865, become amalgamated with, and merged in, the *European* .

And with regard to the alleged acquiescence there are no facts from which any such acquiescence can be inferred. It is found in the case that the deed of 1864 was not submitted to any general meeting, and it is not found, and does not appear, that it was in any other manner made known to the shareholders generally, or that anything was ever done by any one on the faith of or in reliance ***708** on such deed, or in consequence of it, except the above-mentioned entries and memorial which have been already dealt with.

But it is lastly contended that the *British Nation* became equitably liable as contributories. It is said that, under the 200th section of the Act of 1862, all persons legally or equitably liable to contribute to the assets are contributories, and may be put on the list as such. It is impossible to hold that any person who is a debtor to the company in liquidation can be put on the list of contributories. He is bound to pay moneys, which moneys, when paid, will be part of the assets of the company, and in that sense he is liable to contribute to the assets, but that does not make him a contributory within the meaning of the Act. Again, a person who has taken shares in the name of a trustee is, as between him and his own trustee, the person liable to contribute, but that does not make him a contributory as between him and the company. The company may get at him, as it has in several instances, through and in the name of the trustees. But still the equitable liability is to the trustee only, and there is no privity or direct right of any kind as between the company and the cestui que trust . If an officer of the company has misappropriated assets, he may be made to refund them to the liquidator as part of the assets, but that does not make him a contributory. The plain meaning of the Act is a legal or equitable liability to contribute in the character of a partner. A person who has not taken shares may have become bound in equity to the company to take shares. A person who has by some device or contrivance got rid of his shares may be made to take them again. These are instances of the equitable liability to which the Act refers.

But if the *British Nation* did not become actual legal shareholder, it never became under any equitable obligation to the *Commercial* to take shares. It never dealt with the *Commercial* at all in its *quasi* corporate character in respect of the shares. The shares were dealt with by the individual owners of the shares, who alone had a right so to deal.

There was, however, a very substantial equity as between the two companies arising out of the transaction itself. As between the selling company and the purchasing company, the latter became primarily liable to fulfil the contracts of the former, which ***709** has a right to enforce such liability. But as between two such bodies, each of which must be taken to have known the constitution of the other, and indeed without such knowledge, the equitable liability could not extend beyond the legal liability which it would have been intrà vires to give by express covenant,

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namely, a liability to fulfil such contracts pari passu with its other contracts and out of the same funds.

And that liability has, we are told, been actually so dealt with in the winding-up, that is to say, the policies and other obligations of the *Commercial* have been let in to participate pari passu in the distribution of the assets of the *British Nation* .

The result will be to allow the appeal and discharge the order of the arbitrator putting the *British Nation* on the list of contributories of the *British Commercial* .

The arbitrator will deal with the costs of the appeal as he has done in other cases.

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1. Law Rep. 4 Ch. 532 .

2. Ibid. 6 Ch. 196 .

3. 1 Ch. D. 576 .

4. 3 H. L. C. 341 .

5. Law Rep. 3 Ch. 105 .

6. Law Rep. 6 Ch. 902 .

7. Ibid. 905, n.

8. Law Rep. 16 Eq. 449 .

9. Law Rep. 9 Eq. 175; Ibid. 7 Ch. 395 .

10. Law Rep. 3 Eq. 361 .

11. 16 W. R. 451 .

12. Albert Arb. Part I. App. B.

13. Law Rep. 2 H. L. 325 .

14. Law Rep. 3 Ch. 105 .

15. Ibid. 4 Ch. 252 .

16. 3 D. M. & G. 459 .

17. 3 C. B. (N.S.) 725 .

18. Ibid. 756, n.

19. 6 H. L. C. 401 .

20. Vol. i. p. 263.

21. Law Rep. 5 Q. B. 642 .

22. 1 D. J. & S. 504 .

23. Law Rep. 9 Eq. 225 , n.

24. 1 H. & M. 672 .

25. Law Rep. 3 H. L. 249 .

26. Law Rep. 7 C. P. 43 .

27. 3 Giff. 521; 4 D. F. & J. 341 .

28. 2 J. & H. 441 .

29. 5 D. M. & G. 465 .

30. 6 E. & B. 327 .

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31. 3 D. M. & G. 459 .

32. 1 De G. & Sm. 550 .

33. Law Rep. 4 Ch. 532 .

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Index No. 1

Indexed as:

Central Trust Co. v. Rafuse

Central Trust Company, appellant;
v.
Jack P. Rafuse and Franklyn W. Cordon, respondents.

[1986] 2 S.C.R. 147

[1986] S.C.J. No. 52

31 D.L.R. (4th) 481

File No: 17753

Supreme Court of Canada

1984: December 6 / 1986: October 9.

Present: Dickson C.J. and Beetz, Estey, McIntyre, Lamer, Wilson and Le Dain JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR NOVA SCOTIA

Barristers and solicitors -- Professional liability -- Solicitors retained to perform legal services in connection with mortgage transaction -- Mortgage later found void for non-compliance with Companies Act -- Whether solicitors liable in tort or whether liability restricted to contract -- If liable in tort, whether or not action statute-barred -- Whether or not solicitors negligent -- Whether or not contributory negligence -- Whether action not maintainable because based on illegal transaction -- Companies Act, R.S.N.S. 1967, c. 42, s. 96(5) -- The Statute of Limitations, R.S.N.S. 1967, c. 168, s. 2(1)(c).

Torts -- Negligence -- Duty of care -- Solicitors -- Solicitors retained to perform legal services in connection with mortgage transaction -- Mortgage later found void for non-compliance with Companies Act -- Whether or not solicitors concurrently liable in tort -- Whether or not contributory negligence -- Whether action not maintainable because based on illegal transaction -- Whether or not action statute-barred.

Contracts -- Solicitors -- Solicitors retained to perform legal services in connection with mortgage transaction -- Mortgage later found void for non-compliance with Companies Act -- Whether solicitors' liability founded solely in contract and hence statute-barred -- Whether solicitors concurrently liable in tort, and if so, whether or not action statute-barred.

Respondent solicitors acted for the purchasers of all the shares in the capital stock of Stonehouse Motel and Restaurant Limited. A condition of the agreement of purchase and sale was that the purchasers would obtain a mortgage on the Stonehouse property. The proceeds of the mortgage were to be paid to the vendor in part [page148] satisfaction of the purchase price of the shares. One of the purchasers on behalf of Stonehouse applied to appellant's predecessor for a mortgage loan and, in accordance with the practice in such cases, the trust company retained the respondents to perform the necessary legal services in connection with the mortgage transaction. The sale closed, a first mortgage on the Stonehouse property and a chattel mortgage on its equipment were executed and the vendor was paid with funds that included the proceeds of the mortgage loan. The mortgage on the property was certified by respondent Cordon as forming a first charge on the property.

Appellant instituted an action for foreclosure against Stonehouse following default on the mortgage. Both Stonehouse and a creditor with registered judgments intervened to oppose the action, raising the defence that the mortgage was void in that it was contrary to s. 96(5) of the Nova Scotia Companies Act. This provision made it unlawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company.

Appellant instituted its action against the respondents for breach of contract aid for negligence after this Court declared the mortgage to be void as a whole as being contrary to s. 96(5). The action was dismissed at trial where respondents were found not to have been negligent. The Court of Appeal found respondents negligent but dismissed the appeal on the ground that the action was statute-barred.

The principal issue in this appeal was whether a solicitor is liable to a client in tort as well as in contract for the damage caused by a failure to meet the requisite standard of care in the performance of services for which the solicitor has been retained. A consequential issue, if the requisite standard of care was not met, was whether the appellant's action against the respondents is statute-barred.

Held: The appeal should be allowed.

If the respondent solicitors were negligent in the performance of the professional services for which they were retained, they would be liable in tort as well as contract to the appellant, subject to the other defences which they raised.

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The common law duty of care that is created by a relationship of sufficient proximity, in accordance with the general principle affirmed by Lord Wilberforce in Anns v. Merton London Borough Council, is not confined to relationships that arise apart from contract. Although the relationships in Donoghue v. Stevenson, Hedley Burne and Anns were all of a non-contractual nature and there was necessarily reference in the judgments to a duty of care that exists apart from or independently of contract, nothing in the statements of general principle in those cases suggests that the principle was to be confined to relationships that arise apart from contract. The question is whether there is a relationship of sufficient proximity, not how it arose. The principle of tortious liability is a general one for reasons of public policy. A common law duty of care may be created by a relationship of proximity that would not have arisen but for a contract.

What is undertaken by the contract will indicate the nature of the relationship that gives rise to the common law duty of care, but the nature and scope of the duty of care that is asserted as the foundation of the tortious liability must not depend on specific obligations or duties created by the express terms of the contract. It is in that sense that the common law duty of care must be independent of the contract. The distinction, in so far as the terms of the contract are concerned, is, broadly speaking, between what is to be done and how it is to be done. A claim cannot be said to be in tort if it depends for the nature and scope of the asserted duty of care on the manner in which an obligation or duty has been expressly and specifically defined by a contract. Where the common law duty of care is co-extensive with that which arises as an implied term of the contract it does not depend on the terms of the contract, and there is nothing flowing from contractual intention which should preclude reliance on a concurrent or alternative liability in tort. The same is also true of reliance on a common law duty of care that falls short of a specific obligation or duty imposed by the express terms of a contract.

A concurrent or alternative liability in tort will not be admitted if its effect would be to permit the plaintiff to circumvent or escape a contractual exclusion or limitation of liability for the act or omission that would constitute the tort. Subject to this qualification, where concurrent liability in tort and contract exists the plaintiff has the right to assert the cause of action that [page150] appears to be most advantageous to him in respect of any particular legal consequence.

These principles apply to the liability of a solicitor to a client for negligence in the performance of the professional services for which he has been retained. There is no sound reason of principle or policy why the solicitor should be in a different position in respect of concurrent liability from that of other professionals.

The basis of the solicitor's liability in tort for negligence and the client's right in such case to recover for purely financial loss is the principle affirmed in Hedley Byrne and treated in Anns as an application of a general principle of tortious liability for negligence based on the breach of a duty of

care arising from a relationship of sufficient proximity. That principle is not confined to professional advice but applies to any act or omission in the performance of the services for which a solicitor has been retained.

The respondent solicitors were negligent in failing to ascertain the existence of s. 96(5) of the Nova Scotia Companies Act, to perceive that it raised a problem concerning the validity of the proposed mortgage and to advise the Nova Scotia Trust Company accordingly. Their negligence was causative of the damage suffered by the trust company.

A solicitor is required to bring reasonable care, skill and knowledge to the performance of the professional service which he has undertaken. The requirement of professional competence that was particularly involved in this case was reasonable knowledge of the applicable or relevant law. A solicitor is not required to know all the law applicable to the performance of a particular legal service but he must have a sufficient knowledge of the fundamental issues or principles of law applicable to the particular work he has undertaken to enable him to perceive the need to ascertain the law on relevant points.

While the solicitor's duty of care has generally been stated in the context of contractual liability as arising as an implied term of the contract or retainer, the same duty arises as a matter of common law from the relationship of proximity created by the retainer. In the absence of special terms in the contract determining the [page151] nature and scope of the duty of care in a particular case, the duties of care in contract and in tort are the same.

Respondent solicitors acted negligently. The fact that the capacity of a corporation to borrow and give security may be limited or subjected to certain conditions by the provisions of the applicable Companies Act is such basic knowledge that a reasonably competent solicitor must be held to possess it, whether he is a general practitioner or a specialist. It is knowledge which a solicitor who undertakes to do the legal work to obtain a mortgage or other security from a corporation must possess, and with it there is a duty to exercise reasonable care and skill to ascertain by an examination of the relevant legislation what limits or conditions it imposes upon the capacity of a corporation to give security. A reasonably competent solicitor, knowing that the mortgage was being given by Stonehouse to obtain a loan to assist in the purchase of its shares, would have recognized that s. 96(5) of the Companies Act raised a serious question concerning the legality or validity of the proposed mortgage. In the existing state of the law in 1968 the reasonably competent solicitor in Nova Scotia in 1968 would have perceived that there was a serious possibility that the mortgage might be held to be void as being contrary to s. 96(5) and would have advised his client accordingly.

The defence of contributory negligence must fail. The executive officers of the Nova Scotia Trust Company and the members of the Executive Committee of the Board of Directors did not have a duty of care with respect to the legal aspects of a transaction other than to retain qualified solicitors to perform the necessary legal services. They might well have been negligent had they relied on

their own legal judgment in such a case.

A solicitor cannot raise the defence of illegality if it is only because of his negligence that the exercise of the professional services for which he was retained results in the carrying out of an illegal transaction. There was no merit in the contention that because the mortgage was illegal appellant's retainer of the respondents was also illegal and thus unenforceable as a basis of the appellant's action for breach of contract and negligence.

Appellant's action for negligence was not statute-barred. A cause of action arises for purposes of a [page152] limitation period when the material facts on which it is based have been discovered or ought to have been discovered by the plaintiff by the exercise of reasonable diligence. That rule should be followed and applied here. There is no principled reason for distinguishing in this regard between an action for injury to property and an action for the recovery of purely financial loss caused by professional negligence. Since the respondents gave the Nova Scotia Trust Company a certificate on January 17, 1969 that the mortgage was a first charge on the Stonehouse property, the earliest that appellant discovered or should have discovered respondents' negligence by the exercise of reasonable diligence was in April or May 1977 when the validity of the mortgage was challenged in the action for foreclosure. Accordingly, appellant's cause of action in tort did not arise before that date and its action against the respondents is not statute-barred.

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Sillivan Ltd. v. Aliakmon Shipping Co., [1985] 2 W.L.R. 289; Wabasso Ltd. v. National Drying Machinery Co., [1981] 1 S.C.R. 578; Thibault v. Central Trust Company of Canada, [1963] S.C.R. 312; Cartledge v. E. Jopling & Sons Ltd., [1963] A.C. 758; Kamloops (City of) v. Nielsen, [1984] 2 S.C.R. 2; Pirelli General Cable Works Ltd. v. Oscar Faber & Partners, [1983] 2 A.C. 1; referred to: Central and Eastern Trust Co. v. Irving Oil Ltd., [1980] 2 S.C.R. 29, affirming (1978), 89 D.L.R. (3d) 374, reversing (1977), 81 D.L.R. (3d) 495; Howell v. Young (1826), 5 B. & C. 259; Bean v. Wade (1885), 2 T.L.R. 157; Smith v. Fox (1848), 6 Hare 386, 67 E.R. 1216; Jarvis v. Moy, Davies, Smith, Vandervell & Co., [1936] 1 K.B. 399; Kelly v. Metropolitan Railway Co., [1895] 1 Q.B. 944; Turner v. Stallibrass, [1898] 1 Q.B. 56; Sachs v. Henderson, [1902] 1 K.B. 612; Edwards v. Mallan, [1908] 1 K.B. 1002; Jackson v. Mayfair Window Cleaning Co., [1952] 1 All E.R. 215; Clark v. Kirby-Smith, [1964] 1 Ch. 506; Bagot v. Stevens Scanlan & Co., [1966] 1 Q.B. 197; Cook v. Swinfen, [1967] 1 W.L.R. 457; Heywood v. Wellers, [1976] Q.B. 446; Russell v. Palmer (1767) 2 Wils. K.B. 325, 95 E.R. 837; Godefroy v. Jay (1831), 7 Bing. 413, 131 E.R. 159; Batty v. Metropolitan Property Realisations Ltd., [1978] Q.B. 554; Photo Production Ltd. v. Securicor Transport Ltd., [1978] 1 W.L.R. 856; Forster v. Outred & Co., [1982] 2 All E.R. 753; Dabous v. Zuliani (1976), 12 O.R. (2d) 230; Donoghue v. Stevenson, [1932] A.C. 562; Hartman v. The Queen in right of Ontario (1973), 2 O.R. (2d) 244; Hall v. Brooklands Auto Racing Club, [1933] 1 K.B. 205; Power v. Halley (1978), 88 D.L.R. (3d) 381; Royal Bank of Canada v. Clark and Watters (1978), 22 N.B.R. (2d) 693, 39 A.P.R. 693; Anns v. Merton London Borough Council, [1978] A.C. 728; Attorney-General of Nova Scotia v. Aza Avramovitch Associates Ltd. (1984), 11 D.L.R. (4th) 588; Consumers Glass Co. v. Foundation Co. of Canada/Compagnie Foundation du Canada (1985), 20 D.L.R. (4th) 126; Margarine Union G.m.b.H. v. Cambay Prince Steamship Co. (The "Wear Breeze"), [1969] 1 Q.B. 219; Rowe v. Turner Hopkins & Partners, [1982] 1 N.Z.L.R. 178; Flint & Walling Mfg. Co. v. Beckett, 79 N.E. 503 (1906); Arenson v. Casson Beckman Rutley & Co., [1977] A.C. 405; Junior Books Ltd. v. Veitchi Co., [1983] 1 A.C. 521; Tracy v. Atkins (1979), 105 D.L.R. (3d) 632; Hett v. Pun Ponq (1890), 18 S.C.R. 290; Bannerman Brydone Folster & Co. v. Murray, [1972] N.Z.L.R. 411; Sparham-Souter v. Town and Country Developments (Essex) Ltd., [1976] Q.B. 858. [page154]

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[page155]

APPEAL from a judgment of the Nova Scotia Court of Appeal (1983), 57 N.S.R. (2d) 125, 120 A.P.R. 125, 147 D.L.R. (3d) 260, 28 R.P.R. 185, dismissing an appeal from a judgment of Hallett J. (1982), 53 N.S.R. (2d) 69, 109 A.P.R. 69, 139 D.L.R. 385, dismissing appellant's action. Appeal allowed.

R.A. Cluney, Q.C., and R.G. Belliveau, for the appellant.
Arthur R. Moreira, Q.C., Alexander S. Beveridge and Colin D. Bryson, for the respondents.

Solicitor for the appellant: R.A. Cluney, Halifax.
Solicitor for the respondents: Arthur W.R. Moreira, Halifax.

The judgment of the Court was delivered by

1 **LE DAIN J.**:-- The principal question in this appeal is whether a solicitor is liable to a client in

tort as well as in contract for the damage caused by a failure to meet the requisite standard of care in the performance of the services for which the solicitor has been retained. The consequential issue in the appeal is whether, if there was a failure to meet the requisite standard of care, the appellant's action against the respondents is statute-barred.

2 The appeal is by leave of the Nova Scotia Supreme Court, Appeal Division, from the judgment of the Appeal Division on March 30, 1983 dismissing the appeal from the judgment of Hallett J. in the Trial Division on August 9, 1982, which dismissed the appellant's action in damages against the respondent solicitors for breach of contract and negligence in failing to advise their client that a mortgage might, if challenged, be held to be void, as it was later held by this Court, because of a statutory provision making it unlawful for a company to give financial assistance in connection with a purchase of its shares.

I

3 The relationship of solicitor and client arose in the following manner. The respondent solicitors were acting for persons who had agreed to purchase all the shares in the capital stock of Stonehouse Motel and Restaurant Limited (hereinafter [page156] referred to as "Stonehouse") for $315,000. It was a condition of the agreement of purchase and sale that the purchasers would obtain a mortgage on the property of Stonehouse for not less than $225,000, the proceeds of which would be paid to the vendor in part satisfaction of the purchase price of the shares. An application for the mortgage loan was made by one of the purchasers on behalf of Stonehouse to the Nova Scotia Trust Company, and in accordance with the practice in such cases the respondents were retained by the trust company to perform the necessary legal services in connection with the mortgage transaction. A letter dated December 12, 1968 from the trust company to the respondent Rafuse, which confirmed the approval of the mortgage loan to Stonehouse, said: "We would therefore ask you to kindly search the title to the property in question ensuring it is good and valid for our purposes and provide us with your Certificate." The mortgage loan was approved and the instructions given to the respondent solicitors on behalf of the trust company by persons who had had legal training.

4 At the closing of the sale on December 31, 1968 the purchasers of the shares, acting as the new officers of Stonehouse, executed a first mortgage on the real property and a chattel mortgage on the equipment of the company as security for a loan of $225,000 from the trust company. The respondent Cordon, acting for both the purchasers and the trust company, gave the solicitors for the vendor a cheque in the amount of $300,000, the funds for which included the proceeds of $225,000 from the mortgage loan, in payment for the shares. On January 17, 1969 the respondent Cordon, reporting on behalf of his firm to the trust company concerning the mortgage transaction, said: "We hereby certify that the title to the above property is free and clear of all encumbrances and that the mortgage from Stone-House Motel and Restaurant Limited forms a first charge on the property, and that all taxes have been paid to December 31, 1969."

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5 The appellant, Central Trust Company, is the successor of the Nova Scotia Trust Company. On April 21, 1977 it instituted an action against Stonehouse for foreclosure of the mortgage. Irving Oil Limited, a creditor of Stonehouse with registered judgments, intervened to oppose the action. Both Stonehouse and Irving raised the defence that the mortgage was void as being contrary to s. 96(5) of the Nova Scotia Companies Act, R.S.N.S. 1967, c. 42, which provided:

> 96. ...
>
> (5) Subject to this Section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase made or to be made by any person of any shares in the company.

6 By judgment on November 25, 1977 in Central and Eastern Trust Co. v. Stonehouse Motel and Restaurant Ltd. (1977), 81 D.L.R. (3d) 495, the Nova Scotia Supreme Court, Trial Division (Hart J.), held that the mortgage was not void by reason of s. 96(5) and granted an order for foreclosure. On appeal from this judgment the Supreme Court of Nova Scotia, Appeal Division (Coffin, Macdonald and Pace JJ.A.), held on July 10, 1978 in Irving Oil Ltd. v. Central and Eastern Trust Co. (1978), 89 D.L.R. (3d) 374, that the mortgage was void by reason of s. 96(5) except for the amount by which the obligations of Stonehouse were to be reduced by application of the proceeds of the mortgage loan. On appeal from that judgment this Court held on April 22, 1980 in Central and Eastern Trust Co. v. Irving Oil Ltd., [1980] 2 S.C.R. 29, that the mortgage was void as a whole as being contrary to s. 96(5).

7 On October 28, 1980, following the judgment of this Court declaring the mortgage to be void, the appellant instituted its action against the respondents for breach of contract and negligence. It alleged negligence in failing to appreciate and advise the Nova Scotia Trust Company that the mortgage might be held to be void as being contrary [page158] to s. 96(5) of the Companies Act because it was given by Stonehouse to provide financial assistance in connection with the purchase of shares in the company.

8 In their defence the respondents contended: (a) that their liability, if any, was in contract only and not in tort; (b) that they had not been negligent, particularly in view of the conflicting judicial opinion on the question of the validity of the mortgage; (c) that there was contributory negligence on the part of the Nova Scotia Trust Company or those for whom it was responsible because of the approval of the mortgage loan and the instructions to the respondents by persons of legal training; (d) that the contract between the Nova Scotia Trust Company and the respondents, having as its object an illegal transaction, was itself illegal and could not therefore be the basis of an action in damages; and (e) the appellant's action was barred by The Statute of Limitations, R.S.N.S. 1967, c.

168.

9 Hallett J. in the Trial Division (1982), 139 D.L.R. (3d) 385, dismissed the appellant's action on the ground that the respondents had not been negligent. He did not deal with the other issues.

10 The Appeal Division (Cooper, Pace and Jones JJ.A.) (1983), 147 D.L.R. (3d) 260, held that the respondents had been negligent but dismissed the appeal on the ground that the action was barred by The Statute of Limitations. The Court of Appeal was of this view whether or not the appellant's action could be based on tort as well as contract, a question on which it did not express an opinion.

11 It was conceded by the appellant in this Court that if the respondent solicitors were liable in contract only the appellant's action was statute-barred. The issues in the appeal, in the order in which I propose to deal with them to the extent necessary for the disposition of the appeal, may be summarized as follows:

1. Can a solicitor be liable to a client in tort as well as in contract for negligence in the [page159] performance of the professional services for which the solicitor has been retained?
2. Were the respondent solicitors negligent in carrying out the mortgage transaction for the Nova Scotia Trust Company?
3. Was there contributory negligence on the part of the Nova Scotia Trust Company or those for whom it was responsible?
4. Is the appellant prevented from bringing its action because of the illegality of the mortgage?
5. Is the appellant's action barred by The Statute of Limitations?

12 The parties are agreed on the quantum of damages if the respondents are liable. The terms of their agreement were noted by Hallett J. in his judgment as follows: "The defendants have agreed as to the quantum of the plaintiff's claim which consists of $424,434.04 outstanding on the mortgage for principal, interest and taxes, plus interest accruing daily after April 14, 1982, at the rate of $156.93 and legal fees of $56,759.46 incurred by the plaintiff in attempting to enforce the mortgage." This agreement as to quantum was reaffirmed by the parties in their factums in this Court.

II

13 The question whether there can be concurrent liablity in contract and in tort for negligence in the performance of professional services has been the subject of conflicting judicial opinion and a great deal of academic commentary which has been overwhelmingly in favour of the recognition of concurrent liability in such a case. Important legal consequences have turned on the differences in the rules applicable to contractual and tortious liability. The three most important areas in which these differences have been reflected in the decisions on the question of concurrent liability are

limitation of actions, measure of damages and apportionment of liability. Although there has been an increasing judicial disposition to apply similar rules, or at least to reach similar results, with respect to these issues under the two kinds of [page160] liability, there are likely to remain differences of result in certain cases flowing from inherent differences between contract and tort. Although an assimilation of the rules or results under the two kinds of liability has been advocated as one response to the issue of concurrent liability, the question is unlikely to be rendered wholly academic by this clearly discernible development in the law. It has been the important difference of result, particularly in the three areas referred to, that has given the question of concurrent liability its policy focus and interest in the abundant judicial and academic opinion on the subject.

14 At least three major considerations are reflected in that body of opinion. The first is the view of those who oppose concurrent liability that where persons have entered into a contractual relationship their liability for an act or omission which constitutes a breach of contract should be governed entirely by the law of contract. The relationship, which would not have existed but for the contract, should not be held to give rise to a common law duty of care. It would be unfair to add a tortious liability to the contractual liability which the parties may be presumed to have contemplated. This view appears to rest on an implied contractual intent as much as on the scope of tortious liability. The second consideration that one finds reflected in the opinion on the question of concurrent liability is the view of those who favour concurrent liability that a common law duty of care is created by certain kinds of relationship, whether or not the relationship has its origin in contract. On this view, there is nothing in the leading cases affirming the conditions under which a common law duty of care arises to suggest that it is confined to non-contractual relationships. This view recognizes that tortious liability may be limited or excluded by the express or implied terms of a contract but denies that there is any basis for [page161] reading an implied term into every contract that liability is to be governed entirely by the law of contract. This view is really an assertion of the scope of tortious liability in contrast to an assertion of the scope of contractual intention by the opposing view. The third major consideration reflected in the opinion on the issue of concurrent liability is the view, also of those who favour concurrent liability, that to deny that a retained solicitor may be liable to a client in tort as well as in contract for negligence in the performance of the professional services for which he has been retained is to place the solicitor's liability to a client in an anomalous position with resulting injustice. The question of justice, which is urged by the proponents of both views on the issue of concurrent liability, is not free from ambiguity or ambivalence. What may appear just to one party may appear unjust to the other. Take, for example, the limitation of actions, which is a measure for the protection of defendants. There are obviously considerations of justice applicable to both parties. So also with the measure of damages. Perhaps contributory negligence and apportionment of liability is the area in which the question of justice is clearest and least ambiguous: that a person who is only partially liable should not be held to be wholly liable.

15 These, it would seem, are the major policy considerations underlying the issue of concurrent liability. Consideration of the authorities on this issue must begin in this Court with the judgment of Pigeon J. on behalf of the majority in J. Nunes Diamonds Ltd. v. Dominion Electric Protection Co.,

[1972] S.C.R. 769, and his dissenting opinion in Smith v. McInnis, [1978] 2 S.C.R. 1357.

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16 In Nunes Diamonds the issue of concurrent liability was whether the respondent, Dominion Electric Protection Company ("D.E.P."), which had undertaken to provide a burglar alarm service for the appellant diamond merchants ("Nunes"), was liable in tort to Nunes for negligent misrepresentations concerning the functioning of the alarm system despite the existence of a contract containing a limitation of liability. The contract provided that D.E.P. was not an insurer, that the rates charged were based on the probable value of the burglar alarm service, and that in the event of loss resulting from a failure to perform the service the liability of D.E.P. would be limited to $50 as liquidated damages. It also provided that no conditions, warranties or representations had been made by D.E.P., its officers, servants or agents other than those set out in writing in the contract. The alleged misrepresentations that the alarm system had not been and could not be circumvented were made several months after the contract was entered into, following a burglary at the premises of another diamond merchant, who was also using the D.E.P. alarm system. Some time later a burglary occurred at the premises of Nunes, and a large quantity of diamonds was stolen. The alarm system failed to sound because it had been circumvented. Nunes sued D.E.P. for breach of contract and negligence. The trial court, the Ontario Court of Appeal and this Court were all of the opinion that there had not been a breach of contract. The issue was whether there had been negligent misrepresentation concerning the functioning of the alarm system for which D.E.P. was liable in tort on the basis of the principle affirmed in Hedley Byrne & Co. v. Heller & Partners Ltd., [1964] A.C. 465. The trial court and the Court of Appeal were of the opinion that there had not been misrepresentation for which D.E.P. was liable. The majority of this Court appear also to have been of this view but, assuming that there had been a misrepresentation, they held that there could not be liability in tort for it because of the existence of [page163] the contract. Pigeon J., with whom Martland and Judson JJ. concurred, said at pp. 777-78:

> Furthermore, the basis of tort liability considered in Hedley Byrne is inapplicable to any case where the relationship between the parties is governed by a contract, unless the negligence relied on can properly be considered as "an independent tort" unconnected with the performance of that contract, as expressed in Elder, Dempster & Co. Ltd. v. Paterson, Zochonis & Co., Ltd. [[1924] A.C. 522], at p. 548. This is specially important in the present case on account of the provisions of the contract with respect to the nature of the obligations assumed and the practical exclusion of responsibility for failure to perform them.

It appears to have been assumed by the majority, as had been held by the trial judge, that the clause in the contract limiting liability in the case of loss to $50 did not cover negligence and also that the

clause respecting representations did not apply to representations made after the contract was entered into. Pigeon J. said that if D.E.P. were to be liable in tort, despite the limitation of liability in the contract, it would effect a fundamental alteration of the contract. He also said that the representations relied on as the basis of tortious liability were not acts independent of the contractual relationship between the parties because they would not have been made had the parties not been in a contractual relationship. Spence J. dissenting, with whom Laskin J. (as he then was) concurred, held that there had been negligent misrepresentation concerning the functioning of the burglar alarm system for which D.E.P. was liable in tort on the basis of Hedley Byrne. On the question whether there could be liability in tort where there was a contractual relationship, he said at pp. 810-11: "I cannot agree that the mere existence of an antecedent contract foreclosed tort liability under the Hedley Byrne principle."

[page164]

17 In Elder Dempster, on which Pigeon J. relied for the criterion of an independent tort unconnected with the performance of the contract, the issue was whether shipowners who were sued with charterers for damage to cargo could claim the benefit of an exclusion of liability in the bill of lading for bad stowage. The plaintiff cargo owners sought to hold the shipowners liable in tort for the master's negligence and contended that they could not claim the protection of the bill of lading because they were not parties to it. The House of Lords held that the shipowners were protected by the bill of lading, although opinion differed as to the basis on which it applied to them (cf. Scruttons Ltd. v. Midland Silicones Ltd., [1962] A.C. 446). What the case decided in essence was that the contractual exclusion of liability for bad stowage in the bill of lading could not be circumvented by reliance on a liability in tort where the act or omission complained of was one connected with the performance of the contract. This appears from the speech of Viscount Finlay, cited by Pigeon J. in Nunes Diamonds, where, referring to the contention that the shipowners had a liability in tort that was unaffected by the exclusion of liability in the bill of lading, he said at p. 548:

> This contention seems to me to overlook the fact that the act complained of was done in the course of the stowage under the bill of lading, and that the bill of lading provided that the owners are not to be liable for bad stowage. If the act complained of had been an independent tort unconnected with the performance of the contract evidenced by the bill of lading, the case would have been different. But when the act is done in the course of rendering the very services provided for in the bill of lading, the limitation on liability therein contained must attach, whatever the form of the action and whether owner or charterer be sued. It would be absurd that the owner of the goods could get rid of the protective clauses of the bill of lading, in respect of all stowage, by suing the owner of the ship in tort.

[page165]

18 In Smith v. McInnis, however, Pigeon J. referred to the principle affirmed in Nunes Diamonds as one of general application to the question of concurrent liability. The issue turning on concurrent liability in that case was whether there could be apportionment of liability between the defendant solicitors and the third-party solicitors, who had been joined for contribution, for the damage caused by a failure to file proofs of loss and to institute an action in time under a fire insurance policy. The third-party solicitors had been retained by the defendant solicitors, with the approval of the client, to assist the defendant solicitors with preparation of the proofs of loss. The question was whether the third-party solicitors had a duty to advise the defendant solicitors of the time within which to file the proofs of loss and to institute an action. The majority in this Court (Laskin C.J. and Martland, Spence, Dickson and Estey JJ.) held that the third-party solicitors did not have such a duty and that it was therefore unnecessary for the Court to determine whether there could have been apportionment of liability, had they been liable, and for that purpose to consider, as Laskin C.J. put it, "whether a solicitor's liability to his client lies in tort or only in contract." Pigeon J., dissenting, with whom Beetz J. concurred, held that the third-party solicitors were in breach of a duty to advise the defendant solicitors of the time within which to file the proofs of loss. It was contended by counsel for the third-party solicitors that their liability, if any, was in contract and that there was therefore no basis in the applicable contribution legislation for an apportionment of liability. Pigeon J. held that on general principles of contract there could be apportionment of liability for breach of contract, but at the outset of his analysis of this question he expressed the following opinion concerning the nature of a solicitor's liability to a client for negligence in the performance of professional services at p. 1377:

[page166]

> I have to agree that the liability of a solicitor to his client for negligence in his duty to give advice, or otherwise, is in contract only, not in tort. I adhere to the view I have previously expressed in other cases, that a breach of duty may constitute a tort only if it is a breach of a duty owed independently of any contract with the claimant, "an independent tort" as I said in Nunes Diamonds v. Dominion Electric Protection [[1972] S.C.R. 769], at p. 777. In the case of a solicitor retained to give advice, his duty to advise properly arises only under contract and I do not see how liability can arise otherwise than on a contractual basis as was held in the case of a consulting engineer in Halvorson v. McLellan Co. [[1973] S.C.R. 65], at p. 74. Breach of contract appears to be the basis on which a solicitor was found liable by the House of Lords in Nocton v. Ashburton

> [[1914] A.C. 932], and by the English Court of Appeal in Groom v. Crocker [[1939] 1 K.B 194].

I turn to the authority invoked by Pigeon J. in support of this opinion.

19 In Halvorson the issue was the liability of consulting engineers for damage caused by their negligence in making design modifications to a winch to be used for hauling cables up a mountainside for the erection of an aerial tramway. After indicating the basis of the contractual relationship between the plaintiff contractor and the defendant engineers, Pigeon J., delivering the judgment of the Court, said at p. 74: "This means also that Halvorson's only possible claim is against McLellan & Co. for negligent performance of its contract for erection services, not in tort as was contended." The proper characterization of the cause of action appears to have been simply a question of pleading and argument, on which no practical consequence turned.

20 Nocton v. Lord Ashburton is a case that has been cited in support of concurrent liability. It is admittedly difficult to discern the precise basis on which some of the members of the House of Lords held the solicitor to be liable (cf. Lord Devlin in Hedley Byrne, at p. 520), but in my respectful opinion the case does not support the proposition [page167] that the liability of a solicitor to a client for negligence is in contract only. On the contrary, some of its dicta and the general implications of its reasoning and conclusions support the view that a solicitor may have a liability to a client apart from contract for negligence in the performance of professional services. In that case the client sued the solicitor for advising him to release part of the security of a mortgage to the advantage of a mortgage in which the solicitor was interested, and with the result, contrary to the assurances that had been given by the solicitor, that the remaining security proved insufficient. The issue was whether the allegations of the statement of claim supported liability on a basis other than an action of deceit, requiring proof of actual fraud. A majority in the House of Lords (Viscount Haldane L.C., Lord Atkinson and Lord Dunedin) held the solicitor to be liable in equity for breach of a fiduciary duty, clearly a liability distinct from that at law for breach of contract. In the course of reviewing the various bases on which a solicitor may be liable to a client, Viscount Haldane said at p. 956: "My Lords, the solicitor contracts with his client to be skilful and careful. For failure to perform his obligation he may be made liable at law in contract or even in tort, for negligence in breach of a duty imposed on him. In the early history of the action of assumpsit this liability was indeed treated as one for tort." Lord Dunedin did indicate (p. 965) that while he agreed with Viscount Haldane that there was liability for breach of fiduciary duty his own preference would have been for liability for breach of contract, which he referred to as an "action for negligence" (p. 964). Viscount Haldane, with whom Lord Atkinson concurred, also indicated (p. 958) in his conclusion that there was an alternative liability at law for breach of contract. Lord Parmoor held that there was liability based on negligence, and from the language used by him -- "liable in negligence for breach of duty in his position as solicitor to the plaintiff" (p. 973) and "a charge of negligence for breach of duty of the appellant in his employment as a solicitor" (p. 977) -- it would appear that he was thinking of a breach of the solicitor's contractual duty of care. Lord Shaw held that there was liability for breach of duty created by a relationship "equivalent to [page168]

contract" (pp. 971-72) -- that is, a relationship in which there was an assumption of responsibility and a reliance on it. Despite the use of the words "equivalent to contract", or perhaps because of them, I take it that Lord Shaw was speaking of a liability in tort. At least that appears to have been the view taken of his judgment by Lord Devlin in Hedley Byrne, where Lord Devlin adopted the principle of liability affirmed by Lord Shaw in Nocton as the basis for his own statement of the principle of tortious liability for negligent misrepresentation in Hedley Byrne.

21 In contrast, the judgment of the Court of Appeal in Groom v. Crocker was for some forty years clearly authority for the proposition that the liability of a solicitor to a client for negligence in the performance of the services for which he had been retained was in contract only, but at the time Smith v. McInnis was decided its authority had been severely impaired, if not repudiated, by the judgment of the Court of Appeal in Esso Petroleum Co. v. Mardon, [1976] Q.B. 801. Groom v. Crocker was a case in which solicitors retained by an insurer to act for the insured were sued by the latter for the damage caused to him by an admission of liability. In holding that the liability of a solicitor to a client was in contract only, the Court of Appeal said that the solicitor's duty of care had no existence apart from the contractual [page169] relationship. Groom v. Crocker has been criticized both for the authority it relied on and for the authority it apparently did not consider. The earlier cases on which it relied have been the subject of critical analysis in several learned judgments and scholarly articles. See, for example, Midland Bank Trust Co. v. Hett, Stubbs & Kemp, [1979] Ch. 384, at pp. 406-08; Aluminum Products (Qld.) Pty. Ltd. v. Hill, [1981] Qd.R. 33, at pp. 41-42; Macpherson & Kelley v. Kevin J. Prunty & Associates, [1983] 1 V.R. 573, at pp. 575-77; Dwyer, "Solicitor's Negligence -- Tort or Contract?" (1982), 56 A.L.J. 524, at p. 531; and French, "The Contract/Tort Dilemma" (1983), 5 Otago L.R. 236, at pp. 262-63, 294 and 296. I do not think it would serve a useful purpose to attempt to go over that ground in detail here. I content myself with expressing my respectful agreement with the view that Howell v. Young (1826), 5 B. & C. 259, 108 E.R. 97, and the other cases referred to in Bean v. Wade (1885), 2 T.L.R. 157, were not clear authority for the statement in that case, on which Groom v. Crocker relied, that "the right of action in cases of this kind was treated as arising from a breach of contract, and not from negligence apart from contract or from any breach of trust", although Howell v. Young (and Smith v. Fox (1848), 6 Hare 386, 67 E.R. 1216, which applied it) clearly provided authority for the conclusion in Bean v. Wade that the statute of limitations began to run from the date of the breach of duty rather than from its discovery. It has been argued that the necessary inference from that conclusion in Howell v. Young, despite dicta in it which appear to recognize the possibility of concurrent liability, is that the court must have been of the view that the liability was in contract only because of the traditional and well-established distinction between what constitutes a cause of action in contract and a cause of action in tort. I prefer the interpretation of Howell v. Young, admittedly only one of several (see French, op. cit., p. 263), that the court had in mind the usual case where the breach of duty and the damage occur at the same time. In sum, I share the view that the earlier cases relied on in Groom v. Crocker provided a doubtful and somewhat frail basis of [page170] authority for the conclusion it reached on the question of concurrent liability.

22 Groom v. Crocker also relied on Jarvis v. Moy, Davies, Smith, Vandervell & Co., [1936] 1

K.B. 399, one of the special category of cases involving the distinction between contract and tort for certain purposes under the successive County Courts Acts. Other cases in this category are Kelly v. Metropolitan Railway Co., [1895] 1 Q.B. 944; Turner v. Stallibrass, [1898] 1 Q.B. 56; Sachs v. Henderson, [1902] 1 K.B. 612; Steljes v. Ingram (1903), 19 T.L.R. 534; Edwards v. Mallan, [1908] 1 K.B. 1002; and Jackson v. Mayfair Window Cleaning Co., [1952] 1 All E.R. 215. The issue which had to be decided in those cases for such purposes as the applicable scale of costs and the transfer of a case from the High Court to a county court, was whether the action was an action founded on contract or an action founded on tort within the meaning of the Act. The courts had to characterize the action, for purposes of the Act, as one or the other; they could not treat it as an action in both contract and tort. The criterion that was adopted for this purpose was the "substance of the matter" (Steljes v. Ingram, pp. 535-36), that is, whether the action was in substance one founded on contract or one founded on tort, which was determined by asking whether or not the plaintiff had to rely on the terms of the contract for his action. This question was answered by distinguishing between a cause of action based on the breach of a special obligation or duty created by the terms of an express contract (referred to as a "special contract") and a cause of action based on the breach of a duty arising both as an implied term of the contract and at common law from the relationship (Edwards v. Mallan, p. 1005). The former [page171] was an action founded on contract for purposes of the Act; the latter was an action founded on tort. This is the sense in which Greer L.J. in Jarvis is understood to have referred to a duty arising independently of contract (see, for example, Midland Bank Trust, at p. 410; and Finlay v. Murtagh, [1979] I.R. 249, at pp. 255-56) in the following statement at p. 405:

> The distinction in the modern view, for this purpose, between contract and tort may be put thus: where the breach of duty alleged arises out of a liability independently of the personal obligation undertaken by contract, it is tort, and it may be tort even though there may happen to be a contract between the parties, if the duty in fact arises independently of that contract.

It has been suggested that this particular category of cases, because of its very special context and character, is not relevant to the general question of concurrent liability. See Macpherson & Kelley, at p. 577. It is true that in those cases the courts could not make a finding of concurrent liability for the purposes of the County Courts Acts, but in concluding that an action may be an action founded on tort, despite the existence of a contract, they lend support to the recognition of concurrent liability in other contexts. Such was the case of Edwards v. Mallan, in which the Court of Appeal held that an action against a dentist, who was alleged to have been "employed for reward", for the negligent extraction of a tooth was an action of tort within the meaning of s. 66 of the County Courts Act, 1888, providing for the transfer of an action of tort from the High Court to a county court where the plaintiff had no visible means, if unsuccessful, of paying the defendant's costs. Those who favour concurrent liability in the case of persons professing skill in a calling have attached particular importance to this case. See, for example, Dominion Chain Co. v. Eastern [page172] Construction Co. (1976), 68 D.L.R. (3d) 385, at pp. 391 and 393; and Midland Bank Trust, at p. 410.

23 One explanation that has been suggested for the denial of a concurrent or alternative liability in tort in the solicitor and client relationship prior to Hedley Byrne is that before that case there could not be liability in tort for purely economic or financial loss caused by negligence, which was the damage normally caused by the negligence of a solicitor. In Clark v. Kirby-Smith, [1964] 1 Ch. 506, however, Plowman J. rejected the contention that a solicitor had a concurrent liability in tort on the basis of Hedley Byrne, saying at p. 510, "A line of cases going back for nearly 150 years shows, I think, that the client's cause of action is in contract and not in tort: see, for example, Howell v. Young and Groom v. Crocker ...."

24 Greer L.J. in Jarvis and Plowman J. in Clark were quoted with approval by Diplock L.J. in his influential judgment in Bagot v. Stevens Scanlan & Co., [1966] 1 Q.B. 197, where, in holding that an architect could not be concurrently liable to a client in tort, he said at p. 204:

> It seems to me that, in this case, the relationship which created the duty of exercising reasonable skill and care by the architects to their clients arose out of the contract and not otherwise. The complaint that is made against them is of a failure to do the very thing which they contracted to do. That was the relationship which gave rise to the duty which was broken. It was a contractual relationship, a contractual duty, and any action brought for failure to comply with that duty is, in my view, an action founded on contract.

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That statement has been much relied on by those who have concluded that there cannot be concurrent liability in tort for an act or omission that constitutes a breach of contract. See, for example, McLaren Maycroft & Co. v. Fletcher Development Co., [1973] 2 N.Z.L.R. 100; and the dissenting judgment of Wilson J.A., as she then was, in Dominion Chain.

25 The authority of Groom v. Crocker concerning the nature of a solicitor's liability to a client for negligence was reaffirmed by the Court of Appeal in Cook v. Swinfen, [1967] 1 W.L.R. 457, and in Heywood v. Wellers, [1976] Q.B. 446, although with some reservation by Lord Denning in the latter case foreshadowing his judgment in Esso Petroleum Co. v. Mardon. That case was a critical turning point in Anglo-Canadian jurisprudence on the question of the concurrent liability of persons professing skill on which another may reasonably rely. It involved the liability of the petroleum company for a negligent statement concerning the potential throughput of a service station made in pre-contract negotiations by experienced employees of the company holding themselves out as experts. The plaintiff Mardon was induced by the statement, despite his own misgivings, to enter into a tenancy of the service station with eventual loss when the throughput fell far short of that predicted. In an action by the company for possession, money due and mesnes profits Mardon counter-claimed for damages for breach of warranty and negligent misrepresentation. The trial

judge found that there had not been a warranty but upheld the counterclaim for negligent misrepresentation on the basis of Hedley Byrne. The Court of Appeal held that there was liability on the basis of breach of warranty or negligent misrepresentation, a recognition of concurrent or alternative liability in contract and in tort. It was contended by counsel for the petroleum company, citing Clark v. Kirby-Smith, that "when the negotiations between two parties resulted in a contract between them, their rights and duties were governed by the law of contract and not by the law of tort." In rejecting this contention, Lord Denning M.R. held that Groom v. Crocker and the cases which followed it, such as Clark v. Kirby-Smith and Bagot, [page174] had been wrongly decided because they were in conflict with other decisions of "high authority", which did not appear to have been considered by them and which showed that "in the case of a professional man, the duty to use reasonable care arises not only in contract, but is also imposed by the law apart from contract, and is therefore actionable in tort." The authority which Lord Denning cited for this proposition consisted of the statement by Tindal C.J. in Boorman v. Brown (1842), 3 Q.B. 511, at pp. 525-26 concerning the long-established recognition of concurrent liability with respect to the "common callings" and other "status relationships", including various skilled occupations; the statement of Lord Campbell in the House of Lords in the same case (Brown v. Boorman (1844), 11 Cl. & F. 1, at p. 44), suggesting an even broader scope to the well-established principle of concurrent liability to include any contractual relationship of employment; and the dictum of Viscount Haldane L.C. in Nocton v. Lord Ashburton concerning the concurrent liability of the solicitor to a client, which I quoted earlier in the discussion of that case. Lord Denning said that the concurrent liability of the professional person was comparable to that between master and servant, citing Lister v. Romford Ice and Cold Storage Co., [1957] A.C. 555, per Lord Radcliffe at p. 587 and Matthews v. Kuwait Bechtel Corp., [1959] 2 Q.B. 57, at pp. 65-66. The statement by Tindal C.J. in Boorman v. Brown is as follows:

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> That there is a large class of cases in which the foundation of the action springs out of privity of contract between the parties, but in which, nevertheless, the remedy for the breach, or non-performance, is indifferently either assumpsit or case upon tort, is not disputed. Such are actions against attorneys, surgeons, and other professional men, for want of competent skill or proper care in the service they undertake to render: actions against common carriers, against ship owners on bills of lading, against bailees of different descriptions: and numerous other instances occur in which the action is brought in tort or contract at the election of the plaintiff.

The statement by Lord Campbell is as follows:

> But wherever there is a contract, and something to be done in the course of the

> employment which is the subject of that contract, if there is a breach of a duty in the course of that employment, the plaintiff may either recover in tort or in contract.

26 The liability in tort in Esso Petroleum was based on the principle affirmed in Hedley Byrne, which Lord Denning said at p. 820 included, when properly understood, the following proposition: "if a man, who has or professes to have special knowledge or skill, makes a representation by virtue thereof to another -- be it advice, information or opinion -- with the intention of inducing him to enter into a contract with him, he is under a duty to use reasonable care to see that the representation is correct, and that the advice, information or opinion is reliable." The other judges in Esso Petroleum, Ormrod and Shaw L.JJ., appear to have been in essential agreement with the views expressed by Lord Denning.

27 The so-called "status relationships", including the "common callings", to which I have referred above, have played a prominent role in the consideration [page176] of the question of concurrent liability with reference to various skilled professions and occupations. There is a very good discussion of the subject to be found in French, op. cit., pp. 273 ff. As she indicates, historians have differed as to the occupations that were included in the common callings. She sums up the "traditional view" as follows at p. 274:

> According to prevailing academic opinion, a business was classified as a common calling only if it displayed two characteristics. Its services had to be generally available to the public, and its exercise must have demanded skill. Falling within this category were the carrier, innkeeper, surgeon, apothecary, attorney, veterinary surgeon, smith and barber.

Russell v. Palmer (1767), 2 Wils. K.B. 325, 95 E.R. 837, would appear to be an early example of an attorney's liability in tort for negligence in an action which alleged a contractual relationship. See Fifoot, History and Sources of the Common Law: Tort and Contract, 1949, p. 157. To the same effect would appear to be the case of Godefroy v. Jay (1831), 7 Bing. 413, 131 E.R. 159, which was an action in tort against an attorney for negligence in the conduct of an action. In Steljes v. Ingram, in the course of an instructive statement on the nature and historical basis of the status relationships category of concurrent liability, Phillimore J. said at p. 535 with reference to its extension to include persons professing skill in a calling: "A further step was made when contracts with professional men whose professions were specially protected and affected by law were held to create a similar result of status; and it was said that a surgeon or a solicitor could be sued in tort for a breach of the ordinary duty of a surgeon or solicitor ("Lanphier v. Phipos,' 8 C. and P., 475)." It is with reference to this concurrent liability of persons professing skill in a calling that it is said in Winfield on Tort (7th ed. 1963), p. 6, in a passage [page177] that has been cited on several occasions in the cases:

> A dentist who contracts to pull out my tooth is, of course, liable to me for breach of contract if he injures me by an unskilled extraction. But he is also liable to me

> for the tort of negligence; for every one who professes skill in a calling is bound by the law, agreement or no agreement, to show a reasonable amount of such skill. I cannot recover damages twice over, but I may well have alternative claims for damages under different heads of legal liability.

28 Courts have on several occasions referred to the status relationships as a closed or frozen category of concurrent liability, which arose out of special historical circumstances and should not be extended to include the modern professions and other skilled occupations. This was the view taken of the stockbroker in Jarvis (p. 407), the solicitor in Groom v. Crocker (p. 222) and the architect in Bagot (pp. 204-06). This view has been criticized, although in none of the cases which have decided in favour of the concurrent liability of particular professions, as I understand them, has the conclusion been technically rested on an application or extension of the common callings category. Compare, for example, Dominion Chain, at pp. 392-93 and John Maryon International Ltd. v. New Brunswick Telephone Co. (1982), 141 D.L.R. (3d) 193, at p. 232. Rather the common callings and other status relationships, such as that between master and servant, have been invoked in support of two arguments in favour of concurrent liability: (a) they show that the common law has not recognized any general objection in principle to concurrent liability, but on the contrary has recognized concurrent liability in a wide range of cases; and (b) they indicate the extent of the anomaly that exists if concurrent liability is denied to certain professional relationships. Brown v. Boorman, which was relied on by Lord Denning in Esso Petroleum in support of his general statement of principle, has on the whole been treated with considerable caution. There appear to be two reasons for this: the significance of what it actually [page178] decided, as distinct from its dicta, and a question about the soundness of the statement by Lord Campbell. The issue, which was one of pleading raised after verdict on a motion to arrest judgment, was whether the declaration sufficiently alleged the special contractual duty which the plaintiff linseed crushers were obliged to rely on for their cause of action against the oil broker for delivering linseed oil to purchasers without obtaining payment of the price. The established approach of a court to such an issue was indicated by Lord Brougham ((1844), 11 Cl. & F.1, at p. 38) as follows: "The authorities show that, after verdict, it is immaterial whether there are or not technical words; if there are clear words to show that the Defendant has made such contract and has broken it, after verdict everything will be intended that can be intended to support the verdict." In so far as the statement of Lord Campbell is concerned, the view has been expressed from time to time that it goes too far if it is to be understood as meaning that any breach of contractual duty in an employment relationship sounds in tort as well as contract. See Slesser L.J. in Jarvis, p. 406; Oliver J. in Midland Bank Trust, p. 432; French, op. cit., p. 290. Moreover, in the modern doctrine of concurrent liability it is not the breach of contract as such that gives rise to tortious liability, but the breach of a common law duty of care arising from the relationship created by contract.

29 The case of Lister v. Romford Ice and Cold Storage Co. Ltd., which was cited by Lord Denning in Esso Petroleum with reference to concurrent liability in the master and servant relationship, and [page179] in particular the speech of Lord Radcliffe to which he referred, also calls for some comment because it has been cited for opposing views on the question of concurrent

liability. The action by the company against its employee for the damages that the company had been condemned to pay the employee's father, who was negligently injured by his son while acting as his helper, was for breach of the employee's contractual obligation to his employer to exercise due care when driving in the course of his employment. The employee was also sued for contribution as a joint tort-feasor, but that of course was based on the tortious liability of the employee and the employer to the injured third party, not on the nature of the employee's liability to the employer. In their speeches with reference to the nature of the employee's duty of care to the employer, the essential point the members of the House of Lords were making is that they disagreed with the opinion of Denning L.J. in the Court of Appeal, [1956] 2 Q.B. 180, at pp. 187-190, that the employee's duty of care, if any, was in tort only. It was in the course of affirming a contractual duty of care that Viscount Simonds said at p. 573: "It is trite law that a single act of negligence may give rise to a claim either in tort or for breach of a term express or implied in a contract. Of this the negligence of a servant in performance of his duty is a clear example"; and Lord Radcliffe said at p. 587 (the place cited by Lord Denning in Esso Petroleum): "It is a familiar position in our law that the same wrongful act may be made the subject of an action either in contract or in tort at the election of the claimant, and, although the course chosen may produce incidental consequences which would not have followed had the other course been adopted, it is a mistake to regard the two kinds of liability as themselves necessarily exclusive of each other." It is of interest to note that another passage in the speech of Lord Radcliffe on the same page, because of its emphasis on the contractual nature of the relationship between master and servant, was quoted by Lord Scarman in Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank Ltd., [1985] 2 All E.R. 947, at p. 957, to which I shall make further reference, in support of his opinion against concurrent liability in the banker and customer relationship. There can be no [page180] doubt, however, that the recognition of concurrent liability in the master and servant relationship is well established. It was reaffirmed in Matthews v. Kuwait Bechtel Corp., the other case cited by Lord Denning in Esso Petroleum, where again the action was for breach of contract, this time by an employee against his employer for injury suffered in the course of his employment, and the issue was whether the cause of action was in contract, within the applicable rule of service out of the jurisdiction, or entirely in tort, in which case the rule would not apply. The Court of Appeal held that while the master owes a tortious duty of care to his servant, such a duty is also an implied term of the contract of employment (citing Lister), and in case of injury the servant may at his option sue for breach of contract or in tort.

30 The authority of Esso Petroleum on the question of concurrent liability was affirmed by the Court of Appeal in Batty v. Metropolitan Property Realisations Ltd., [1978] Q.B. 554, where, in a case involving the liability of a development company for breach of warranty and negligence, it was held that the plaintiffs were entitled to have judgment entered in their favour for the tort of negligence as well as for breach of contract. Megaw L.J. held that the principle of concurrent liability recognized in Esso Petroleum was a general one, not confined to the common callings and skilled professions. In Photo Production Ltd. v. Securicor Transport Ltd., [1978] 1 W.L.R. 856, which involved the application of an exclusion of liability in a contract for the provision of a night patrol service for the plaintiff's factory, Lord Denning [page181] referred to the principle of concurrent liability in general terms as follows at p. 862: "But, during the last few years, it has

become plain that, if the facts disclose the self-same duty of care arising both in contract and in tort -- and a breach of that duty -- then the plaintiff can sue either in contract or in tort, as he pleases: see Esso Petroleum Co. Ltd. v. Mardon [1976] Q.B. 801, 818-820 and Batty v. Metropolitan Properties Realisation Ltd. [1978] 2 W.L.R. 500."

31 Esso Petroleum and Hedley Byrne were applied in Midland Bank Trust Co. Ltd. v. Hett, Stubbs & Kemp, in which it was held that solicitors were liable to a client in tort as well as in contract for failure to register an option to purchase. It is not possible in these reasons to do justice to the judgment of Oliver J., which remains one of the most thorough and penetrating analyses of the authorities and the issues on the question of concurrent liability to be found in the cases. His essential concern in his canvass of the authorities was to determine whether he was free to find that the solicitors were liable in tort on the basis of Hedley Byrne, despite the existence of a contractual relationship. He concluded, in the light of the interpretation and application that had been given to Hedley Byrne in Esso Petroleum and of his own analysis of the speeches in Hedley Byrne, particularly that of Lord Devlin (to which I have referred in the discussion of Nocton v. Lord Ashburton) that the principle in Hedley Byrne applied to a relationship of the kind described there, whether or not the relationship was created by contract. He said at p. 413: "The inquiry upon which the court is to embark is "what is the relationship between plaintiff and defendant?' not "how did the relationship, if any, arise?'" On this view of Hedley Byrne he concluded that it was in conflict with the premise on which Groom v. Crocker and the cases which followed it had been decided and that he was free to follow Esso Petroleum on the question of concurrent liability. Oliver J. was of the opinion [page182] that Esso Petroleum presented a clear issue of concurrent liability despite the fact that the negligent misrepresentation had been made in pre-contract negotiations. On this point he said at p. 428, "The noticeable feature of this, in the present context, is that the contractual duty found by the Court of Appeal not only covered the same ground as, but was, in practical terms, identical and co-terminous with, the duty arising from a special relationship of the Hedley Byrne type", and at p. 432 he said, "As I read the case it is authority for the proposition that the existence of a contractual duty of care -- in that case created by the warranty which the court found -- does not preclude a parallel claim in tort under the Hedley Byrne principle."

32 The judgment of Oliver J. in Midland Bank Trust was referred to with approval by Sir Robert Megarry V.-C. in Ross v. Caunters, [1980] Ch. 297. That was an action for damages by the beneficiary of a will against solicitors of the testator for negligence in failing to warn the testator to whom they sent the will for execution that it should not be witnessed by the spouse of a beneficiary. It was argued on behalf of the solicitors that since a retained solicitor could not be liable to a client in tort, according to Groom v. Crocker and the cases which had followed it, he should not be exposed to liability in tort to a third person for negligence in the performance of the services for which he had been retained. In rejecting the premise on which this contention was based, Sir Robert Megarry V.-C. referred to Groom v. Crocker and the cases which followed it on the nature of the solicitor's liability to a client as having been "rejected" in Esso Petroleum and spoke of the judgment of Oliver J. in Midland Bank Trust as follows at p. 308: "I would, indeed, express my most respectful concurrence in an [page183] exhaustive and convincing discussion of a complex

subject." In Forster v. Outred & Co., [1982] 2 All E.R. 753, where it was conceded for purposes of the argument in the Court of Appeal that a retained solicitor could be sued by a client in tort as well as in contract for negligent advice, Dunn L.J. said at p. 764 that he found the reasoning of Oliver J. in Midland Bank Trust "wholly convincing".

33 I turn now to a consideration of the impact of Esso Petroleum and Midland Bank Trust on the Canadian jurisprudence with respect to the question of concurrent liability. Before Esso Petroleum the views of provincial courts of appeal on the question of concurrent liability are reflected in Schwebel v. Telekes, [1967] 1 O.R. 541, and Sealand of the Pacific v. Robert c. McHaffie Ltd. (1974), 51 D.L.R. (3d) 702. In Schwebel, where the issue was whether an action against a notary public for negligence was statute-barred, Laskin J.A. (as he then was), delivering the judgment of the Ontario Court of Appeal, said at p. 543, "The only circumstance that could bring any duty of the defendant to the plaintiff herein into operation was her contracting for the defendant's assistance." He added, citing Groom v. Crocker and Clark v. Kirby-Smith, that "the duty of care arose by virtue of the contractual relationship and had no existence apart from that relationship." He referred to Brown v. Boorman as reflecting "a line of older authority" on the question of concurrent liability. He concluded, however, referring to Howell v. Young and other cases to similar effect, that it would not have made a difference in the result if the notary public could have been sued in tort as well as in contract because the limitation period began to run when the breach of duty (or damage) occurred and not when it was or ought to have been discovered. In Sealand, the British Columbia Court of Appeal relied on Nunes Diamonds for the view that naval architects could not [page184] be liable in tort, on the basis of Hedley Byrne, for negligent misstatement in the performance of a contract. Seaton J.A. expressed the rationale for the denial of concurrent liability in such a case as follows at p. 705: "If additional duties and liabilities are to be attached, it will have the effect of changing the bargain made by the parties. That would be inappropriate."

34 Esso Petroleum was followed by a majority of the Ontario Court of Appeal in Dominion Chain Co. v. Eastern Construction Co., and Dabous v. Zuliani (1976), 12 O.R. (2d) 230, where it was held that engineers and architects could be liable in tort for negligence in the performance of a contract. The court also held that a contractor or builder was subject to concurrent liability in such a case. Jessup J.A., with whom Zuber J.A. concurred, dealt in Dominion Chain with the question of concurrent liability in both appeals. With respect to the liability of the engineers in Dominion Chain and the liability of the architect in Dabous, Jessup J.A. said that as a result of Esso Petroleum he was free to follow the "line of older authority" on concurrent liability referred to by Laskin J.A. in Schwebel and reflected, in so far as persons professing skill in a calling are concerned, in the statement of principle in Winfield on Tort (7th ed. 1963), p. 6, which I have quoted above in the discussion of the status relationships, and in which it was said that "every one who professes skill in a calling is bound by the law, agreement or no agreement, to show a reasonable amount of such skill." Jessup J.A. indicated the extent to which he proposed to adopt the principle of concurrent liability supported by the line of older authority, in so far as the liability of the engineers and the architect was concerned. Referring to Esso Petroleum as having approved Brown v. Boorman, [page185] as it applied to "professional men", and quoting from Winfield, he said at pp. 392-93:

> I confine myself to the nature of the liabilities of those who do profess skills in a calling which a reasonable man would rely on and leave the case of unskilled employments to another day. However, I can find no justification in principle, authority or policy for the modern English trend, noted by some of the law authors, to close the categories of callings to whom the principle stated by Winfield applies: e.g., Millner, Negligence in Modern Law (1967), at p. 131 et seq. The anachronistic exemption of solicitors from concurrent tort liability has been ended in England by Esso Petroleum Co. Ltd. v. Mardon, where the modern authorities referred to in Schwebel are overruled.

Jessup J.A. based the concurrent liability of the contractor in Dominion Chain and the builder in Dabous on the principle of tortious liability affirmed in Donoghue v. Stevenson, [1932] A.C. 562, from which at one point in his reasons he quoted the following dictum on concurrent liability of Lord Macmillan at p. 610:

> The fact that there is a contractual relationship between the parties which may give rise to an action for breach of contract, does not exclude the co-existence of a right of action founded on negligence as between the same parties, independently of the contract, though arising out of the relationship in fact brought about by the contract. Of this the best illustration is the right of the injured railway passenger to sue the railway company either for breach of the contract of safe carriage or for negligence in carrying him.

The observations of Jessup J.A. with reference to Nunes Diamonds and other cases which have applied Elder Dempster to the question of concurrent liability were of particular significance for subsequent consideration of the principle for which those cases stand. He referred to the citation by Estey J.A. in Hartman v. The Queen in right of [page186] Ontario (1973), 2 O.R. (2d) 244, at p. 257 of Hall v. Brooklands Auto Racing Club, [1933] 1 K.B. 205, at p. 213, where Scrutton L.J. said: "Further, in my view, where the defendant has protection under a contract, it is not permissible to disregard the contract and allege a wider liability in tort: Elder, Dempster & Co. v. Paterson, Zochonis & Co." Jessup J.A. said at p. 399 in Dominion Chain that Elder Dempster, Brooklands Auto Racing and Nunes Diamonds were cases that stood for the proposition that a plaintiff cannot escape a contractual exclusion or limitation of liability, whether express or implied, by reliance on a concurrent liability in tort. Wilson J.A., dissenting in Dominion Chain and Dabous on the question of concurrent liability, was of the view that because of the different legal consequences attaching to the distinction between contract and tort the recognition of concurrent liability should not extend beyond the categories for which there was clear historical warrant. She referred to Jarvis, Bagot, Schwebel, and Nunes Diamonds, among other cases, but she appears to have placed particular reliance on the reasoning in Bagot, as indicated by the following passages in her reasons at pp. 408 and 414 respectively:

> In other words, it would appear that if the acts or omissions complained of by the

> plaintiff are in relation to the very matters covered by the contract, the essence of the plaintiff's action is breach of the contractual duty of care rather than breach of the general duty of care owed to one's "neighbour" in tort;
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> . . .
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> In this case where negligent supervision is the substance of the allegation and supervision is the essence of the contract the action, in my view, is properly framed in contract.

Wilson J.A. appears to have regarded Esso Petroleum as distinguishable on the ground that it [page187] involved a representation in pre-contract negotiations.

35 The appeal of the engineers in Dominion Chain to this Court against the rejection of their claim for contribution from the contractor was dismissed in Giffels Associates Ltd. v. Eastern Construction Co., [1978] 2 S.C.R. 1346, on the ground that it was an essential condition of the right to contribution under s. 2 of The Negligence Act of Ontario that the person from whom contribution is sought should be liable to the plaintiff and in this case the contractor had been found not to be liable to the plaintiff by reason of provisions in the construction contract excluding or limiting liability. For this reason the Court found it unnecessary to determine whether the contractor and the engineers could be liable in tort as well as in contract to the owner. It expressed the view, assuming that the contractor could have been liable in tort, that the provisions in the construction contract excluding or limiting liability would have applied to the liability in tort as well as to the liability for breach of contract. As Laskin C.J. put it at p. 1355: "In the present case, it was the same negligence, whether regarded as a breach of contract or as a basis for an independent tort claim, which lay at the base of any claim by the plaintiff against Eastern for damages."

36 In 1978, after judgment was pronounced in Smith v. McInnis, on March 7th, there were three other reported decisions in Canada on the liability of the solicitor to a client which I shall refer to briefly in in their chronological order. In Power v. Halley (1978), 88 D.L.R. (3d) 381, a solicitor was sued by a client for breach of the duty to ensure that the client got a good title to certain land, and the issue turning on the question of concurrent liability was the application of the statute of limitations. Mifflin C.J.T.D. in the Supreme Court of Newfoundland, Trial Division, applied Esso Petroleum and Dominion Chain in concluding as [page188] follows at p. 388: "In my view in the present case the claim of the plaintiff can be said to be equally founded on contract and on tort, and he can rely on whichever foundation gives him the more favourable position under the statute." In Royal Bank of Canada v. Clark and Watters (1978), 22 N.B.R. (2d) 693, 39 A.P.R. 693, solicitors were sued by their client, the bank, for the damage caused by the release of mortgage funds to the borrower before the mortgage was executed and registered. The action of the solicitors was contrary to the instructions in the bank's "Requisition to Lawyer" form. Although the plaintiff does not appear to have asserted a concurrent or alternative liability in tort, the New Brunswick Supreme Court, Appeal Division, in grounding liability on the solicitor's failure to comply with the client's

instructions respecting release of the mortgage funds, said that the liability of a solicitor to a client was contractual. Hughes C.J.N.B., delivering the judgment of the Appeal Division, said at p. 700: "A solicitor's liability to his client for professional negligence is based on breach of the terms of his engagement, the liability being contractual in nature: See Schwebel v. Telekes, [1967] 1 O.R. 541, per Laskin J.A., at p. 543; Rowswell v. Pettit et al. (1968), 68 D.L.R. (2d) 202. It was the failure by the defendants to follow the instructions which they had been given respecting disbursement from the trust fund which constituted their breach of the contract and entitled the Bank to damages." In Messineo v. Beale (1978), 20 O.R. (2d) 49, a majority of the Ontario Court of Appeal (Arnup and Martin JJ.A.) held that the liability of a solicitor to his client for a negligent failure to discover that a vendor did not have title to a significant part of the land to be purchased by his clients was in contract only. Arnup J.A. said at p. 52: "I agree also that the basis of liability of the defendant solicitor lies in breach of contract. In this respect the cases appear to be uniform." Zuber J.A., concurring in the result, which turned on the measure of damages, since it would not have been different had the solicitor been held to be liable in tort as well as contract, differed from the majority on the question of concurrent liability. He said, citing Esso Petroleum and Dominion Chain, at p. 54: "A solicitor, being one of those [page189] who profess skills in a calling, is liable for failure to exercise those skills both in tort and contract." To these cases may be added Jacobson Ford-Mercury Sales Ltd. v. Sivertz (1979), 103 D.L.R. (3d) 480, in which a solicitor was sued by a client for negligently drafting an option to purchase which proved to be unenforceable. The issue turning on the question of concurrent liability was whether the action was statute-barred. Kirke Smith J. in the British Columbia Supreme Court held, applying Esso Petroleum, Dominion Chain, Midland Bank Trust, and Power, that the solicitor was liable in tort as well as contract and that the action was not statute-barred because the limitation period began to run from the time the damage was discovered or ought reasonably to have been discovered, which was when the client sought to exercise the option and was met by the objection that it was not enforceable. Kirke Smith J. said at p. 484:

> In the result, I conclude that, in the case of a professional man such as the defendant, a plaintiff client can claim either in contract or in tort, basing that claim "on whichever foundation gives him the more favourable position under the statute" to adopt the language of Mifflin, C.J.T.D. (at p. 388), in the Power case.

I am informed that an appeal in Jacobson was abandoned on March 27, 1980.

37 In District of Surrey v. Carroll-Hatch & Associates Ltd. (1979), 101 D.L.R. (3d) 218, the [page190] British Columbia Court of Appeal held that an architect was liable in tort as well as contract to the owner of a building for failure to inform the owner, as he had been advised by an engineer retained by him, that a proper soils test was required to determine the load-bearing capacity of the soil. The engineer, who did not have a contract with the owner, was held to be liable in tort to the owner for negligent misstatement in failing, when giving a letter in the nature of a soils report and a certificate of compliance with the national building code, to inform the owner that a proper soils test had not been carried out and that there was a risk in proceeding with the

construction of the building in the absence of such a test. The issue turning on the question of the concurrent liability of the architect was whether there could be apportionment of liability between the architect and the engineer under the Contributory Negligence Act. Hinkson J.A., delivering the unanimous judgment of the Court of Appeal, applied the principle of liability laid down by Lord Shaw in Nocton v. Lord Ashburton in holding that the architect was liable in tort to the owner for failure to warn the owner of the risk of proceeding with the construction upon the basis of an inadequate soils investigation. He held that Nunes Diamonds did not prevent a finding of concurrent liability in tort and contract in this case because there was no contractual limitation of liability in issue and the general question of concurrent liability in tort, where there is a contractual relationship, had been left open by the majority opinion of this Court in Smith v. McInnis. He said at pp. 236-37:

> The decision in J. Nunes Diamonds Ltd. v. Dominion Electric Protection Co., supra, does not prevent the Court from finding Church liable for negligence as well as for breach of contract, in the present circumstances. In the Nunes case, the parties had by their contract agreed on the extent of the liability of the defendant in the event a breach of contract occurred. In those circumstances, it was held that it was not appropriate to rewrite the terms of the agreement between the parties [page191] to impose a greater liability than that agreed upon between the parties. However, it is clear that a party to a contract may, because of the relationship established thereby between the parties, assume common law duties in addition to the obligations imposed by the contract. When such a duty is not performed, it is not then open to the negligent party to attempt to avoid the consequences of his negligence by invoking the contract, if its terms do not limit the liability.
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> . . .
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> While one view of the Nunes case might be that where the parties have a contractual relationship any claim lies only in contract, in the recent case of Smith et al. v. McInnis et al. (1978), 91 D.L.R. (3d) 190, [1978] 2 S.C.R. 1357, 25 N.S.R. (2d) 272 sub nom. Webb Real Estate Ltd. et al. v. McInnnis et al., the Supreme Court of Canada in dealing with a claim against a solicitor left open the question whether a solicitor's liability to his client lies in tort or only in contract.

38 Canadian Western Natural Gas Co. v. Pathfinder Surveys Ltd. (1980), 12 Alta. L.R. (2d) 135, was a case in which concurrent liability was applied in favour of the defendant. The plaintiff gas company brought an action for breach of contract against the defendant surveyors for damage caused by an error in surveying and staking out a natural gas pipeline. The issue turning on the question of concurrent liability was whether the defendants could raise the defence of contributory negligence under The Contributory Negligence Act. A majority of the Alberta Court of Appeal (Prowse and Harradence JJ.A.) held that the defendant was liable to the plaintiff in tort as well as in

contract, and that the plaintiff could not, by framing its action in contract alone, deprive the defendant of the defence of contributory negligence. Haddad J.A., dissenting, held that there had not been contributory negligence on the part of the plaintiff. On the question of concurrent liability Prowse J.A., who delivered the judgment of the majority, framed the issue as follows at p. 151: "The question being considered is whether facts which establish a breach of contract and arise from carelessness in the performance of a contract may be held to constitute a breach of the [page192] common law duty of care set out in Donoghue v. Stevenson and give rise to an action in tort between the parties to the contract." After consideration of the scope of the principle of tortious liability affirmed in that case and in Anns v. Merton London Borough Council, [1978] A.C. 728, and an extensive review of the cases on concurrent liability, including Nunes Diamonds, Esso Petroleum, Midland Bank Trust, and Dominion Chain, Prowse J.A. concluded that a common law duty of care arose from the relationship of proximity or neighbourhood between the parties independently of the contract. He said at p. 152:

> The duty that arises at common law is not connected, in law, with the contract. The contract is only of historical interest and the presence or absence of a contract is not the test for determining whether the duty arises. That is determined by resolving whether the necessary relationship of proximity or neighbourhood is present, for one does not cease being a neighbour merely because he happens to be a party to a contract, unless the contract negates the duty.

Prowse J.A. held that the court should treat the plaintiff's action as being in substance one in tort permitting the defendant to raise the defence of contributory negligence under The Contributory Negligence Act, because that characterization would lead to a just result.

39 In John Maryon International Ltd. v. New Brunswick Telephone Co., the respondent telephone company sued the appellant engineers for breach of contract and negligence in the design of a tower. The trial judge found the engineers liable for breach of contract but held that they could not be concurrently liable in tort. On the appeal to the New Brunswick Court of Appeal the issue which turned on the question of concurrent liability was the time at which the cause of action arose for purposes of determining the applicable statutory provision respecting jurisdiction to award interest. [page193] The Court of Appeal held that there was a cause of action in tort as well as in contract, and that there was as a result jurisdiction to award interest. In the course of his very thorough discussion of the authorities and the issues on concurrent liability, La Forest J.A. (as he then was), who delivered the unanimous judgment of the Court of Appeal, made two points that appear in the earlier decisions to which I have referred. The first, that was emphasized in Esso Petroleum and Midland Bank Trust, is that it would be anomalous if a person who has assumed responsibility gratuitously is subject to the legal consequences of tortious liability for a particular act or omission but a person who has assumed such responsibility under contract is not. The second point, which was made in Dominion Chain and District of Surrey, is that Nunes Diamonds stands for the proposition that "the law of negligence will not be used to give a remedy to a person for a

breach of contract for which he is absolved under the contract." La Forest J.A. concluded that he would rest the concurrent or alternative liability in tort of the engineers on the general principle of tortious liability applicable to their relationship to the owners rather than on an extension of the common callings and skilled professions category of concurrent liability to include the profession of engineer. He concluded on the issue of concurrent liability at pp. 232-33 as follows:

> From the foregoing, I would conclude that N.B. Tel could properly bring an action concurrently in tort and in contract, though as Winfield notes it cannot, of course, recover twice in respect of the same damage. The attempt in the 19th century to create a barrier between tort and contract was contrary to the spirit of the common law which allowed various forms of action to be used in respect of the same facts. This was one of its instruments of growth. So too was the tendency to add to categories that fell within a form of action, a [page194] tendency sought for a time to be reversed in this context. But in England, at least, this tendency could not be resisted indefinitely. Nor could the broad sweep of the rationalizing principle of Donoghue v. Stevenson. The particular duties recognized in earlier law are now simply applications of the duty of care to one's "neighbour".
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> For these reasons, while I could dispose of this case by simply adding the profession of structural engineer to the list of common callings and skilled professions, I prefer to base my judgment on the generalized tort of negligence: in this context see the Dominion Chain and Canadian Western cases. I am fortified in the conclusion I have reached by the fact that it also appears to accord with the law in the United States as well as in England (see Brian Morgan, "The Negligent Contract-Breaker", 58 Can. Bar Rev. 299 (1980), and the view is overwhelmingly supported by the legal academic community. For example, Fleming's The Law of Torts, 5th ed. (1977), pp. 176-7, had this to say about the pre-Esso Petroleum and Batty situations:
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>> Curiously, the cases reflect a widespread assumption that only one duty, tortious or contractual, can arise out of a particular set of facts: thus the search for the "substance", "gist" or "gravamen" of the action, regardless of the form of pleading. This is certainly out of spirit with the tradition of the old forms of action and the modern procedural policy of permitting a plaintiff to cumulate causes of action or at least elect the one most favourable to him.

40 The judgment of La Forest J.A. on the issue of concurrent liability in John Maryon was quoted with approval and applied by the Nova Scotia Supreme Court, Appeal Division, in

Attorney-General of Nova Scotia v. Aza Avramovitch Associates Ltd. (1984), 11 D.L.R. (4th) 588, and by the Ontario Court of Appeal in Consumers Glass Co. v. Foundation Co. of Canada/Compagnie Foundation du Canada (1985), 20 D.L.R. (4th) 126. In Avramovitch, where the issue was the right to contribution under the Tortfeasors Act, an architect was held to be liable in tort as well as contract to the owner of a building for negligent location of a sewage system. In [page195] Consumers Glass, where the issue was whether the action was statute-barred, a contractor and engineers were held to be liable to the owner of a wareshed in tort as well as in contract for the damage caused by the collapse of a roof. The Court of Appeal also held, however, that the same test respecting the limitation of actions applied, whether the liability was in contract or in tort: the cause of action did not arise until such time as the plaintiff discovered or ought reasonably to have discovered the facts with respect to which the remedy was being sought.

41 Before turning to a consideration of decisions in other common law jurisdictions on the question of concurrent liability it is convenient to refer to the recent expressions of judicial opinion in England having a bearing on this question in Leigh and Sillivan Ltd. v. Aliakmon Shipping Co., [1985] 2 W.L.R. 289 (C.A.), and Tai Hing Cotton Mill Ltd. v. Liu Chong Hing Bank. Leigh and Sillivan involved the effect on a third party's right of action in tort of provisions limiting liability in the contract out of which the alleged relationship of proximity arose. The buyer of goods under a c. and f. contract sued the owners of a vessel that was under a time charter for the loss caused by damage to the goods as a result of bad stowage. The Court of Appeal held that the buyers did not have a right of action in contract against the shipowners because ownership had not passed to the buyers as required by s. 1 of the Bills of Lading Act, 1855 and that there was no implied contract with the shipowners arising from the buyers having taken delivery of the goods upon presentation of the bill of lading because the buyers did so as the agents of the sellers under their agreement with the latter. A majority of the Court (Sir John Donaldson M.R. and Oliver J.) held, applying Margarine Union G.m.b.H. v. Cambay Prince Steamship Co. (The "Wear Breeze"), [1969] 1 Q.B. 219, that the buyers did not have a right of action in tort against the shipowners because they did not have the ownership or a right to immediate possession of [page196] the goods at the time the damage occurred. The majority gave as a further consideration for adhering to the decision in The "Wear Breeze" that to admit a liability in tort in such a case would be to impose on the shipowners a greater liability than they had under the Hague Rules in the contract of carriage, which was the bargain on which they had agreed to carry the goods. The majority were of the view that a tortious duty of care in such a case could not be made subject, as a matter of legal principle, to the contractual provisions limiting liability. Sir John Donaldson put it thus at p. 301:

> I have, of course, considered whether any duty of care owed in tort to the buyer could in some way be equated to the contractual duty of care owed to the shipper, but I do not see how this could be done. The commonest form of contract of carriage by sea is one on the terms of the Hague Rules. But this is an intricate blend of responsibilities and liabilities (Article III), rights and immunities (Article IV), limitations in the amount of damages recoverable (Article IV, r. 5), time bars (Article III, r. 6) evidential provisions (Article III, rr.

> 4 and 6), indemnities (Article III, r. 5 and Article IV, r. 6) and liberties (Article IV, rr. 4 and 6). I am quite unable to see how these can be synthesised into a standard of care.

Robert Goff L.J. was of the view that contrary to The "Wear Breeze", which he held should be overruled, a c. and f. buyer should have a direct action in tort against a shipowner for damage caused to goods in transit, but that the liability of the shipowner should and would be subject to any exclusions or limitations in the bill of lading. He said that if that were not possible he would not be prepared to recognize a direct action in tort by the [page197] buyer. In this particular case he was of the opinion that the shipowners were not liable in tort for damage caused by the bad stowage because the stowage was the responsibility of the time charterers.

42 In Tai Hing the issue of concurrent liability was whether a customer owed a duty of care in tort to his bank to adopt certain procedures with respect to the operation of his current account to prevent and detect forgeries of his cheques. The precise issue was whether, if the customer's duty by reason of the implied terms of the contract with his bank was limited to drawing his cheques in such a manner as not to facilitate fraud or forgery and to advising his bank of any unauthorized cheque drawn on his account as soon as he became aware of it, he had a wider duty in tort, arising from the relationship of proximity to the bank, to take reasonable precautions in the management of his business to prevent forgery and to verify his monthly bank statements to enable him to notify the bank of any unauthorized item. The Hong Kong Court of Appeal, [1984] 1 Lloyd's L.R. 555, held that this wider duty existed both as an implied term of the contract and as a common law duty of care on the basis of the principle affirmed in Anns v. Merton London Borough Council. Reference was also made by Hunter J. to Esso Petroleum and Midland Bank Trust. The Judicial Committee of the Privy Council held that the customer's duty, whether in contract or in tort, was the narrower one indicated above. Lord Scarman, who delivered the judgment of the Judicial Committee, spoke against concurrent liability as a matter of general principle, but held, without deciding whether the customer had a duty in tort as well as in contract, that in any event the duty in tort could not be any greater than that imposed by the implied terms of the contract. After stating that it was, in their Lordship's opinion, "correct in principle and necessary for the avoidance of confusion in the law to adhere to the contractual analysis: on principle because it is a relationship in which the parties have, subject to a few exceptions, [page198] the right to determine their obligations to each other, and for the avoidance of confusion because different consequences do follow according to whether liability arises from contract or tort, eg in the limitation of action" (citing in support of this proposition something said by Lord Radcliffe in Lister v. Romford Ice and Cold Storage Co., at p. 587), Lord Scarman said at p. 957:

> Their Lordships do not, therefore, embark on an investigation whether in the relationship of banker and customer it is possible to identify tort as well as contract as a source of the obligations owed by the one to the other. Their Lordships do not, however, accept that the parties' mutual obligations in tort can be any greater than those to be found expressly or by necessary implication in

> their contract. If, therefore, as their Lordships have concluded, no duty wider than that recognised in Macmillan and Greenwood can be implied into the banking contract in the absence of express terms to that effect, the respondent banks cannot rely on the law of tort to provide them with greater protection than that for which they have contracted.

43 I turn now to a consideration of decisions in other common law jurisdictions on the question of concurrent liability. In Finlay v. Murtagh, the Supreme Court of Ireland (O'Higgins C.J., Henchy, Griffin, Kenny and Parke JJ.), on appeal from the High Court, held that a solicitor who had been retained by a client to act for him in a claim for damages for personal injury was liable to the client in tort as well as in contract for failure to institute an action within the limitation period. The Court applied the distinction, reflected in the test laid down by Greer L.J. in Jarvis, Moy, Davies, Smith, Vandervell & Co., at p. 405, which I quoted earlier, between a cause of action based on a special obligation or duty created by the express terms of a retainer (sometimes referred to [page199] as a "special contract") and a cause of action based on an implied term of the retainer to exercise reasonable care and skill and a co-extensive common law duty of care. The Court based the tortious liability of a solicitor on the principle affirmed in Hedley Byrne, as applying to a person who "undertakes to show professional care and skill towards a person who may be expected to rely on such care and skill and who does so rely", and it held that the Hedley Byrne principle, as indicated by the speeches in the House of Lords in that case, was not confined to non-contractual relationships. The Court held that since a solicitor may be liable in tort to persons with whom he has no contractual relationship (such as one for whom he acts gratuitously or a third party injured by his negligence) there is no reason in principle why he should not be liable in tort for the same negligence to a client with whom he has a contractual relationship. As Henchy J. put it at p. 257, subject to the qualification for the case of necessary reliance for the cause of action on a special contractual obligation or duty not falling within the scope of the common law duty of care, "For the same default there should be the same cause of action." The Court referred to Midland Bank Trust, Batty and Photo Production in concluding in favour of concurrent liability.

44 The position in New Zealand, which has been opposed to concurrent liability for professional negligence, was established in 1972 in McLaren Maycroft & Co. v. Fletcher Development Co., where the Court of Appeal held that the liability of engineers for alleged failure to exercise the requisite professional care and skill in the supervision of the carrying out of an earthwork contract was in contract only. The Court followed Bagot, [page200] quoting the statement from the judgment of Diplock L.J. which I have quoted earlier in these reasons. In Rowe v. Turner Hopkins & Partners, [1982] 1 N.Z.L.R. 178, where a solicitor was held not to have been negligent, Cooke and Roper JJ. in the Court of Appeal expressed the view that McLaren Maycroft required reconsideration in view of later English decisions bearing on the question of concurrent liability, such as Midland Bank Trust. As far as I have been able to ascertain that has not yet been done by the Court of Appeal. There is a very full analysis of McLaren Maycroft and its effect on the New Zealand jurisprudence in French, op. cit., in which the author concludes at pp. 314-15 in favour of concurrent liability.

45 The Australian position on concurrent liability is reflected in Aluminum Products (Qld.) Pty. Ltd. v. Hill, and Macpherson & Kelley v. Kevin J. Prunty & Associates. In Aluminum Products a majority of the Full Court of the Supreme Court of Queensland (Douglas and Campbell JJ.), Connolly J. dissenting, held on a stated case, following Midland Bank Trust and Ross v. Caunters, that the liability of a solicitor, if any, to a client for the release of mortgage moneys in return for a mortgage executed by a non-existent company would be in tort as well as contract. In his dissenting opinion Connolly J. expressed the view that Groom v. Crocker was correctly decided and that Hedley Byrne did not apply to a contractual relationship. In Macpherson & Kelley, a majority of the Full Court of the Supreme Court of Victoria (Lush and Beach JJ.), Murphy J. dissenting, followed Midland Bank Trust and Aluminum Products in holding that a retained solicitor was liable to a client in tort as well as in contract for failure to institute an action within the limitation period. In his dissenting opinion, in which he referred to McLaren Maycroft, Murphy J. said at p. 587: "I believe that it is unarguable that where there is a contract then it is, together with its incidents both express and implied, the sole measure of the duties of the parties to one another. Irrespective of how the action is pleaded, the plaintiff cannot recover more [page201] than the defendant was obliged to perform under the contractual duties imposed upon him."

46 Liability in tort for breach of a duty of care arising out of a relationship created by contract, including that between attorney and client, is well established in the United States. See Prosser, Handbook of the Law of Torts (4th ed. 1971), p. 617, where it is said: "The principle which seems to have emerged from the decisions in the United States is that there will be liability in tort for misperformance of a contract whenever there would be liability for gratuitous performance without the contract". A leading case, which has frequently been cited, is Flint & Walling Mfg. Co. v. Beckett, 79 N.E. 503 (Ind. 1906), in which the principle or rationale underlying such liability is stated as follows at p. 505:

> It is, of course, true that it is not every breach of contract which can be counted on as a tort, and it may also be granted that if the making of a contract does not bring the parties into such a relation that a common-law obligation exists, no action can be maintained in tort for an omission properly to perform the undertaking. It by no means follows, however, that this common-law obligation may not have its inception in contract. If a defendant may be held liable for the neglect of a duty imposed on him, independently of any contract, by operation of law, a fortiori ought he to be liable where he has come under an obligation to use care as the result of an undertaking founded on a consideration. Where the duty has its roots in contract, the undertaking to observe due care may be implied from the relationship, and should it be the fact that a breach of the agreement also constitutes such a failure to exercise care as amounts to a tort, the plaintiff may elect, as the common-law authorities have it, to sue in case or in assumpsit.

The following statement of the principle in 38 Am. Jur., Negligence para. 20, is also cited in the cases:

[page202]

> Ordinarily, a breach of contract is not a tort, but a contract may create the state of things which furnishes the occasion of a tort. The relation which is essential to the existence of the duty to exercise care may arise through an express or implied contract. Accompanying every contract is a common-law duty to perform with care, skill, reasonable expedience and faithfulness the thing agreed to be done, and a negligent failure to observe any of these conditions is a tort, as well as a breach of the contract. In such a case, the contract is mere inducement creating the state of things which furnishes the occasion of the tort. In other words, the contract creates the relation out of which grows the duty to use care.

What is not clearly or consistently established is the approach of the courts to the choice of rule or result in a case in which the action may be characterized as being in both contract and tort and different legal consequences flow from the two kinds of liability. This question is very fully examined in Prosser, "The Borderland of Tort and Contract," in Selected Topics on the Law of Torts (1953), where the author sums up the state of the law in his conclusion on pp. 450-51 as follows:

> Taking New York as a typical jurisdiction, and an injury to a passenger at the hands of a carrier as a typical case, the action takes on the color of tort or contract with a facility which a chameleon might envy. It is contract for purposes of jurisdiction, the recovery of interest, survival of the action, the effect of a limiting term of the contract, and of the application of contract rules of the conflict of laws. It becomes tort for purposes of the statute of limitation, the measure of damages, recovery for wrongful death, and of the assignability of the cause of action. Change the state, or make the injury one to goods, and different results follow in many respects. Sometimes the plaintiff is permitted to elect his cause of action; sometimes he is told what it must be; sometimes he is told that it must be contract, sometimes that it must be tort.

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The situation is described in Prosser, Wade and Schwartz, Cases and Materials on Torts (6th ed. 1976), as follows at pp. 457-58:

> In these situations the courts have proceeded along two different lines. One

> is to permit the plaintiff to choose the theory of his action, and dispose of the particular question accordingly....
>
> On the other hand, some courts will not give the plaintiff this latitude. Rather, the court will determine the "gravamen" or "gist" of the action, which is to say the essential facts on which the plaintiff's claim rests
>
> As these cases suggest, there is little consistency in the decisions, even in a single state; although many courts have tended to look to the policy underlying the particular rule of law or statute to be applied in order to assist themselves in making the characterization.

47 It should also be noted, at least from the point of view of policy, that the principle of concurrent or alternative liability was applied by this Court to the Quebec civil law in Wabasso Ltd. v. National Drying Machinery Co., [1981] 1 S.C.R. 578, where the issue on a declinatory exception was whether the Superior Court for the District of Trois-Rivières had jurisdiction with respect to an action in damages based on fault in connection with the installation in Trois-Rivières of a machine for processing polyester fibres sold under a contract made in Philadelphia. The fault complained of, which allegedly caused the destruction of the plaintiff's factory by fire, was the failure of the manufacturer's technicians at the time of installation to warn the plaintiff's employees of the danger of fire if the upper part of the machine was not kept clean. The issue of concurrent or alternative liability was whether the plaintiff could base its action on delictual responsibility (which would give the Superior Court for the District of Trois-Rivieres jurisdiction), despite the existence of the contract. The Court held that the plaintiff could base its action on delictual responsibility under art. 1053 of the Quebec Civil Code, although the alleged fault occurred in the performance of the contract. After a review of the civil law authorities on the much debated question of the "joint application of the systems of contractual [page204] and delictual liability and of an election by the creditor of either system", Chouinard J., delivering the unanimous judgment of the Court, concluded at p. 590 as follows:

> I conclude that the same fact can constitute both contractual fault and delictual fault, and that the existence of contractual relations between the parties does not deprive the victim of the right to base his remedy on delictual fault.

Chouinard J. quoted with approval a passage from the judgment of Paré J.A. in the Quebec Court of Appeal, in which it was said: "It is therefore necessary that the fault committed within the framework of the contract be in itself a fault sanctioned by art. 1053 C.C. even in the absence of a contract."

48 I must now attempt to draw conclusions from what I fear has been a much too lengthy survey of judicial opinion on the question of concurrent liability. My conclusions as to what I conceive,

with great respect, to be the opinion with which I am in agreement on the various issues underlying this question may be summarized as follows.

49 1. The common law duty of care that is created by a relationship of sufficient proximity, in accordance with the general principle affirmed by Lord Wilberforce in Anns v. Merton London Borough Council, is not confined to relationships that arise apart from contract. Although the relationships in Donoghue v. Stevenson, Hedley Byrne and Anns were all of a non-contractual nature and there was necessarily reference in the judgments to a duty of care that exists apart from or independently of contract, I find nothing in the statements of general principle in those cases to suggest that the principle was intended to be confined to relationships that arise apart from contract. Indeed, the dictum of Lord Macmillan in Donoghue v. Stevenson concerning concurrent liability, which I have quoted earlier, would clearly suggest the contrary. I also find this conclusion to be persuasively demonstrated, with particular reference to Hedley Byrne, by the judgment of Oliver J. in Midland [page205] Bank Trust. As he suggests, the question is whether there is a relationship of sufficient proximity, not how it arose. The principle of tortious liability is for reasons of public policy a general one. See Arenson v. Casson Beckman Rutley & Co., [1977] A.C. 405, per Lord Simon of Glaisdale at p. 417. Junior Books Ltd. v. Veitchi Co., [1983] 1 A.C. 521, in which an owner sued flooring subcontractors directly in tort, is authority for the proposition that a common law duty of care may be created by a relationship of proximity that would not have arisen but for a contract.

50 2. What is undertaken by the contract will indicate the nature of the relationship that gives rise to the common law duty of care, but the nature and scope of the duty of care that is asserted as the foundation of the tortious liability must not depend on specific obligations or duties created by the express terms of the contract. It is in that sense that the common law duty of care must be independent of the contract. The distinction, in so far as the terms of the contract are concerned, is, broadly speaking, between what is to be done and how it is to be done. A claim cannot be said to be in tort if it depends for the nature and scope of the asserted duty of care on the manner in which an obligation or duty has been expressly and specifically defined by a contract. Where the common law duty of care is co-extensive with that which arises as an implied term of the contract it obviously does not depend on the terms of the contract, and there is nothing flowing from contractual intention which should preclude reliance on a concurrent or alternative liability in tort. The same is also true of reliance on a common law duty of care that falls short of a specific obligation or duty imposed by the express terms of a contract.

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51 3. A concurrent or alternative liability in tort will not be admitted if its effect would be to permit the plaintiff to circumvent or escape a contractual exclusion or limitation of liability for the act or omission that would constitute the tort. Subject to this qualification, where concurrent

liability in tort and contract exists the plaintiff has the right to assert the cause of action that appears to be most advantageous to him in respect of any particular legal consequence.

52 4. The above principles apply to the liability of a solicitor to a client for negligence in the performance of the professional services for which he has been retained. There is no sound reason of principle or policy why the solicitor should be in a different position in respect of concurrent liability from that of other professionals.

53 5. The basis of the solicitor's liability in tort for negligence and the client's right in such case to recover for purely financial loss is the principle affirmed in Hedley Byrne and treated in Anns as an application of a general principle of tortious liability for negligence based on the breach of a duty of care arising from a relationship of sufficient proximity. That principle is not confined to professional advice but applies to any act or omission in the performance of the services for which a solicitor has been retained. See Midland Bank Trust Co. v. Hett, Stubbs & Kemp, at p. 416; Tracy v. Atkins (1979), 105 D.L.R. (3d) 632, at p. 638.

54 Applying these conclusions to the facts of the case at bar, I am of the opinion that if the respondent solicitors were negligent in the performance of the professional services for which they were retained they would be liable in tort as well as contract to the appellant, subject, of course, to the other defences which they have raised.

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III

55 I turn now to the question whether the respondent solicitors were negligent in taking a mortgage that was void as being contrary to s. 96(5) of the Companies Act. As I have indicated, the Trial Division and the Appeal Division of the Nova Scotia Supreme Court came to different conclusions on this issue. Hallett J. in the Trial Division held that the respondents had not failed to meet the applicable standard of care. The Appeal Division held that they had been negligent. This difference in conclusion appears to have turned to some extent on a difference of view as to the relevance of some of the expert evidence concerning the practice of solicitors in real estate transactions involving corporations in Nova Scotia in 1968.

56 The work which the respondents undertook for the Nova Scotia Trust Company was to perform the necessary legal services to obtain a valid first mortgage on the property of Stonehouse. Although the trust company's letter of December 12, 1968 to the respondent Rafuse and the respondent Cordon's letter of January 17, 1969, to the trust company (from both of which I have quoted at the beginning of these reasons), did not make explicit reference to the validity of the mortgage, the respondent Cordon, in his evidence on discovery, acknowledged that the obligation to the Nova Scotia Trust Company was "to see that there was a valid first mortgage."

57 The act or omission which, it is contended, constituted the negligence in this case was the failure of the respondents to know of or discover s. 96(5) of the Companies Act, to perceive that it raised a question concerning the validity of the proposed mortgage and to advise the Nova Scotia Trust Company accordingly. The question is whether this was a failure to meet the applicable standard of care in discharging the professional responsibility which the respondents had assumed.

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58 A solicitor is required to bring reasonable care, skill and knowledge to the performance of the professional service which he has undertaken. See Hett v. Pun Pong (1890), 18 S.C.R. 290, at p. 292. The requisite standard of care has been variously referred to as that of the reasonably competent solicitor, the ordinary competent solicitor and the ordinary prudent solicitor. See Mahoney, "Lawyers -- Negligence -- Standard of Care" (1985), 63 Can. Bar Rev. 221. Hallett J., in referring to the standard of care as that of the "ordinary reasonably competent" solicitor, stressed the distinction between the standard of care required of the reasonably competent general practitioner and that which may be expected of the specialist. It was on the basis of this distinction that he disregarded the evidence of one of the expert witnesses concerning the practice in real estate transactions involving corporations.

59 The requirement of professional competence that was particularly involved in this case was reasonable knowledge of the applicable or relevant law. A solicitor is not required to know all the law applicable to the performance of a particular legal service, in the sense that he must carry it around with him as part of his "working knowledge", without the need of further research, but he must have a sufficient knowledge of the fundamental issues or principles of law applicable to the particular work he has undertaken to enable him to perceive the need to ascertain the law on relevant points. The duty in respect of knowledge is stated in 7 Am Jur 2d, Attorneys at Law para. 200, in a passage that was quoted by Jones J.A. in the Appeal Division, as follows: "An attorney is expected to possess knowledge of those plain and elementary principles of law which are commonly known by well-informed attorneys, and to discover those additional rules of law which, although not commonly known, may readily be found by standard research techniques." See Charlesworth and Percy on Negligence (7th ed. 1983), pp. 577-78 to similar effect, where it is said: "Although a solicitor is not bound to know the contents of every statute of the realm, there are some statutes, about which it is his duty to know. The test for deciding [page209] what he ought to know is to apply the standard of knowledge of a reasonably competent solicitor." The duty or requirement of professional competence in respect of knowledge is put by Jackson and Powell, Professional Negligence (1982), at pp. 145-46 as follows: "Although a solicitor is not "bound to know all the law,' he ought generally to know where and how to find out the law in so far as it affects matters within his field of practice. However, before the solicitor is held liable for failing to look a point up, circumstances must be shown which would have alerted the reasonably prudent solicitor to the point which ought to be researched", citing Bannerman Brydone Folster & Co. v. Murray, [1972]

N.Z.L.R. 411. In that case, where a solicitor undertook on very short notice to prepare the necessary document to give effect to an oral agreement providing that a mortgagee would have an option to purchase, the New Zealand Court of Appeal held that it was not negligence to have failed to perceive that making the option to purchase a condition of the mortgage rendered it void or unenforceable as a clog on the equity of redemption. The point was referred to as a rather old and obscure principle which had not been the subject of judicial commentary for many years and was mainly a subject of academic interest. It is clear, however, that the determining considerations in the Court's conclusion were the time available to the solicitor and the fact that the client was already committed to the transaction in the form that proved defective. See Turner J. at p. 427. The decision is nevertheless instructive concerning the duty of a solicitor to perceive problems and to warn the client of them. For a statement of the solicitor's duty "to identify problems and to bring their effect to the attention of the client", with reference to cases in which this duty has been applied, see Dugdale and Stanton, Professional Negligence (1982), p. 203.

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60 While the solicitor's duty of care has generally been stated, for obvious reasons, in the context of contractual liability as arising as an implied term of the contract or retainer, the same duty arises as a matter of common law from the relationship of proximity created by the retainer. In the absence of special terms in the contract determining the nature and scope of the duty of care in a particular case, the duties of care in contract and in tort are the same. See Esso Petroleum, supra, at p. 15; Mahoney, op. cit., p. 223; Dugdale & Stanton, op. cit., p. 218.

61 Two solicitors, Mr. S. David Bryson, Q.C., and Mr. Arthur G.H. Fordham, Q.C., gave evidence as to their practice and that of other solicitors in real estate transactions involving corporations. Both stated that it was the practice to determine the capacity of a corporation to give security and for this purpose to examine the provisions of the Companies Act. Mr. Bryson said that he could not be certain that he knew of the existence of s. 96(5) of the Act in 1968, that the transaction handled by the respondents was "a rather unusual one and not in the common run of real estate mortgage transactions", and that he did not recall having encountered a transaction of this kind in his practice. Mr. Fordham said that he was aware of s. 96(5) in 1968. Hallett J. disregarded the evidence of Mr. Fordham as being that of the specialist in commercial real estate transactions. He attached particular importance to the evidence of Mr. Bryson as being more relevant, despite his acknowledged experience and expertise, to the standard of care to be expected of the reasonably competent general practitioner in real estate matters. From the evidence of Mr. Bryson, the fact that persons of legal training in the Nova Scotia Trust Company had approved the loan and instructed the respondents, and the differences of judicial opinion concerning the validity of the mortgage, Hallett J. concluded that the ordinary reasonably competent solicitor in Nova Scotia in 1968 would not have known of s. 96(5) of the Companies Act, and if he did, would not have perceived the possible implications of this [page211] provision for the validity of the proposed mortgage.

62 The Appeal Division held that the trial judge erred in disregarding the evidence of Mr. Fordham, that the issue was not whether a reasonably competent solicitor would have known of the existence of s. 96(5) of the Companies Act without an examination of the Act, or would have formed the opinion that the mortgage was void, but rather whether he would have examined the Companies Act to determine if it placed any restrictions on the capacity of a corporation to give security and whether he would have perceived that s. 96(5) raised a problem concerning the validity of the proposed mortgage. In concluding that the respondent solicitors had been negligent, Jones J.A., delivering the unanimous judgment of the Appeal Division, said:

> The solicitor's obligation in the present case was to ensure that the mortgage was valid. As the security was being given by a company it was their duty to be acquainted with those provisions of the Companies Act which might affect the security. Where a solicitor does not have knowledge of the statutes pertaining to a transaction then he has an obligation to inform himself of those provisions. With respect, I find nothing unusual about the provisions of s. 96(5) of the Companies Act. Once a solicitor was aware of that provision, from the language of the section, he would realize that he was faced with a problem. Regardless of the interpretation placed on the provision, he would be under a duty to inform the client. It was the solicitor's duty to exercise reasonable skill and knowledge. That duty was not placed on the officials of the appellant company, who were only concerned with the business aspects of the transaction.

63 With respect, I am in agreement with the conclusion of the Appeal Division on the issue of negligence. The fact that the capacity of a corporation to borrow and give security may be limited or subjected to certain conditions by the provisions of the applicable Companies Act is such basic knowledge that a reasonably competent solicitor must be held to possess it, whether he is a general practitioner or a specialist. It is knowledge which a [page212] solicitor who undertakes to do the legal work to obtain a mortgage or other security from a corporation must possess, and with it there is a duty to exercise reasonable care and skill to ascertain by an examination of the relevant legislation what limits or conditions it imposes upon the capacity of a corporation to give security. A reasonably competent solicitor knowing, as the respondent solicitors did, that the mortgage was being given by Stonehouse to obtain a loan to assist in the purchase of its shares would have recognized that s. 96(5) of the Companies Act raised a serious question, to say the least, concerning the legality or validity of the proposed mortgage. With great respect I cannot agree with the trial judge that the reasonably competent solicitor would have concluded that s. 96(5) did not affect the validity of the mortgage, as was later held by Hart J. in the action for foreclosure, and would have said nothing about the matter to his client. In the existing state of the law in 1968 the reasonably competent solicitor in Nova Scotia in 1968 would have perceived that there was a serious possibility that the mortgage might be held to be void as being contrary to s. 96(5) and would have advised his client accordingly. In Thibault v. Central Trust Company of Canada, [1963] S.C.R. 312, some five years before the mortgage transaction in the case at bar, this Court held that a mortgage given by a company to secure the payment by the new owner of the purchase price of his shares in the

company was void as contrary to s. 37(1) of the New Brunswick Companies Act, R.S.N.B. 1952, c. 33, which provides, in words essentially the same as those of s. 96(5) of the Nova Scotia Companies Act, that a company "shall not ... give whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of, or in connection with, a purchase made or to be made by any person of any shares in the company." Martland J., delivering the judgment of the Court, held that the appeal from the judgment of the Appeal Division of the Supreme Court of New Brunswick should be dismissed for the reasons of Ritchie J.A., who said (1962), 33 D.L.R. (2d) 317, at p. 332: "The purpose and result of the mortgage was the creation of a charge on the real property of the [page213] company to secure payment of the price Clavette had agreed to pay Thibault for shares in its capital stock. There was no outstanding indebtedness of the company to Thibault. The company received no consideration for the mortgage, either express or implied." With reference to the effect of s. 37(1) he said at pp. 334-35: "I find in the explicit and unambiguous language of s. 37(1) a clear intention on the part of the legislature to restrict, except as to five specified types of transaction, the powers of any company so as to prevent it giving financial assistance to any person for the purpose of, or in connection with, a purchase of shares in its capital stock. The peremptory nature of the language used is directed to the corporate capacity and so renders the restriction mandatory. The mortgage comes squarely within the wording of the prohibition. In view of such statutory restriction on its corporate powers the mortgage must be held ultra vires the company. No authorization or ratification by the directors or the shareholders could serve to make the mortgage valid." Hart J. in Central and Eastern Trust Co. v. Stonehouse Motel and Restaurant Ltd., drew a distinction, in effect, between a mortgage given, as in Thibault, to secure the payment to the vendor of the purchase price of shares and a mortgage given to secure a loan to the company, the proceeds of which were to be given to the vendor in part payment for the shares. While the reasonably competent solicitor might well be of the view that this distinction, had it occurred to him, might prevail if there were a challenge to the validity of the mortgage, there would have to remain in his view a serious question as to whether the mortgage might be held to be void for the reasons given by Ritchie J. delivering the judgment of this Court in Central and Eastern Trust Co. v. Irving Oil Ltd. Saying that he was unable to accept the view taken of the mortgage transaction by Hart J., Ritchie J. held that it was an unavoidable conclusion from the facts as found by the trial judge and the Court of Appeal that the proceeds of the mortgage loan were never intended to go to the company but were to be paid to the vendor for the shares. A reasonably competent solicitor would in my opinion have seen that this was possibly, if not probably, the view that would ultimately be taken of the mortgage [page214] transaction and would have advised his client for this reason that he could not give any assurance as to the validity of the proposed mortgage. I am therefore of the opinion that the respondent solicitors were negligent in failing to ascertain the existence of s. 96(5) of the Nova Scotia Companies Act, to perceive that it raised a problem concerning the validity of the proposed mortgage and to advise the Nova Scotia Trust Company accordingly, and that their negligence was causative of the damage suffered by the trust company.

IV

64 The respondents contend that if they were negligent there was contributory negligence on the part of the Nova Scotia Trust Company or those for whom it was responsible and that accordingly there should be an apportionment of liability between the appellant and the respondents. This contention is based essentially on the fact that the mortgage loan to Stonehouse was recommended and approved by persons of legal training and experience, who knew that the proceeds of the loan were to be used to purchase the shares of the company. Mr. John Mroz, the mortgage manager of the Nova Scotia Trust Company, who recommended the loan to the Executive Committee of the Board of Directors of the trust company, and Mr. D.G. Grant, the President of the company and a member of the Executive Committee, were both graduates in law with some experience in practice before joining the company and members of the Bar of Nova Scotia. Mr. Lorne Clarke, Q.C., one of the members of the Truro Advisory Board which advised the trust company as to whether Stonehouse was a good risk, was an experienced practitioner. At least two members of [page215] the Executive Committee, besides Mr. Grant, who were present at the meeting which approved the loan, were lawyers. Mr. John A. Walker, Q.C., was a prominent and experienced member of the Nova Scotia Bar, although he was apparently retired from practice at the time the loan was approved. Although the testimony on this point was not too clear, the trial judge found that Mr. Mroz and Mr. Grant, and by implication the other members of the Executive Committee, must have known from the documentation that the proceeds of the mortgage loan were to be used to purchase the shares. The loan application contained the words "money required to assist in the purchase (chattel mortgage on equipment)", and the reference to the loan in the minutes of the meeting of the Executive Committee at which the loan was approved contained the words "Purchase price of the Company shares -- $315,000." Jones J.A. in the Court of Appeal said with reference to the company's knowledge of the nature of the transaction at p. 270:

> The second issue concerns the knowledge of the appellant. If the appellant knew that the transaction was invalid then presumably it would be responsible for the loss. It would not be relying on the solicitors for that information. The trial judge found that both parties knew that the proceeds of the loan were to be used to purchase the Stonehouse shares. There was ample evidence to support that conclusion. It was clear on the face of the documents and in the company's minutes that the money was to be used for that purpose. It also appears from the decision that the parties were not aware that the loan was illegal. Certainly there is no finding by the trial judge that the appellant knew that the transaction was illegal.

65 In my opinion the defence of contributory negligence must fail. The executive officers of the Nova Scotia Trust Company and the members of the Executive Committee of the Board of Directors did not have a duty of care with respect to the legal aspects of a transaction other than to retain qualified solicitors to perform the necessary legal services. As the testimony of Mr. Mroz and Mr. Grant indicated, they were administrative officers who, despite their legal qualifications, were not expected to provide the company with legal advice. [page216] They and the Executive Committee were concerned with the business or financial aspects of a loan -- whether the borrower

was a good risk -- and quite properly left the legal aspects of a transaction to the retained solicitors. They might well have been negligent had they relied on their own legal judgment in such a case. The fact that neither the executive officers nor the members of the Executive Committee were responsible for the legal aspects of a proposed mortgage loan was acknowledged by the trial judge, who said at p. 391: "Again, I am mindful that it was not the function of the executive committee to decide on legal matters. Their function was to assess the feasibility of making the loan." Although Jones J.A. found it unnecessary, because of his conclusion on the question of limitation, to decide the issue of contributory negligence, he said at p. 270, "It was the solicitor's duty to exercise reasonable skill and knowledge. That duty was not placed on the officials of the appellant company, who were only concerned with the business aspects of the transaction", and at p. 278 he said that the trust company "took the only course open to it to determine the validity of the mortgage, namely, consulting the solicitors." I respectfully agree with these observations.

V

66 The respondents further contended that the appellant's action was not maintainable because it was based on an illegal transaction. It was contended that because the mortgage was illegal the appellant's retainer of the respondents was also illegal and thus unenforceable as a basis of the appellant's action for breach of contract and negligence. In my opinion this contention is without merit. It was considered and rejected by the Appeal Division, and I am in respectful agreement with their reasons for doing so. The retainer itself was separate from the mortgage transaction and did not have an unlawful purpose to the knowledge [page217] of either of the parties. A solicitor cannot raise the defence of illegality if it is only because of his negligence that the exercise of the professional services for which he was retained results in the carrying out of an illegal transaction.

VI

67 The final issue is whether the appellant's action in tort is statute-barred. As I indicated earlier, the appellant conceded that if its recourse against the respondents was in contract only its action was barred. As will appear, the limitations issue ultimately turns on whether the discoverability rule is to apply to the appellant's cause of action in tort.

68 The applicable limitation period is six years after the cause of action arose, as prescribed by s. 2(1)(e) of The Statute of Limitations, R.S.N.S. 1967, c. 168, as follows:

> 2(1) The actions in this Section mentioned shall be commenced within and not after the times respectively in such Section mentioned, that is to say:
>
> . . .
>
> (e) all actions grounded upon any lending, or contract, expressed or implied, without specialty, or upon any award where the submission is not by specialty, or for money levied by execution; all actions for direct

> injuries to real or personal property; actions for the taking away or conversion of property, goods and chattels; actions for libel, malicious prosecution and arrest, seduction, criminal conversation; and actions for all other causes which would formerly have been brought in the form of action called trespass on the case, except as herein excepted, within six years after the cause of any such action arose;

69 The relevant dates are as follows: the mortgage was executed by Stonehouse and taken by the respondents as security for the loan on December 31, 1968; the certificate of title stating that the mortgage formed a first charge on the property was given by the respondents on January 17, 1969; [page218] the validity of the mortgage was challenged in the appellant's action for foreclosure instituted on April 21, 1977; the mortgage was held to be void by this Court on April 22, 1980; and the appellant's action for negligence was instituted on October 22, 1980.

70 Without deciding whether there was concurrent liability, the Appeal Division of the Nova Scotia Supreme Court held that the appellant's action was statute-barred, whether it was in contract or in tort. It held that the appellant's cause of action for negligence, however characterized, arose for purposes of The Statute of Limitations when the negligence occurred and not when it was discovered or ought to have been discovered by the appellant with the exercise of reasonable diligence. As to when the breach of duty and damage occurred, Jones J.A. said at p. 274: "In this case the negligence occurred when the solicitors gave the certificate of title. As found by the Supreme Court of Canada, the mortgage was void when it was delivered. The loss at that point was the face value of the defective mortgage." In support of his conclusion on the limitations issue Jones J.A. relied particularly on the opinion of Laskin J.A. in Schwebel v. Telekes, in which he held, following Howell v. Young, that whether the cause of action for negligence against the notary public was viewed as being in contract or in tort it arose for purposes of the statute of limitations when the breach of duty occurred and not when it was discovered or should have been discovered. Jones J.A. also referred to Cartledge v. E. Jopling & Sons Ltd., [1963] A.C. 758, in which the House of Lords acknowledged the harshness or injustice of the rule that a cause of action for negligence may arise for purposes of the statute of limitations before the injured party has discovered or could have discovered the negligence but held that the rule could be changed only by legislation. Jones J.A. was of the view that to apply the discoverability rule would be in effect to amend The Statute of Limitations.

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71 The appellant made alternative submissions on the limitations issue: (a) if the rule that should govern is the one applied in Cartledge, that a cause of action for negligence arises when damage occurs whether or not it has been discovered or ought to have been discovered, the appellant's action in tort is not statute-barred because the damage did not occur before the mortgage was declared to

be void by this Court on April 22, 1980; and (b) if the applicable rule, as the appellant contends, is that a cause of action for negligence does not arise for purposes of the statute of limitations before the damage is discovered or ought to have been discovered by the exercise of reasonable diligence, the basis of the appellant's cause of action in tort was discoverable at the earliest in April or May 1977 when the validity of the mortgage was challenged in the action for foreclosure.

72 If the discoverability rule were not to apply, I would agree that the cause of action in tort arose when damage occurred, according to the established rule affirmed in Cartledge and applied in Midland Bank Trust Co. v. Hett, Stubbs & Kemp, at p. 433 and Forster v. Outred & Co., to the concurrent liability in tort of solicitors to clients. As I indicated earlier, the reference in Howell v. Young (followed in Schwebel), in the context of a consideration of possible concurrent liability, to the time when the breach of duty, rather than the damage, occurred has been questioned by commentators. The better view, as I have suggested, is that the courts had in mind the usual case of solicitor's negligence where actual damage, if not ultimate financial loss, occurs at the same time as the breach of duty. There would appear to be no reason in principle why the established distinction in this regard between a cause of action in contract and a cause of action in tort should not apply to a case of concurrent liability. This does not, however, in my opinion, assist the appellant. Although the mortgage was not declared by final judgment to be void until April 22, 1980, it was void ab initio and actual damage occurred when the respondents took it on December 31, 1968 because as a result the Nova Scotia Trust Company [page220] acquired no interest in the Stonehouse property as security for its loan. Cf. Forster v. Outred.

73 It is necessary then to consider the appellant's alternative submission on the limitations issue. The question raised by this submission, as I see it, is whether there is any reason why the judgment of the majority in City of Kamloops v. Nielsen, [1984] S.C.R. 2, which applied the discoverability rule to the limitation period in s. 738(2) of the Municipal Act, R.S.B.C. 1960, c. 255, should not be followed with respect to the appellant's cause of action in tort under s. 2(1)(e) of the Nova Scotia Statute of Limitations, R.S.N.S. 1967, c. 168.

74 Kamloops involved a claim against a municipality for negligent failure to prevent the construction of a house with defective foundations. Section 738(2) of the Municipal Act provided that such an action must be brought within one year "after the cause of such action shall have arisen", and s. 739 provided that notice of the damage must be given to the municipality within two months "from and after the date on which such damage was sustained". Counsel for the municipality conceded that time began to run under both sections from the date the plaintiff actually discovered the damage or ought to have discovered it by the exercise of reasonable diligence. The issue was when he should have discovered it. The British Columbia Court of Appeal accepted this view of the law, citing Sparham-Souter v. Town and Country Developments (Essex) Ltd., [1976] Q.B. 858 (C.A.), in support of the discoverability rule.

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75 Limitation of actions was not an issue when the appeal in Kamloops was argued in this Court but after the decision of the House of Lords in Pirelli General Cable Works Ltd. v. Oscar Faber & Partners, [1983] 2 A.C. 1, the Court called for written submissions on the question. In Pirelli, the House of Lords held that the date of accrual of a cause of action in tort for damage caused by the negligent design or construction of a building was the date when the damage came into existence, and not the date when the damage was discovered or should have been discovered by the exercise of reasonabl8 diligence. Cartledge was applied and Sparham-Souter disapproved on this issue. As in Cartledge, the House of Lords acknowledged the injustice of the established rule but was of the opinion that it could only be changed by legislation. In Cartledge, the House of Lords attached particular importance to s. 26 of the Limitation Act, 1939, which provided that in certain cases of fraud and mistake "the period of limitation shall not begin to run until the plaintiff has discovered the fraud or the mistake, as the case may be, or could with reasonable diligence have discovered it", as indicating the limited application to be given to the discoverability rule. In Pirelli, which involved an action against engineers for negligence with respect to the design of a chimney, the House of Lords had the further expression of legislative intent reflected in the amendment made by the Limitation Act 1963 to remedy the injustice demonstrated by Cartledge in cases of personal injury. Lord Fraser of Tullybelton said at p. 14 that the amendment of 1963, confined as it was to personal injury cases, indicated that "Parliament deliberately left the law unchanged so far as actions for damages of other sorts was concerned." Both Lord Fraser and Lord Scarman, however, adverted to the more general reason for leaving such an important change in the law affecting the limitations of actions to the legislature: the inability of the courts to provide a satisfactory scheme for the accommodation of the competing interests, including the provision of an outside limit or "final longstop date", as Lord Fraser referred to it. Lord Fraser put the general [page222] objection to the judicial introduction of the discoverability rule as follows at p. 19:

> Postponement of the accrual of the cause of action until the date of discoverability may involve the investigation of facts many years after their occurrence -- see, for example, Dennis v. Charnwood Borough Council [1983] Q.B. 409 -- with possible unfairness to the defendants, unless a final longstop date is prescribed, as in sections 6 and 7 of the Prescription and Limitation (Scotland) Act 1973. If there is any question of altering this branch of the law, this is, in my opinion, a clear case where any alteration should be made by legislation, and not by judicial decision, because this is, in the words of Lord Simon of Glaisdale in Miliangos v. George Frank (Textiles) Ltd. [1976] A.C. 443, 480: "a decision which demands a far wider range of review than is available to courts following our traditional and valuable adversary system -- the sort of review compassed by an interdepartmental committee." I express the hope that Parliament will soon take action to remedy the unsatisfactory state of the law on this subject.

Lord Scarman spoke in a similar vein as follows at p. 19:

> It is tempting to suggest that in accordance with the Practice Statement (Judicial Precedent) [1966] 1 W.L.R. 1234, the House might consider it right to depart from the decision in Cartledge. But the reform needed is not the substitution of a new principle or rule of law for an existing one but a detailed set of provisions to replace existing statute law. The true way forward is not by departure from precedent but by amending legislation. Fortunately reform may be expected, since the Lord Chancellor has already referred the problem of latent damage and date of accrual of cause of action to his law reform committee.

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76 These considerations were obviously before the Court in Kamloops, yet in spite of them the majority chose to apply the discoverability rule to s. 738(2) of the Municipal Act. While noting the importance attached in Cartledge to s. 26 of the Limitation Act, 1939, they did not suggest that Cartledge and Pirelli were distinguishable because of the particular legislative context in Kamloops. Indeed, it is questionable whether they were distinguishable on that basis. While s. 738(2) was in force, prior to its repeal and replacement by s. 16 of the Limitations Act, S.B.C. 1975, c. 37, which makes express provision for the discoverability rule and an outside limit, the Statute of Limitations, R.S.B.C. 1948, c. 191, afforded a similar basis for an argument as to legislative intent in s. 38, which provided that the right of action for the recovery of any land or rent of which a person may have been deprived by concealed fraud "shall be deemed to have first accrued at and not before the time at which such fraud shall or with reasonable diligence might have been first known or discovered." There is a similar provision in s. 28 of the Nova Scotia Statute of Limitations, R.S.N.S. 1967, c. 168. Although Wilson J., who delivered the judgment of the majority in Kamloops, did not comment explicitly on the opinion that the introduction of the discoverability rule should be left to legislative rather than judicial decision, it is an obvious implication of her reasons and conclusion that she disagreed with the views on this question expressed in Cartledge and Pirelli. She appears to have been led to this conclusion essentially by the acknowledged injustice of the rule applied out of judicial restraint in those cases. Referring to Pirelli, she said at p. 40:

> But perhaps the most serious concern is the injustice of a law which statute-bars a claim before the plaintiff is even aware of its existence. Lord Fraser and Lord Scarman were clearly concerned over this but considered [page224] themselves bound by Cartledge. The only solution in their eyes was the intervention of the legislature.
>
> This Court is in the happy position of being free to adopt or reject Pirelli. I would reject it. This is not to say that Sparham-Souter presents no problem. As Lord Fraser pointed out in Pirelli the postponement of the accrual of the cause of

> action until the date of discoverability may involve the courts in the investigation of facts many years after their occurrence. Dennis v. Charnwood Borough Council, [1982] 3 All E.R. 486, is a classic illustration of this. It seems to me, however, to be much the lesser of two evils.

77 I am thus of the view that the judgment of the majority in Kamloops laid down a general rule that a cause of action arises for purposes of a limitation period when the material facts on which it is based have been discovered or ought to have been discovered by the plaintiff by the exercise of reasonable diligence, and that that rule should be followed and applied to the appellant's cause of action in tort against the respondents under the Nova Scotia Statute of Limitations, R.S.N.S. 1967, c. 168. There is no principled reason, in my opinion, for distinguishing in this regard between an action for injury to property and an action for the recovery of purely financial loss caused by professional negligence, as was suggested in Forster v. Outred, supra, at pp. 765-66. Since the respondents gave the Nova Scotia Trust Company a certificate on January 17, 1969 that the mortgage was a first charge on the Stonehouse property, thereby implying that it was a valid mortgage, the earliest that it can be said that the appellant discovered or should have discovered the respondents' negligence by the exercise of reasonable diligence was in April or May 1977 when the validity of the mortgage was challenged in the action for foreclosure. Accordingly the appellant's cause of action in tort did not arise before that date and its action for negligence against the respondents is not statute-barred.

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78 For these reasons I would allow the appeal, set aside the judgments of the Trial Division and the Appeal Division of the Supreme Court of Nova Scotia and enter judgment against the respondents ordering them to pay to the appellant, in accordance with the agreement of the parties as to quantum, the sum of $424,434.04 outstanding on the mortgage for principal, interest and taxes, plus interest accruing daily after April 14, 1982 at the rate of $156.93 and legal fees of $56,759.46 incurred by the appellant in attempting to enforce the mortgage, the whole with costs in this Court and in the Trial and Appeal Divisions.

qp/cvd

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an eligible financial contract that is entered into before the filing, in respect of an insolvent person of a notice of intention or, where no notice of intention is filed, a proposal, and that is terminated on or after that filing, but only in accordance with the provisions of that contract:

(*a*) the netting or setting off or compensation of obligations between the insolvent person and the other parties to the eligible financial contract; and

(*b*) any dealing with financial collateral including

(i) the sale or foreclosure or, in the Province of Quebec, the surrender of financial collateral, and

(ii) the setting off or compensation of financial collateral or the application of the proceeds or value of financial collateral.

Net termination values

(10) If net termination values determined in accordance with an eligible financial contract referred to in subsection (9) are owed by the insolvent person to another party to the eligible financial contract, that other party is deemed, for the purposes of paragraphs 69(1)(*a*) and 69.1(1)(*a*), to be a creditor of the insolvent person with a claim provable in bankruptcy in respect of those net termination values.

1992, c. 27, s. 30; 1997, c. 12, s. 41; 2001, c. 9, s. 573; 2004, c. 25, s. 36(E); 2005, c. 47, s. 43; 2007, c. 29, s. 92; 2012, c. 31, s. 415.

Disclaimer or resiliation of agreements

65.11 (1) Subject to subsections (3) and (4), a debtor in respect of whom a notice of intention was filed under section 50.4 or a proposal was filed under subsection 62(1) may — on notice given in the prescribed form and manner to the other parties to the agreement and the trustee — disclaim or resiliate any agreement to which the debtor is a party on the day on which the notice of intention or proposal was filed. The debtor may not give notice unless the trustee approves the proposed disclaimer or resiliation.

Individuals

(2) In the case of an individual,

(*a*) they may not disclaim or resiliate an agreement under subsection (1) unless they are carrying on a business; and

(*b*) only an agreement in relation to the business may be disclaimed or resiliated.

le dépôt d'un avis d'intention relatif à une personne insolvable ou, à défaut, d'une proposition la visant est résilié lors de ce dépôt ou par la suite, il est permis d'effectuer les opérations ci-après en conformité avec le contrat :

a) la compensation des obligations entre la personne insolvable et les autres parties au contrat;

b) toute opération à l'égard de la garantie financière afférente, notamment :

(i) la vente, la demande en forclusion ou, dans la province de Québec, la demande en délaissement,

(ii) la compensation, ou l'affectation de son produit ou de sa valeur.

Valeurs nettes dues à la date de résiliation

(10) Si, aux termes du contrat financier admissible visé au paragraphe (9), des sommes sont dues par la personne insolvable à une autre partie au contrat au titre de valeurs nettes dues à la date de résiliation, cette autre partie est réputée, pour l'application des alinéas 69(1)*a*) et 69.1(1)*a*), être un créancier de la personne insolvable et avoir une réclamation prouvable en matière de faillite relativement à ces sommes.

1992, ch. 27, art. 30; 1997, ch. 12, art. 41; 2001, ch. 9, art. 573; 2004, ch. 25, art. 36(A); 2005, ch. 47, art. 43; 2007, ch. 29, art. 92; 2012, ch. 31, art. 415.

Résiliation de contrats

65.11 (1) Sous réserve des paragraphes (3) et (4), le débiteur à l'égard duquel a été déposé un avis d'intention aux termes de l'article 50.4 ou une proposition aux termes du paragraphe 62(1) peut — sur préavis donné en la forme et de la manière prescrites aux autres parties au contrat et au syndic et après avoir obtenu l'acquiescement de celui-ci relativement au projet de résiliation — résilier tout contrat auquel il est partie à la date du dépôt de l'avis ou de la proposition.

Personne physique

(2) Toutefois, lorsque le débiteur est une personne physique, il ne peut effectuer la résiliation que s'il exploite une entreprise et, le cas échéant, seuls les contrats relatifs à l'entreprise peuvent être résiliés.

Court may prohibit disclaimer or resiliation

(3) Within 15 days after the day on which the debtor gives notice under subsection (1), a party to the agreement may, on notice to the other parties to the agreement and the trustee, apply to a court for an order that the agreement is not to be disclaimed or resiliated.

Court ordered disclaimer or resiliation

(4) If the trustee does not approve the proposed disclaimer or resiliation, the debtor may, on notice to the other parties to the agreement and the trustee, apply to a court for an order that the agreement be disclaimed or resiliated.

Factors to be considered

(5) In deciding whether to make the order, the court is to consider, among other things,

(*a*) whether the trustee approved the proposed disclaimer or resiliation;

(*b*) whether the disclaimer or resiliation would enhance the prospects of a viable proposal being made in respect of the debtor; and

(*c*) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.

Date of disclaimer or resiliation

(6) An agreement is disclaimed or resiliated

(*a*) if no application is made under subsection (3), on the day that is 30 days after the day on which the debtor gives notice under subsection (1);

(*b*) if the court dismisses the application made under subsection (3), on the day that is 30 days after the day on which the debtor gives notice under subsection (1) or any later day fixed by the court; or

(*c*) if the court orders that the agreement is disclaimed or resiliated under subsection (4), on the day that is 30 days after the day on which the debtor gives notice or any later day fixed by the court.

Intellectual property

(7) If the debtor has granted a right to use intellectual property to a party to an agreement, the disclaimer or resiliation does not affect the party's right to use the intellectual property — including the party's right to enforce an exclusive use — during the term of the agreement, including any period for which the party extends the agreement as of right, as long as the party continues to perform its obligations under the agreement in relation to the use of the intellectual property.

Contestation

(3) Dans les quinze jours suivant la date à laquelle le débiteur donne le préavis mentionné au paragraphe (1), toute partie au contrat peut, sur préavis aux autres parties au contrat et au syndic, demander au tribunal d'ordonner que le contrat ne soit pas résilié.

Absence d'acquiescement du syndic

(4) Si le syndic n'acquiesce pas au projet de résiliation, le débiteur peut, sur préavis aux autres parties au contrat et au syndic, demander au tribunal d'ordonner la résiliation du contrat.

Facteurs à prendre en considération

(5) Pour décider s'il rend l'ordonnance, le tribunal prend en considération, entre autres, les facteurs suivants :

a) l'acquiescement du syndic au projet de résiliation, le cas échéant;

b) la question de savoir si la résiliation favorisera la présentation d'une proposition viable à l'égard du débiteur;

c) le risque que la résiliation puisse vraisemblablement causer de sérieuses difficultés financières à une partie au contrat.

Résiliation

(6) Le contrat est résilié :

a) trente jours après la date à laquelle le débiteur donne le préavis mentionné au paragraphe (1), si aucune demande n'est présentée en vertu du paragraphe (3);

b) trente jours après la date à laquelle le débiteur donne le préavis mentionné au paragraphe (1) ou à la date postérieure fixée par le tribunal, si ce dernier rejette la demande présentée en vertu du paragraphe (3);

c) trente jours après la date à laquelle le débiteur donne le préavis mentionné au paragraphe (4) ou à la date postérieure fixée par le tribunal, si ce dernier ordonne la résiliation du contrat en vertu de ce paragraphe.

Propriété intellectuelle

(7) Si le débiteur a autorisé par contrat une personne à utiliser un droit de propriété intellectuelle, la résiliation n'empêche pas la personne de l'utiliser ni d'en faire respecter l'utilisation exclusive, à condition qu'elle respecte ses obligations contractuelles à l'égard de l'utilisation de ce droit, et ce pour la période prévue au contrat et pour toute période additionnelle dont elle peut et décide de se prévaloir de son propre gré.

Loss related to disclaimer or resiliation

(8) If an agreement is disclaimed or resiliated, a party to the agreement who suffers a loss in relation to the disclaimer or resiliation is considered to have a provable claim.

Reasons for disclaimer or resiliation

(9) A debtor shall, on request by a party to the agreement, provide in writing the reasons for the proposed disclaimer or resiliation within five days after the day on which the party requests them.

Exceptions

(10) This section does not apply in respect of

(*a*) an eligible financial contract;

(*b*) a lease referred to in subsection 65.2(1);

(*c*) a collective agreement;

(*d*) a financing agreement if the debtor is the borrower; or

(*e*) a lease of real property or of an immovable if the debtor is the lessor.

2005, c. 47, s. 44; 2007, c. 29, s. 93, c. 36, s. 26; 2009, c. 31, s. 63.

Application for authorization to serve a notice to bargain

65.12 (1) An insolvent person in respect of whom a notice of intention is filed under section 50.4 or a proposal is filed under subsection 62(1) who is a party to a collective agreement and who is unable to reach a voluntary agreement with the bargaining agent to revise any of its provisions may, on giving five days notice to the bargaining agent, apply to the court for an order authorizing the insolvent person to serve a notice to bargain under the laws of the jurisdiction governing collective bargaining between the insolvent person and the bargaining agent.

Conditions for issuance of order

(2) The court may issue the order only if it is satisfied that

(*a*) the insolvent person would not be able to make a viable proposal, taking into account the terms of the collective agreement;

(*b*) the insolvent person has made good faith efforts to renegotiate the provisions of the collective agreement; and

(*c*) the failure to issue the order is likely to result in irreparable damage to the insolvent person.

Pertes découlant de la résiliation

(8) En cas de résiliation du contrat, toute partie à celui-ci qui subit des pertes découlant de la résiliation est réputée avoir une réclamation prouvable.

Motifs de la résiliation

(9) Dans les cinq jours qui suivent la date à laquelle une partie au contrat le lui demande, le débiteur lui expose par écrit les motifs de son projet de résiliation.

Exceptions

(10) Le présent article ne s'applique pas aux contrats suivants :

a) les contrats financiers admissibles;

b) les baux visés au paragraphe 65.2(1);

c) les conventions collectives;

d) les accords de financement au titre desquels le débiteur est l'emprunteur;

e) les baux d'immeubles ou de biens réels au titre desquels le débiteur est le locateur.

2005, ch. 47, art. 44; 2007, ch. 29, art. 93, ch. 36, art. 26; 2009, ch. 31, art. 63.

Demande pour que le tribunal autorise l'avis de négociations collectives

65.12 (1) Si la personne insolvable à l'égard de laquelle a été déposé un avis d'intention aux termes de l'article 50.4 ou une proposition aux termes du paragraphe 62(1) est partie à une convention collective à titre d'employeur et qu'elle ne peut s'entendre librement avec l'agent négociateur sur la révision de tout ou partie de la convention collective, elle peut, sur préavis de cinq jours à l'agent négociateur, demander au tribunal de l'autoriser, par ordonnance, à transmettre à l'agent négociateur un avis de négociations collectives en vue de la révision de la convention collective conformément aux règles de droit applicables aux négociations entre les parties.

Cas où l'autorisation est accordée

(2) Le tribunal ne rend l'ordonnance que s'il est convaincu que, à la fois :

a) la personne insolvable ne pourrait faire de proposition viable compte tenu des dispositions de la convention collective;

b) elle a tenté de bonne foi d'en négocier de nouveau les dispositions;

c) elle subirait vraisemblablement des dommages irréparables s'il ne la rendait pas.

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Husky Oil Operations Ltd. v. Minister of National Revenue

WORKERS' COMPENSATION BOARD v. HUSKY OIL OPERATIONS LTD., R. IN RIGHT OF CANADA, as represented by MINISTER OF NATIONAL REVENUE, R. IN RIGHT OF PROVINCE OF SASKATCHEWAN, as represented by MINISTER OF HUMAN RESOURCES, LABOUR AND EMPLOYMENT, R. IN RIGHT OF PROVINCE OF SASKATCHEWAN, as represented by MINISTER OF FINANCE, BANK OF MONTREAL, ERIC ZIMMERMAN, GARTH PRICE, TREVOR BROWN, ARTHUR GINGRAS, KELLY HOUSTON, DARCY KUZIO, HANS BOHLE, CHARLES PSHEBENICKI, TERRY SAPERGIA, SBW-WRIGHT CONSTRUCTION INC., CAMPBELL WEST (1991) LTD., FULLER AUSTIN INSULATION INC., UNITED INDUSTRIAL EQUIPMENT RENTALS LTD., ATCO ENTERPRISES LTD. and DELOITTE & TOUCHE INC., as Trustee in Bankruptcy of Estate of METAL FABRICATING & CONSTRUCTION LTD., ATTORNEY GENERAL FOR SASKATCHEWAN

ATTORNEY GENERAL FOR ONTARIO, ATTORNEY GENERAL FOR NEW BRUNSWICK, ATTORNEY GENERAL OF BRITISH COLUMBIA, ATTORNEY GENERAL FOR ALBERTA, WORKERS' COMPENSATION BOARD OF ONTARIO, WORKERS' COMPENSATION BOARD OF BRITISH COLUMBIA, WORKERS' COMPENSATION BOARD OF ALBERTA and YUKON WORKERS' COMPENSATION HEALTH AND SAFETY BOARD (Intervenors)

Supreme Court of Canada

Lamer C.J.C., La Forest, L'Heureux-Dubé, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

Heard: January 25, 1995
Judgment: October 19, 1995
Docket: Doc. No 23936

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Subject: Corporate and Commercial; Insolvency; Contracts; Labour and Employment; Public

Bankruptcy --- Bankruptcy and insolvency jurisdiction — Constitutional jurisdiction of Dominion and provinces — Paramountcy of federal legislation.

Construction Law --- Construction and builders' liens — Holdback.

Employment Law --- Workers' compensation legislation — Constitutional issues.

Constitutional law — Constitution Act, 1867 — Exclusive federal jurisdiction over bankruptcy — Project owner indebted to bankrupt construction company — Workers' Compensation Board suing owner under s. 133(1) of The Workers' Compensation Act for sum bankrupt owing board for unremitted employee payroll contributions — Owner claiming under s. 133(3) to set off moneys paid to board from moneys owing bankrupt — Section 133(1) and (3) should be read in tandem — Where s. 133(1) and (3) applying on facts s. 133 inapplicable in bankruptcy for intruding into exclusive federal sphere beyond ancillary effect — Section 97(3) of Bankruptcy and Insolvency Act allowing only party claiming set-off and not third party to recover ahead of its priority — Court presuming constitutionality and reading down s. 133 to extent of conflict with s. 136 of Bankruptcy and Insolvency Act — Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 97(3), 136 — The Workers' Compensation Act, S.S. 1979, c. W-17.1, ss. 133(1), 133(3).

The Workers' Compensation Board gave a fabricating company a Notice of Assessment that it owed the board for unremitted employee payroll contributions. The fabricator then gave a bank a general assignment of book debts for bank loans it received, and the bank gave notice to a project owner with which the fabricator had contracted. The contract obliged the fabricator to indemnify the owner for non-performance of the contract. When the fabricator became bankrupt, the owner was indebted to it under the contract. The board sued the owner under s. 133(1) of *The Workers' Compensation Act* (Sask.) for the sum the fabricator owed the board. The owner claimed that, if it was required to pay the board under s. 133(1), then it was entitled to set off the payment against the amount it owed the fabricator. A chambers judge granted the owner a fiat of non-suit on the ground that s. 133 was constitutionally inoperative because it altered the federal *Bankruptcy and Insolvency Act*'s

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scheme of distribution. When the Saskatchewan Court of Appeal dismissed the board's appeal, it appealed to the Supreme Court of Canada.

Held:

The appeal was dismissed.

Per Gonthier J. (Lamer C.J.C., La Forest, L'Heureux-Dubé and McLachlin JJ. concurring)

Section 133 of *The Workers' Compensation Act* does not apply in bankruptcy, and s. 133(3) cannot by means of set-off effectively reorder the priorities contained in s. 136 of the *Bankruptcy and Insolvency Act*. The combined effect of the deemed debt in s. 133(1) and the set-off against the bankrupt's property in s. 133(3) is to secure the board's claim against the bankrupt's estate with the bankrupt's debtor acting merely as conduit. The bankrupt's estate is diminished, the board is correspondingly enriched, and the debtor's estate is unaffected. The board thus recovers against the bankrupt ahead of its federally mandated priority in s. 136(1)(*h*) of the *Bankruptcy and Insolvency Act*, creating an operational conflict. Section 97(3) of the *Bankruptcy and Insolvency Act* incorporating the provincial law of set-off does not apply. Section 97(3) allows only the party claiming set-off, and not a third party, to recover exceptionally ahead of its priority. The set-off allowed is a defence to the payment of a debt, and not a statutory security device securing the claims of third parties against the estate. Section 133 not only gives a priority to the debtor claiming set-off, which is permissible under s. 97(3), it also effectively secures the board's claim against the estate, which is not so permissible. Under the presumption of constitutionality, s. 133 should be read down to the extent of its conflict with s. 136 of the *Bankruptcy and Insolvency Act*. Accordingly, s. 133 is inapplicable in bankruptcy.

Parliament's exclusive power over bankruptcy and insolvency in s. 91(21) of the *Constitution Act, 1867* empowers it to rank bankruptcy creditors under s. 136 of the *Bankruptcy and Insolvency Act*. Section 136(1)(*h*) ranks a bankrupt's indebtedness under any worker's compensation legislation eighth in the list. Provinces cannot create priorities between creditors or change the distribution scheme in s. 136(1). While provincial law may validly affect priorities outside of bankruptcy, in bankruptcy s. 136(1) determines a claim's status and priority. The bankruptcy distribution scheme would otherwise vary from province to province, which would be unacceptable. Provinces also cannot affect how the terms such as "secured creditor" are defined for the *Bankruptcy and Insolvency Act*'s purposes. As the provinces may not do indirectly what they cannot do directly, the substance of the provincial interest created governs and not its form. Such provincial law is inapplicable even if the province does not intend to intrude into the bankruptcy sphere and conflict with the *Bankruptcy and Insolvency Act*'s priorities. It is enough if that is the law's effect. The assessment of the impugned law's applicability, even after its validity has been established, and the non-requirement of intention to intrude into a federal sphere distinguish the above propositions from the doctrine of colourability.

Under s. 133 the bankrupt's debtor is essentially the surety or guarantor of the bankrupt's obligation, with the board determining the debtor's indemnification from the withheld funds. When s. 133(1) and (3) operate in tandem as intended, the debtor is no worse off after having acted as the bankrupt's surety. The reality is that the bankrupt discharges its own liability to the board, mediated through the debtor's legally compelled agency. The exercise of set-off, triggered by the deemed debt, thus has the effect of creating a straightforward security device in favour of the debt and the right to withhold and set off against property of the bankrupt which secures the board's claim against the bankrupt's property. The constitutional validity of s. 133(1) must thus be examined in conjunction with that of s. 133(3).

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The operation of set-off in bankruptcy confers on the claimant a security interest or quasi-lien against the bankrupt's estate. Under s. 97(3) of the *Bankruptcy and Insolvency Act*, the law of set-off allows a bankrupt's debtor who is also the bankrupt's creditor to refrain from paying the full debt owing the bankrupt's estate. In this limited sense, such a claimant may use the law of set-off to reorder its priority in bankruptcy. However, the law of set-off may not be used to reorder the priority of any person other than the person claiming set-off against the estate. Any provincial law doing so is inapplicable in bankruptcy.

Where s. 133(1) and (3) both apply on the facts, s. 133 is inapplicable in bankruptcy for intruding into an exclusive federal sphere. Before bankruptcy, the security device created by s. 133(3) and triggered by s. 133(1) is within provincial jurisdiction. After bankruptcy, the subsections' combined effect is to secure the board's claim against the bankrupt's estate ahead of its priority under s. 136(1)(*h*) of the *Bankruptcy and Insolvency Act*. The two laws thus conflict in their operation. Apart from s. 133(1) and (3), s. 133(4) also has the effect of intruding into the exclusive federal bankruptcy sphere. That section empowers the board to determine the extent of its claim against the estate, and thus indirectly the estate remaining available for other creditors. A province cannot empower a bankrupt's creditor to determine the estate available for distribution. While otherwise valid, s. 133(4) also is inapplicable to bankruptcy. The court should only read down s. 133 insofar as its application conflicts with the *Bankruptcy and Insolvency Act*'s distribution scheme. Where s. 133(1) alone applies because the bankrupt's debtor has retained no moneys allowing set-off, the board's claim against the debtor remains fully applic- able.

Section 133 must be declared inapplicable rather than inoperable in bankruptcy. Bankruptcy is an exclusive federal domain rather than an area of joint or overlapping jurisdiction. As bankruptcy is carved from the provincial domain of property and civil rights, valid provincial legislation of general application continues to apply in bankruptcy until Parliament legislates under its exclusive jurisdiction. Provincial legislation conflicting with the federal law then becomes inapplicable only to the extent of the conflict.

When federal and provincial laws potentially conflict, the court must first determine whether they are respectively valid federal or provincial laws. If so, the court must then determine whether they are in operational conflict. If so, the federal laws prevail and the provincial laws are without effect to the extent of this conflict. Provincial laws will be inapplicable as being ultra vires to the extent that they conflict with an exclusive federal field. Provincial laws will be intra vires but inoperative if the operational conflict is within an area of concurrent or overlapping jurisdiction. To the extent that there is operational conflict, there is no room for a provincial law's incidental or ancillary effect. If there is no operational conflict, both federal and provincial laws continue to operate and have effect. Short of operational conflict, provincial law may validly affect bankruptcy. Here, there was operational conflict in that s. 133(1) and (3) subverted the federal order of priorities under the *Bankruptcy and Insolvency Act*. That intrusion into an exclusive federal sphere went far beyond an incidental and ancillary effect.

Per Iacobucci J. (dissenting) (Sopinka, Cory and Major JJ. concurring)

Where there is very clear operational conflict between valid federal and provincial legislation, the doctrine of paramountcy requires that the provincial legislation be declared inoperative to the extent of the conflict. Conflict is found where one cannot obey one level of government's law without disobeying the law of the other. Where possible, the court must read overlapping provincial and federal law in a complementary manner. A review of the history and purpose of workers' compensation statutes did not show that s. 133 of the *The Workers' Compensation Act* was enacted to improve the board's ranking in federal bankruptcy.

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Provincial laws are inoperative where they directly improve a claim's priority against the bankrupt's property over the priority under s. 136(1) of the *Bankruptcy and Insolvency Act*. A broad approach declaring inoperative any provincial law affecting the final result of a bankruptcy would risk nullifying the provincial legislation underpinning the *Bankruptcy and Insolvency Act*. Provincial law plays a critical role in defining both the number and type of participants in the bankruptcy process and the size of the bankrupt's estate. Section 72(1) of the *Bankruptcy and Insolvency Act* recognizes that provincial law will affect the bankruptcy process. Section 133 of *The Workers' Compensation Act* would only be inoperative if it actually reordered the priority scheme under s. 136(1) by directly creating interests in the bankrupt's property.

Section 133(1) is constitutionally valid. Section 136(1) encompasses a claim against the bankrupt's property. Section 133(1) has nothing to do with the bankrupt's property and thus is not in operational conflict with the bankruptcy scheme. It simply creates the bankrupt's debtor's third party guarantee that the bankrupt will pay its debts to the board. Section 133(1) only alters the board's recovery by allowing recovery from a solvent third party. Nothing in the *Bankruptcy and Insolvency Act* precludes a creditor from pursuing its remedies against a third party instead of pursuing its claim in bankruptcy. Here s. 133(1) validly created two debts that were independent although interconnected: the owner's debt to the board as surety; and the fabricator's debt to the owner for the sum the latter paid for the former's default. None of this altered the priorities under the *Bankruptcy and Insolvency Act*. Further, s. 133(1) is intra vires, and intra vires legislation may have an incidental and ancillary effect on a federal sphere.

As the components of s. 133 are severable, the court must evaluate s. 133(3) separately. Section 133(3) contains the remedies of set-off and indemnification. Section 97(3) of the *Bankruptcy and Insolvency Act* envisions that money may be withheld from the bankrupt's estate due to set-off. The focus here should be on equitable set-off because the fabricator's assignment of its book debts to the bank eliminated the availability of legal set-off. As s. 133(3) creates no new rights of set-off and merely confirms the availability of traditional equitable set-off, s. 133(3) is consistent with the *Bankruptcy and Insolvency Act*. Absent s. 133(3), a set-off claim would exist under the laws of restitution or contract. In restitution, a person may claim repayment of moneys he paid under compulsion of law if the payment discharged another's liability. As the owner was legally required to pay the board, thus releasing the fabricator, it could seek restitution from the fabricator. In contract, the fabricator's failure to pay gave the owner a claim under their contract. Equitable set-off may operate against an assignee where the debts are so closely connected that it would be unfair to enforce one without allowing the other to be set off. Although the fabricator had assigned its book debts to the bank, the owner was entitled to equitable set-off since its claim arose out of the same contract under which the funds were now owing the bank. Further, the main reason for the doctrine of equitable set-off is to promote fairness. As the fabricator had the main responsibility to pay the board, it was equitable and fair to allow the owner the right of set-off. Section 133(3) was fully operative here.

Section 133 should not be treated as indivisible. Section 133(1) is the key feature of s. 133, and operates apart from s. 133(3). Section 133(1) does not make a bankrupt's debtor's obligation to the board contingent on the debtor's ability to obtain indemnity or set-off under s. 133(3). Even if the debtor had no right of set-off under s. 133(3) or under the common law, the legislature could still pass s. 133(1).

Cases considered:

Per Gonthier J. (Lamer C.J.C., La Forest, L'Heureux-Dubé and McLachlin JJ. concurring)

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Per Iacobucci J. (dissenting) (Sopinka, Cory and Major JJ. concurring)

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s. 47

s. 47(*a*)

s. 49(2)

s. 50(6)

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s. 107

s. 107(1)

s. 107(1)(*h*)

s. 107(1)(*j*)

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s. 2 "secured creditor"

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s. 67

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Workmen's Compensation Act, 1929, The, S.S. 1928-29, c. 73 —

s. 11

Appeal from judgment reported at (1993), [1994] 1 W.W.R. 629, 22 C.B.R. (3d) 153, 116 Sask. R. 46, 108 D.L.R. (4th) 681, 11 C.L.R. (2d) 1 (C.A.), dismissing appeal from judgment (1992), 104 Sask. R. 225, 96 D.L.R. (4th) 495, 3 C.L.R. (2d) 194, 16 C.B.R. (3d) 290 (Q.B.) , granting fiat of non-suit on ground that s. 133 of *The Workers' Compensation Act* (Sask.) constitutionally inoperative

Gonthier J. (Lamer C.J.C., La Forest, L'heureux-Dubé **and** ***McLachlin JJ.*****:**

1 I have had the benefit of the reasons of my colleague Justice Iacobucci. I respectfully disagree with his conclusion that s. 133 of *The Workers' Compensation Act, 1979*, S.S. 1979, c. W-17.1, is applicable in bankruptcy, and that provincial legislation can, through the operation of set-off in this manner, effectively reorder the priorities otherwise provided in the *Bankruptcy Act*, R.S.C. 1985, c. B-3.

2 In my opinion, the combined effect of the deemed debt in s.133(1) and set-off against property of the bankrupt in s. 133(3) is to secure the Workers' Compensation Board's claim against the estate of the bankrupt. When s. 133(1) and (3) operate in tandem as intended by the Legislature, the effect is that the Board's claim is satisfied with property of the bankrupt in the form of the monies withheld by the principal. The principal becomes nothing more than a conduit for transferring to the Board monies which form property of the bankrupt's estate. The end result is that the bankrupt's estate is diminished to the extent of the contractor's liability to the Board, and the Board is correspondingly enriched by an identical amount, thereby recovering its claim in full. On the other hand, the principal's estate or patrimony remains entirely unaffected. The Board's claim is thus secured against the bankrupt's estate, mediated through the legally compelled agency of the principal. In this way, the Board recovers against the estate ahead of the priority mandated by Parliament in s. 136(1)(*h*) of the *Bankruptcy Act*, creating an operational conflict.

3 Recourse to s. 97(3) of the *Bankruptcy Act*, which incorporates by reference the provincial law of set-off, does not provide much assistance to the Board in this case. It is true that set-off itself may give rise to a reordering of priorities in bankruptcy in the limited sense that the party claiming set-off will secure his or her claim against the estate rather than recover under the priority otherwise provided by the *Bankruptcy Act*. This much is acknowledged by Parliament in enacting s. 97(3). However, the real question is the extent to which Parliament has deferred to the relevant provincial law. Here, Parliament has deferred to the extent of allowing the party claiming set-off to recover exceptionally ahead of his priority. But Parliament has not deferred to the extent of allowing third parties the same benefit as a result of the operation of provincial legislation. Set-off, in other

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words, is simply a defence to the payment of a debt, not a basis for validating statutory security devices which have the effect of securing the claims of third parties against the estate ahead of the priority stipulated by Parliament. The question is thus not whether the province has created a proprietary interest, but rather, it is whether that interest can have the effect of defeating the scheme of distribution under the *Bankruptcy Act*. Here, s. 133 not only gives a priority to the principal claiming set-off, which is permissible under s. 97(3), it also has the effect of securing the Board's claim against the estate, which most assuredly is impermissible. As a result, if s. 133 were applicable in bankruptcy, it would enter into conflict with the order of priorities required by the *Bankruptcy Act*. Consistent with the presumption of constitutionality, it is my opinion that s. 133 should be read down to the extent of the conflict; that is, s. 133 is inapplicable in bankruptcy. I would therefore dismiss the appeal with costs throughout.

I. Background Facts, Relevant Legislation and the Courts Below

4 Since my colleague Iacobucci J. has helpfully summarized the relevant factual and legislative background together with the judgments of the courts below, I need not repeat that discussion. However, for reasons that will become apparent, it is important to reproduce the impugned provision, s. 133 of the Saskatchewan *Workers' Compensation Act*, in its entirety:

> 133. — (1) Where a person, whether carrying on an industry included under this Act or not, in this section referred to as the principal, contracts with any other person, in this section referred to as the contractor, for the execution by or under the contractor of the whole or any part of any work for the principal, it is the duty of the principal to ensure that any sum that the contractor or any subcontractor is liable to contribute to the fund is paid and, where the principal fails to do so and the sum is not paid, he is personally liable to pay that sum to the board.
>
> (2) The board shall have the same powers and be entitled to the same remedies for enforcing payment under subsection (1) that it possesses in respect of an assessment under this Act.
>
> (3) Where the principal is liable to make payment to the board under subsection (1), he is entitled to be indemnified by any person who should have made the payment and is entitled to withhold, out of any indebtedness due to that person, a sufficient amount in respect of that indemnity.
>
> (4) All questions as to the right to and the amount of such indemnity shall be determined by the board.

II. Issues on Appeal

5 The constitutional questions raised by this appeal were stated by the Chief Justice on September 14, 1994 as follows:

> 1. Where a contractor as referred to in s. 133 of *The Workers' Compensation Act*, S.S. 1979, c. W-17.1, is in bankruptcy and but for the bankruptcy, the principal as referred to in s. 133 would be liable to pay the assessment due by the contractor under the Act, is s. 133 of the said Act inoperative or inapplicable in whole or in part, by reason of being in conflict with the *Bankruptcy Act*, R.S.C., 1985, c. B-3, and in particular ss. 17(1), 67, 95, 136(1)(*h*), 148, 158(*a*) and 198(*a*) thereof?
>
> 2. Was s. 133 of the said Act inoperative or inapplicable in the circumstances of this case?

6 I agree with my colleague Iacobucci J. that the parties before this Court focused their arguments on the al-

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leged conflict between s. 133 of the Saskatchewan *Workers' Compensation Act* and s. 136(1)(*h*) of the *Bankruptcy Act*. Certainly, that is the gravamen of this appeal. However, I respectfully disagree with Iacobucci J.'s restatement of the issues in the constitutional questions posed by the Chief Justice. Iacobucci J.'s reasons adopt the appellant's reformulation of the issues and examine the constitutional validity of s. 133(1) and (3) separately. As will become apparent, in my view this manner of proceeding obscures the response to the constitutional questions. The question is not whether these provisions are independently valid, but rather, it is whether when combined they have the effect of reordering priorities in bankruptcy. When s. 133(1) is read together with s. 133(3), it is clear that the combined effect of the statutory deemed debt and the right to set-off against property of the bankrupt is to secure the Board's claim against the bankrupt's estate. In so doing, s. 133 *read as a whole* conflicts with Parliament's intention to accord the Board's claim the priority established in s. 136(1)(*h*) of the *Bankruptcy Act*.

III. Analysis

7

A. The Purposes of Federal Bankruptcy Legislation

8 At the outset, it is useful to remember that our bankruptcy system serves two distinct goals. The first is to ensure the equitable distribution of a bankrupt debtor's assets among the estate's creditors in ter se. As one commentator has noted (Aleck Dadson, "Comment" (1986) 64 Can. Bar Rev. 755, at p. 755):

> ... bankruptcy serves this goal by replacing a regime of individual action with a regime of collective action. While the pre-bankruptcy regime of individual action allows creditors to pursue their separate and competing claims to the debtor's assets, bankruptcy's regime of collective action sorts out those diverse claims and deals with the debtor's assets in a way which brings benefits to creditors as a group (reduced costs, increased recovery) ... The collectivization of insolvency proceedings can only be achieved by denying to creditors the use of pre-bankruptcy remedies.

See also Peter W. Hogg, *Constitutional Law of Canada* (3rd ed., 1992) (supplemented), at p. 25-3. The second goal of the bankruptcy system is the financial rehabilitation of insolvent individuals (Dadson, at p. 755). This goal is furthered through the opportunity for an insolvent individual's discharge from outstanding debts.

9 It has long been accepted that the first goal of ensuring an equitable distribution of a debtor's assets is to be pursued in accordance with the federal system of bankruptcy priorities. In the seminal case of *Royal Bank of Canada v. Larue*, [1928] A.C. 187, affirming [1926] S.C.R. 218, Viscount Cave L.C. confirmed that the exclusive federal power over bankruptcy and insolvency in s. 91(21) of the *Constitution Act, 1867* enables Parliament to provide for the ranking of creditors in bankruptcy. He observed at p. 197:

> In *Attorney-General of Ontario v. Attorney-General for Canada* [[1894] A.C. 189], Lord Herschell observed that a system of bankruptcy legislation might frequently require various ancillary provisions for the purpose of preventing the scheme of the Act from being defeated, and added: "It may be necessary for this purpose to deal with the effect of executions and other matters which would otherwise be within the legislative competence of the Provincial Legislature. Their Lordships do not doubt that it would be open to the Dominion Parliament to deal with such matters as part of a bankruptcy law, and the Provincial Legislature would doubtless be then precluded from interfering with this legislation inasmuch as such interference would affect the bankruptcy law of the Dominion Parliament." Taking these observations as affording assistance in

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> the construction of s. 91, head 21, of the Act of 1867, their Lordships are of the opinion that *the exclusive authority thereby given to the Dominion Parliament to deal with all matters arising within the domain of bankruptcy and insolvency enables that Parliament to determine by legislation the relative priorities of creditors under a bankruptcy or an authorized assignment*. (Emphasis added.)

10 The power to determine the priorities of distribution of the bankrupt's assets thus confirmed, Parliament has created an equitable distribution wherein the general rule is that creditors are to rank equally, with claims provable in bankruptcy being paid rateably (*Bankruptcy Act*, s. 141). The rule of creditor equality is subject to ten classes of debt which are accorded priority in a stated order, the so-called list of "preferred" creditors (s. 136). Included in these classes of exceptions is "all indebtedness of the bankrupt under any Workmen's Compensation Act" in s. 136(1)(*h*), ranked eighth in the list. Lastly, the entire scheme of distribution is "subject to the rights of secured creditors" (s. 136) which, as Professor Hogg has noted, "enables secured creditors to realize their security as if there were no bankruptcy" (Hogg, at p. 25-9).

B. The "Quartet" of Supreme Court Bankruptcy Decisions

11 In recent years, the constitutional relationship between the scheme of distribution under the *Bankruptcy Act* and various branches of provincial law governing property has received heightened scrutiny in the so-called "quartet" of decisions of this Court. Since my interpretation of the quartet differs from Iacobucci J.'s, I hope that I will be forgiven for re-canvassing that familiar terrain in order to explain the basis of my position.

(i) Overview of the Quartet

12 First, in *Quebec (Deputy Minister of Revenue) c. Rainville* (sub nom. *Re Bourgault*), [1980] 1 S.C.R. 35, the trustee in bankruptcy sought to cancel a privilege registered by the Quebec Deputy Minister of Revenue on the bankrupt's immovable property under the provincial *Retail Sales Tax Act*, R.S.Q. 1964, c. 71. The Quebec Deputy Minister of Revenue argued that the province was a "secured creditor" under s. 2 of the *Bankruptcy Act*, since the Quebec *Retail Sales Tax Act* provided that sums due to the Crown under the Act were "a privileged debt ranking immediately after law costs".

13 Writing for the majority, Pigeon J. rejected the priority claimed by the province. In so doing, he offered the following remarks on the interpretation of s. 107(1)(*j*) of the *Bankruptcy Act* (now s. 136(1)(*j*)) (at p. 44):

> Accordingly, I find that the case turns upon the interpretation of para. 107(1)(*j*) ... It is abundantly clear that this was intended to put on an equal footing all claims by Her Majesty in right of Canada or of a province except in cases where it was provided otherwise, namely, para. (*c*), the levy, and para. (*h*), workmen's compensation or unemployment insurance assessments and withholdings for income tax. Paragraph (*j*) ends with the following words, "*notwithstanding any statutory preference to the contrary*". The purpose of this part of the provision is obvious. Parliament intended to put all debts to a government on an equal footing; it therefore cannot have intended to allow provincial statutes to confer any higher priority. In my opinion, this is precisely what is being contended for when it is argued that, because the Quebec statute creates a privilege on immovable property effective from the date of registration, the Crown thereby becomes a "secured creditor" and thus escapes the effect of the provision which gives it only a lower priority. (Emphasis in original.)

Pigeon J. later concluded at p. 46:

> If the contention of the Deputy Minister of Revenue in the case at bar was upheld, it would mean that the

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> Quebec tax collector, provided his privilege was registered before the bankruptcy, would obtain a special preference on the proceeds of the sale of the immovable property in question, instead of having only the *pari passu* priority contemplated in the scheme of distribution established by the *Bankruptcy Act*. In my opinion, such result would be contrary to the intent of Parliament and no imperfection in drafting could justify it.

14 This Court confirmed and extended this approach to the relationship between the *Bankruptcy Act* and provincial law in *Deloitte, Haskins & Sells Ltd. v. Alberta (Workers' Compensation Board)*, [1985] 1 S.C.R. 785 . Section 78(4)(*a*) of the Alberta *Workers' Compensation Act*, S.A. 1973, c. 87, provided that the provincial Workers' Compensation Board retained a "charge upon the property or proceeds of property of the employer" for unpaid assessments under the Act. The question before the Court was whether this provision rendered the Board a secured creditor of the bankrupt employer for the purposes of the opening words of s. 107(1) of the *Bankruptcy Act* which subjected the list of preferred claims "to the rights of secured creditors", or whether the Board's claim was postponed to s. 107(1)(*h*) which expressly addressed "all indebtedness of the bankrupt under any Workmen's Compensation Act".

15 A majority of the Court ruled that the Board was not a secured creditor and could only recover under s. 107(1)(*h*) of the *Bankruptcy Act*. Speaking for the majority on this point, Wilson J. cited approvingly (at pp. 804-805) the following remarks of Jones J.A. in *Re Black Forest Restaurants Ltd.* (1981), (sub nom. *Nova Scotia (Director of Labour Standards) v. Trustee in Bankruptcy)* 38 C.B.R. (N.S.) 253 (N.S. C.A.), at p. 260, on the ratio of the *Re Bourgault* decision:

> *Mr. Justice Pigeon made it abundantly clear that priorities of provincial claims must be determined in accordance with s. 107(1) priorities of the Bankruptcy Act notwithstanding any statutory preference to the contrary*. Debts under the Workers' Compensation Act fall under s. 107(1)(*h*) of the Act. Claims for wages are governed by s. 107(1)(*d*). With deference, it is not open to the province to provide any higher or more extensive priority for wages in view of the express provisions contained in that clause. *It is clear from Rainville that the provincial Crown cannot claim as a secured creditor under the Bankruptcy Act, notwithstanding the form of the provincial legislation, where the claim is governed by s. 107(1) of the Bankruptcy Act*. (Emphasis added.)

16 In the same vein, Wilson J. later added the following important comments at p. 806:

> With respect, the issue in *Re Bourgault* [*Rainville*] and *Re Black Forest Restaurant Ltd.* was not whether a proprietary interest has been created under the relevant provincial legislation. It was whether provincial legislation, even if it did create a proprietary interest, could defeat the scheme of distribution under s. 107(1) [now s. 136(1)] of the *Bankruptcy Act*. These cases held that it could not, that while the provincial legislation could validly secure debts on the property of the debtor in a non-bankruptcy situation, once bankruptcy occurred s. 107(1) determined the status and priority of the claims specifically dealt with in the section. It was not open to the claimant in bankruptcy to say: By virtue of the applicable provincial legislation I am a secured creditor within the meaning of the opening words of s. 107(1) of the *Bankruptcy Act* and therefore the priority accorded my claim under the relevant paragraph of s. 107(1) does not apply to me ... [This position] cannot be supported as a matter of statutory interpretation of s. 107(1) since, if the section were to be read in this way, it would have the effect of permitting the provinces to determine priorities on a bankruptcy, a matter within exclusive federal jurisdiction.

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17 Having concluded that the case was governed by *Re Bourgault*, the majority of the Court considered the question of the appropriate response to the constitutional question: Was the provincial legislation inapplicable or inoperative? Wilson J. (McIntyre J. and Lamer J. (as he then was) concurring) noted that by virtue of the presumption of constitutionality, a province should be presumed to be legislating within its competence rather than outside it. As a result, she concluded that there was no conflict between s. 78(4) of the *Workers' Compensation Act* and s. 107(1)(*h*) of the *Bankruptcy Act* since the former should be construed or read down as simply having no application in the event of bankruptcy (at p. 808). By contrast, Chouinard J. (Dickson C.J.C. and Beetz J. concurring) agreed with the body of Wilson J.'s reasons but ruled that s. 78(4) was inoperative in the event of bankruptcy since it conflicted with s. 107(1)(*h*) of the *Bankruptcy Act* (at pp. 788-89).

18 This Court's decision in *Deloitte, Haskins* is thus "significant because it confirms that any statutory lien conferred by a province on creditors listed in [s. 136] will nonetheless be inoperative [or inapplicable] in bankruptcy proceedings" (Dadson, at p. 758).

19 The third decision in the bankruptcy quartet is *Québec (Commission de la santé et de la sécurité du travail) c. Banque fédérale de développement*, [1988] 1 S.C.R. 1061 ("*F.B.D.B.*"). Subject to certain restrictions, s. 49(2) of the *Bankruptcy Act*, R.S.C. 1970, c. B-3 (now s. 69(2)), entitled a secured creditor to "realize or otherwise deal with his security in the same manner as he would have been entitled to realize or deal with it if this section had not been passed". The question before the Court was whether federal or provincial law determined the order of priorities of distribution when a secured creditor availed himself of s. 49(2) to liquidate his security outside of the bankruptcy proceedings. Interestingly, the provincial security interest was a privilege registered on the debtor's immovable property by the Commission de la santé et de la sécurité du travail under s. 110(1) of the Quebec *Workmen's Compensation Act*, R.S.Q. 1977, c. A-3, which ranked its privilege as a claim "ranking immediately after law costs without registration".

20 Speaking for the Court, Lamer J. noted at p. 1066 that this provincial legislation was in direct conflict with the *Bankruptcy Act*:

> If the provincial law rules prevail, respondent is a secured creditor and its debt ranks before that of the trustee. If on the other hand the *Bankruptcy Act* has priority, the scheme of distribution set out in s. 107 of the Act determines the priority ranking. According to the decision of this Court in *Deloitte, supra*, respondent would then lose the benefit of its privilege and become merely a preferred creditor, since its claim is dealt with by s. 107(1)(*h*) ...

21 After concluding that the immovable property remained "property of the bankrupt" within the meaning of s. 47 (now s. 67) of the *Bankruptcy Act* notwithstanding its seizure by the bankrupt's trustee and mandatary (at p. 1068), Lamer J. stated at p. 1069:

> The issue then is to determine what legislation, provincial or federal, applies here. A problem of the same type came before this Court in *Re Bourgault* and *Deloitte, supra*. In *Re Bourgault*, this Court held that in a bankruptcy matter s. 107(1)(*j*) of the *Bankruptcy Act* determines the priority of any claim covered by that provision. *A provincial statute cannot override the scheme of distribution set out in s. 107 of the Act*. To borrow the words of Pigeon J. (at p. 44), *"Parliament intended to put all debts to a government on an equal footing; it therefore cannot have intended to allow provincial statutes to confer any higher priority*." Similarly, the majority of the Court in *Deloitte* held that a creditor who holds a privilege under a provincial statute cannot claim the status of a secured creditor within the meaning of the *Bankruptcy Act* so as to avoid the

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> order of distribution of s. 107 of the Act. *In the event of bankruptcy, priorities are exclusively a matter for federal jurisdiction*. (Emphasis added.)

22 It is important to stress that the respondent in *F.B.D.B.* sought to distinguish the Court's earlier decisions of *Re Bourgault* and *Deloitte, Haskins*. Lamer J. stated the respondent's argument thus (at p. 1070):

> ... respondent is arguing that, as the hypothecated property was liquidated outside the bankruptcy proceeding, without involvement by the trustee in bankruptcy, the solution must be sought not in federal but in Quebec law. Respondent added that, as the trustee chose to realize his security himself outside the bankruptcy, he must bear the consequences of that choice and accept the order of collocation determined by provincial statutes.

But the Court rejected this attempt to circumvent the order of priorities required by the *Bankruptcy Act*. Lamer J. ruled at p. 1071:

> ... I feel that the decisions in *Re Bourgault* and *Deloitte* are conclusive as to the fate of the appeal. These cases stand for the following proposition: *in a bankruptcy matter, it is the Bankruptcy Act which must be applied. If a bankruptcy occurs, the order of priority is determined by that ranking in s. 107 of the Act, and any debt mentioned in that provision must therefore be given the specified priority*. (Emphasis added.)

23 As a result, Lamer J. classified the respondent as a preferred creditor in s. 107(1)(*h*) of the *Bankruptcy Act*. He accepted, at p. 1072, that this result might encourage secured creditors "to bring about the bankruptcy of their debtor in order to improve their title". Nevertheless, he was mindful that "this solution has obvious advantages". As he explained at p. 1072:

> As soon as the bankruptcy occurs the *Bankruptcy Act* will be applied: *the mere fact that a creditor is mentioned in s. 107 of the Act suffices for such creditor to be ranked as a preferred creditor and in the position indicated in that provision*. As provincial statutes cannot affect the priorities created by the federal statute, *consistency in the order of priority in bankruptcy situations is ensured from one province to another*. (Emphasis added.)

24 Finally, in *British Columbia v. Henfrey Samson Belair Ltd.*, [1989] 2 S.C.R. 24, at issue was whether the deemed statutory trust created by s. 18 of the British Columbia *Social Service Tax Act*, R.S.B.C. 1979, c. 388, in favour of the province for provincial sales tax collected was a valid trust within the meaning of s. 47(*a*) (now s.67(*a*)) of the *Bankruptcy Act*. Section 47(*a*) exempted "property held by the bankrupt in trust for any other person" from "the property of a bankrupt divisible among his creditors". A majority of the Court ruled that this deemed statutory trust was not a valid trust. Instead, the province's claim for the monies collected under the purported trust was really a Crown preferred claim under s. 107(1)(*j*) of the *Bankruptcy Act*, which covered "claims of the Crown ... in right of Canada or of any province".

25 Speaking for the majority, McLachlin J. noted at p. 30 that the impugned deemed statutory trust lacked the essential attributes of a trust under general principles of trust law, namely the possibility of being identified and traced. She stated at p. 33:

> To interpret s. 47(*a*) as applying not only to trusts as defined by the general law, but to statutory trusts created by the provinces lacking the common law attributes of trusts, would be to permit the provinces to create their own priorities under the *Bankruptcy Act* and to invite a differential scheme of distribution on bank-

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ruptcy from province to province.

26 Significantly, McLachlin J. also stated, at pp. 33-34, the Court's preference for an interpretation of s. 47(*a*) consistent with "the clear intention of Parliament, in enacting the *Bankruptcy Act*, of setting up a clear and orderly scheme for the distribution of the bankrupt's assets".

27 Moving to the nature of the legal interests created by s. 18 of the *Social Service Tax Act*, McLachlin J. noted at p. 34 that at the moment of collection the "trust property is identifiable and the trust meets the requirements for a trust under the principles of trust law". However, she was cautious to note that the trust monies are soon mingled with other money in the hands of the merchant and converted to other property, and as a result they could not be traced. She observed at p. 34:

> ... as the presence of the deeming provision tacitly acknowledges, the reality is that after conversion the statutory trust bears little resemblance to a true trust. There is no property which can be regarded as being impressed with a trust. Because of this, *s. 18(2) goes on to provide that the unpaid tax forms a lien and charge on the entire assets of the collector, an interest in the nature of a secured debt*. (Emphasis added.)

McLachlin J. was thus at pains to stress that the reality of the property interest created by the province ought to govern over the form, and as a result the province's claim necessarily failed.

28 McLachlin J. also addressed the province's contention that it remained sovereign over the definition of what constitutes a trust. She made the following important observations at p. 35:

> The province ... argues that it is open to it to define "trust" however it pleases, property and civil rights being matters within provincial competence. The short answer to this submission is that the definition of "trust" which is operative for purposes of exemption under the *Bankruptcy Act* must be that of the federal Parliament, not the provincial legislatures. *The provinces may define "trust" as they choose for matters within their own legislative competence, but they cannot dictate to Parliament how it should be defined for purposes of the Bankruptcy Act: Deloitte Haskins and Sells Ltd. v. Workers' Compensation Board*. (Emphasis added.)

29 As a result, McLachlin J. ruled that the provincial legislation was inapplicable in bankruptcy and that the province's claim was governed by s. 107(1)(*j*) of the *Bankruptcy Act*.

(ii) The Principles and Philosophy Embodied in the Quartet

30 What principles should be distilled from the quartet?The intervener Attorney General for Saskatchewan suggested that there are two possible interpretations of these decisions: what it called a broader "bottom line" approach which posits that "any time provincial law affects the final result of a bankruptcy, the province is improperly attempting to alter the priorities of distribution"; and a narrower "jump the queue" approach to the effect that "the province cannot attempt to alter the position of a person within the scheme of distribution created by Parliament, vis-à-vis the other creditors who are claiming from the bankrupt's estate".

31 My colleague Iacobucci J. properly rejects the broader "bottom line" approach since, as he indicates, such an approach "risks nullifying the broad array of provincial legislation underpinning the *Bankruptcy Act*" (at para. 142). It is trite to observe that the *Bankruptcy Act* is contingent on the provincial law of property for its operation. The Act is superimposed on those provincial schemes when a debtor declares bankruptcy. As a result,

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provincial law necessarily affects the "bottom line", but this is contemplated by the *Bankruptcy Act* itself. Indeed, it is no exaggeration to say that there is no "bottom line" without provincial law. The "bottom line" approach is therefore not the appropriate characterization of the quartet.

32 However, even rejecting the simplistic "bottom line" approach, I do not agree that the quartet stands for the sole proposition that the provinces cannot "jump the queue". In my opinion, the quartet embodies a consistent and general philosophy as to the purposes of the federal system of bankruptcy and its relation to provincial property arrangements. That philosophy cannot be captured in the pithy but limited proposition that the provinces cannot "jump the queue".

33 The quartet is better stated, in my view, as standing for a number of related propositions which are themselves part of a consistent philosophy. In their lucid and thorough study of the quartet, "The Conflict Between Canadian Provincial Personal Property Security Acts and the Federal Bankruptcy Act: The War is Over" (1992) 71 Can. Bar Rev. 77, at pp. 78-79, Andrew J. Roman and M. Jasmine Sweatman state that the quartet stands for the following four propositions:

> (1) provinces cannot create priorities between creditors or change the scheme of distribution on bankruptcy under s. 136(1) of the Bankruptcy Act;
>
> (2) while provincial legislation may validly affect priorities in a non-bankruptcy situation, once bankruptcy has occurred section 136(1) of the Bankruptcy Act determines the status and priority of the claims specifically dealt with in that section;
>
> (3) if the provinces could create their own priorities or affect priorities under the Bankruptcy Act this would invite a different scheme of distribution on bankruptcy from province to province, an unacceptable situation; and
>
> (4) the definition of terms such as "secured creditor", if defined under the Bankruptcy Act, must be interpreted in bankruptcy cases as defined by the federal Parliament, not the provincial legislatures. Provinces cannot affect how such terms are defined for purposes of the Bankruptcy Act. [Footnote omitted.]

34 See also for concurrence with Roman and Sweatman's general conclusions drawn from the quartet, Jacob S. Ziegel, "Personal Property Security and Bankruptcy: There Is No War! — A Reply to Roman and Sweatman" (1993) 72 Can. Bar Rev. 44, at p. 45.

35 My colleague Iacobucci J. states at para. 141 that the quartet "stands for the position that only those provincial laws which *directly* improve the priority of a claim upon the actual property of the bankrupt over that accorded by the *Bankruptcy Act* are inoperative" (emphasis added). This statement falls within Roman and Sweatman's proposition (1). However, as my summary of those cases has hopefully indicated, the quartet is clearly not limited to provincial "laws which directly improve the priority of a claim". To quote Roman and Sweatman, at p. 78:

> ... the reasoning in [the quartet] is not limited to trusts, nor to situations of colourable legislation attempting to give an artificial preference to government. Rather, these rulings are broad enough to encompass any potential area of conflict between provincial power to legislate in the area of property and civil rights, and exclusive federal jurisdiction over bankruptcy and insolvency.

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In a similar vein these authors add at p. 81:

> The Supreme Court of Canada's quartet of decisions, although dealing with provincial statutory trusts which affected priorities in bankruptcy, has progressively and finally provided a definite ruling on the relationship between priorities under the Bankruptcy Act and *any* other provincial statute which directly or indirectly affects priorities. (Emphasis in original.) [Footnote omitted.]

Importantly, they conclude at p. 105:

> The law, in our opinion, is settled by these four judgments of the Supreme Court of Canada. In all four cases the issues were not whether the provinces could directly and blatantly attempt to alter the scheme of interests of secured and other creditors under what is now section 136(1) of the Bankruptcy Act. Rather, the issue was whether a province could indirectly influence priorities under the Bankruptcy Act. Even in this weaker version of influence, the Supreme Court of Canada has held that the provinces could not.

And in so concluding, they are also quick to caution at p. 106:

> It is also incorrect to state that in all four cases the provinces attempted to redistribute or change priorities by explicitly elevating one of the lower ranked claims to a higher rank. As seen from an examination of the dissenting judgments in *Deloitte Haskins* and *Henfrey*, the provinces were not attempting specifically to target the bankruptcy situation but, rather, to create a general priority. [Footnote omitted.]

36 As a result, the "jump the queue" or "directly improve bankruptcy priorities" approach captures only part of the reasoning of the quartet. As Roman and Sweatman noted, in the *Deloitte, Haskins* and *Henfrey Samson* cases, for example, the provinces were not directly or intentionally attempting to influence bankruptcy priorities. Rather, the provinces enacted laws of general application which sought to create a general priority not necessarily targeted to bankruptcy, but which had the *effect* of altering bankruptcy priorities. This Court nevertheless ruled that such provincial laws were inapplicable in the event of bankruptcy.

37 I underline that the "effect" which Roman and Sweatman speak of is the effect on bankruptcy *priorities* (Roman and Sweatman, at pp. 81-105). Consequently, clear conflict, that is an inconsistent or mutually exclusive result, which in this case entails a *reordering* of federal *priorities*, is necessary in order to declare a provincial law to be inapplicable in bankruptcy.

38 I also think it is important to emphasize the importance of Roman and Sweatman's proposition (3). While I agree with my colleague Iacobucci J. that complete standardization of the distribution of property in bankruptcies is not possible across Canada having regard to the diversity of provincial laws relating to property and civil rights, yet the value of a national bankruptcy system is confirmed by the placing of bankruptcy under exclusive federal jurisdiction. As Professor Hogg has explained (at pp. 25-1 and 25-2):

> ... debtors may move from one province to another, and may have property and creditors in more than one province. A national body of law is required to ensure that all of a debtor's property is available to satisfy his debts, that all creditors are fairly treated, and that all are bound by any arrangements for the settlement of their debtor's debts. Indeed, without these assurances, lenders would be reluctant to extend credit to persons who could evade their obligations simply by removing themselves or their assets across a provincial boundary.

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Furthermore, as my overview of the quartet hopefully indicated, the goal of maintaining a nationally homogeneous system of bankruptcy priorities has properly been a constant concern of this Court. Were the situation otherwise, "Canada [would] have a balkanized bankruptcy regime which [would] diminish the significance of the exclusivity of federal jurisdiction over bankruptcy and insolvency ... Otherwise there could be a different scheme in every jurisdiction; ten different bankruptcy regimes would make ordinary commercial affairs extremely complex, unwieldy and costly, not only for Canadians but also for our international trading partners" (Roman and Sweatman, at pp. 80, 104). This is a prospect which this Court has been acutely mindful of in the past, and its vigilance has ensured the continuing vitality of our nation's bankruptcy legislation. In my view, its past vigilance commends itself to the present and, barring an amendment to s. 91(21) of the *Constitution Act, 1867*, also to the future.

39 In this regard, I agree with Iacobucci J., at para. 127, that a bankruptcy priority is a category, and also that provincial law may result in the content of such categories being different from province to province. However, provincial law does not and cannot define the content of bankruptcy priorities or categories without limitation. Indeed, crucial limitation is imposed by the order of priorities in the *Bankruptcy Act* itself. Thus, while individual provinces can define and rank categories such as "secured creditor" and "trust" as they each have their own purposes, those provincial laws which enter into conflict with the provisions of the *Bankruptcy Act* are simply without application in bankruptcy. Such, indeed, was this Court's unequivocal holding in *Re Bourgault*, *Deloitte, Haskins*, and *F.B.D.B.* with respect to "secured creditors" and in *Henfrey Samson* with respect to "trusts".

40 Finally, I would observe that while in agreement with the above four propositions as embodying the reasoning of the quartet, in my view the list would be more complete with the addition of a fifth and sixth, as fol- lows:

> (5) in determining the relationship between provincial legislation and the *Bankruptcy Act*, the form of the provincial interest created must not be allowed to triumph over its substance. The provinces are not entitled to do indirectly what they are prohibited from doing directly;
>
> (6) there need not be any provincial intention to intrude into the exclusive federal sphere of bankruptcy and to conflict with the order of priorities of the *Bankruptcy Act* in order to render the provincial law inapplicable. It is sufficient that the *effect* of provincial legislation is to do so.

41 I would hope that these propositions need little if any explanation or defence. They are clearly important principles at work in McLachlin J.'s reasons for the majority of the Court in *Henfrey Samson* in concluding that while the province was clearly entitled to define "trust" as it chose for the purposes of provincial law, the *substance* of the interest created was what was really relevant for the purpose of applying the *Bankruptcy Act*. Furthermore, there was no suggestion in that case that the province intended to subvert the scheme of distribution of the *Bankruptcy Act*. Instead, it had simply enacted a valid law of general application pursuant to its exclusive jurisdiction in relation to property and civil rights in the province, and was attempting to give itself a general priority with respect to collected but unpaid sales tax revenues. The Court ruled that the legislation was only inapplicable upon the occurrence of bankruptcy, because it was then that, if it had been applicable, it would have had the effect of conflicting with the scheme of distribution of the *Bankruptcy Act*.

42 What is more, these fifth and sixth propositions bear a close family resemblance to the doctrine of colourability. In describing the colourability doctrine, Professor Hogg has observed (at pp. 15-17):

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> The courts are, of course, concerned with the substance of the legislation to be characterized and not merely its form. The "colourability" doctrine is invoked when a statute bears the formal trappings of a matter within jurisdiction, but in reality is addressed to a matter outside jurisdiction.

See also *R. v. Morgentaler*, [1993] 3 S.C.R. 463 at pp. 496-97, Sopinka J. for the Court. The concern raised by colourable legislation has also been phrased thus: "it is a very familiar principle that you cannot do that indirectly what you are prohibited from doing directly" (*Madden v. Nelson & Fort Sheppard Railway*, [1899] A.C. 626 at pp. 627-28; see also *Laskin's Canadian Constitutional Law*, vol. 1 (5th ed., 1986), by Neil Finkelstein, at p. 310).

43 There are, however, two fundamental differences between the doctrine of colourability and the above propositions (5) and (6). First, the doctrine of colourability is a concept which is only applicable in assessing the threshold question of the *validity* of the impugned legislation, which is to say, its pith and substance. The above propositions, by contrast, continue to apply after having determined the validity of the impugned provincial law when assessing its applicability in the exclusive federal sphere of bankruptcy (see Hogg, at pp. 15-25). In the case at bar, it has been accepted that the provincial law is valid within its sphere; the question is as to its *applicability* outside its sphere, when it intrudes into the exclusive federal sphere of bankruptcy and conflicts with federal bankruptcy legislation.

44 In light of this distinction, it will be evident that none of the quartet cases were concerned with colourable provincial legislation. There was no question as to the validity of the impugned legislation in any of the quartet. Those cases are devoid of *any* suggestion that the impugned laws were anything other than provincial laws of general application, and thus validly enacted laws under the provinces' ex clusive jurisdiction in relation to property and civil rights. Instead, those cases were only concerned with the applicability of provincial laws in bankruptcy, not their validity.

45 This last observation is also an important additional reason why I respectfully believe that it is inaccurate to interpret the quartet as only prohibiting legislation which "directly improves the priority of a claim". Such a characterization suggests that the quartet was concerned with the validity of the impugned laws. However, if the provinces had been attempting to improve the priority of their claims in bankruptcy *directly*, presumably this Court would simply have declared their laws to be ultra vires and invalid for being in relation to an exclusive federal matter, and no question of applicability or operability would ever have arisen.

46 The second crucial distinction between the doctrine of colourability and the above propositions (5) and (6) is that the doctrine of colourability often connotes a legislative *intention* to intrude into an exclusive federal sphere (see Elizabeth Edinger, "Comment" (1985) 63 Can. Bar Rev. 203, at pp. 206-11, and Albert S. Abel, "The Neglected Logic of 91 and 92" (1969) 19 U.T.L.J. 487, at p. 494). But even without such an intention, provincial legislation can quite evidently have the *effect* of trespassing onto an exclusive federal domain, and would thus be equally subject to an examination as to its applicability in the federal sphere. Were the situation otherwise, our constitutional law would countenance the absurd situation that valid provincial legislation of general application which entered into clear conflict with a valid federal law promulgated in an exclusive federal sphere would be exempt from constitutional challenge. In short, a legislative intention to intrude into an exclusive federal sphere is neither necessary nor sufficient to scrutinize the applicability of provincial law. It is the fact of intrusion, and not the intention to intrude, which is determinative for division of powers purposes.

47 As a result, the inquiry in the case at bar must be limited to assessing whether, if applied in bankruptcy,

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the *effect* of s. 133 of the Saskatchewan *Workers' Compensation Act* would be to conflict with the scheme of distribution in the *Bankruptcy Act*. It is this question which I now address.

C. Application of the Quartet to s. 133 of the Saskatchewan Workers' Compensation Act

48

(i) The Nature of the Legal Interest Created by s. 133

49 As I indicated earlier, it is important to examine the operation of s. 133 as a whole in order to address the issue raised in this appeal. This provision creates a curious scheme of liability. Section 133(1) imposes a duty on a principal to ensure that its contractor pays into the Workers' Compensation fund, and declares the principal absolutely liable for those payments in the event of the contractor's default. Using the language of the Civil Law, one might say that the principal (or owner) is under an obligation of diligence or means to ensure that the contractor makes its payments, and in the event of the contractor's default the principal is under an obligation of guarantee to the Board for those payments (see Paul-André Crépeau, *L'intensité de l'obligation juridique ou des obligations de diligence, de résultat et de garantie* (1989), at pp. 8-14). Section 133(3) then entitles the principal to withhold and indemnify itself from any funds owing to the contractor if the principal is deemed liable for the contractor's debt to the Board. In other words, it entitles a principal to set-off against monies owing to the contractor the principal's claim for having paid the contractor's assessments. Finally, s. 133(4) empowers the Board to determine all questions as to the right and amount of the principal's indemnity for discharging the contractor's obligation.

50 In essence, under this scheme the principal is the surety or guarantor *of the contractor's obligation*, with the right and extent of the principal's indemnification from the withheld funds being determined by the provincial Workers' Compensation Board. It is abundantly clear that it is the contractor's obligation which is primarily in issue, since s. 133(3) entitles the principal to be indemnified "by any person *who should have made the payment*" (emphasis added).

51 Furthermore, when s. 133(1) and (3) operate in tandem as intended by this legislation, the principal's right to withhold and be indemnified from monies owing to the contractor in the event that the principal is deemed responsible *for the contractor's liability* means that the principal will ultimately *not* be responsible for that liability. Instead, the debt to the Board is effectively discharged with property of the contractor when the principal exercises its right of set-off. Differently put, when s. 133(1) and (3) operate together, the principal is no worse off after having acted as the contractor's surety. The principal's estate or, to use Civil Law terminology, its patrimony remains entirely unaffected even after discharging its "personal" liability to the Board. As a result of the principal's right of set-off against monies owing to the contractor, it is the contractor's estate or patrimony — which is diminished to the extent of the assessments owing to the Board. The reality of this scheme, then, is that the contractor discharges its own liability to the Board, mediated through the legally compelled agency of the principal.

52 I would add that this is not a scheme of joint and several liability, since the principal and the contractor are not joint co-debtors at the outset. Nor does the Board have an unfettered choice as to which party to sue for recovery for outstanding fund payments, as it would if the principal and contractor were jointly and severally liable for the assessments. (See, for the accepted definitions of joint and several liability, G.H.L. Fridman, *The Law of Torts in Canada*, vol. 2 (1990), at pp. 350-51; Glanville Williams, *Joint Torts and Contributory Negligence* (1951), at pp. 49-50; *Parkland (County) v. Stetar* (1974), [1975] 2 S.C.R. 884 at p. 899 (per Dickson J., as

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he then was).)Instead, upon default a personal liability of the principal is created for the amount owed by the contractor. As a result, the principal is compelled by statute to act as the surety for the contractor's obligation to the Board. I therefore believe that it is more accurate to characterize this provision as creating a form of involuntary, statutory suretyship. It is of course arguable that when the Board deems the principal liable for the contractor's default, they are jointly and severally liable for the assessment, even though the provision does not so specify expressly. But even this would only be an incident of the statutory suretyship in s. 133.

53 It is also clear that while formally the contractor is potentially liable for two debts, namely the debt to the Board for the unpaid assessment and the potential debt to the principal if the principal pays the contractor's assessment, the reality is that these are one and the same *as against the contractor*. The contractor cannot be liable for both cumulatively. There is thus an inseparable nexus between the Board's claim against the contractor and the principal's potential claim against the contractor. This point was well stated by Swinfen Eady L.J. in discussing the nature of suretyship in *Re Melton; Milk v. Towers*, [1918] 1 Ch. 37 at pp. 47-48, followed in *Re Coughlin & Co.* (1923), 4 C.B.R. 294 at p. 300 (Man. C.A.):

> It may well be that technically there are two claims against the debtor in respect of the transaction and two separate liabilities of the debtor arising out of the transaction. One of these is the debtor's liability to the bank for the money that he owed. The other, which is a separate liability arising out of the contract of guarantee, is the debtor's liability to indemnify the sureties in respect of their liability to the principal creditor. *Technically, they are two separate liabilities, but in substance they are the same*; and in respect of that liability there could not be double proof against the estate. (Emphasis added.)

54 As a result, in light of the wording of s. 133 creating a form of involuntary suretyship, I would respectfully qualify Iacobucci J.'s characterization of this provision as imposing joint and several liability on the principal and the contractor for the unpaid assessments (see paras. 129, 183, 184 [pp. 57, 73, 73, post).

55 With these preliminary remarks on the structure of the scheme of liability in s. 133 in mind, it is clear that when s. 133(1) operates in combination with s. 133(3), the effect is to secure the claim of the Saskatchewan Workers' Compensation Board against assets of the contractor. This is accomplished through the *combined* operation of the statutory deemed debt imposed on the principal in the event of the contractor's default *and* the right of the principal to withhold and be indemnified from monies owing to the contractor. Thus, the combined effect of the deemed debt in s. 133(1) and set-off in s. 133(3) secures the Board's claim against the contractor's assets.

56 Read in this way, s. 133 creates a straightforward security device. This device secures the claim of the Workers' Compensation Board. When s. 133(1) operates in tandem with s. 133(3), the principal becomes nothing more than a conduit for transferring to the Board monies which are otherwise owed to the contractor. In other words, the principal essentially transfers an asset of the contractor (i.e., monies owing from the principal to the contractor) to the Board. This is because it is the *contractor's* liability for unpaid assessments which is imposed on the principal, and the *contractor's* monies which are withheld as security in order to be paid to the Board for the contractor's default. While s. 133(1) speaks of the principal's personal liability in the event of the contractor's default, the reality of the matter is that it is the contractor who is still liable, since as a result of s. 133(3) monies owing to the contractor are used to satisfy the debt owing to the Board. The contractor's patrimony is diminished to the extent of the liability to the Board for the unpaid assessment, whereas the size of the principal's patrimony remains unaffected. The net effect is thus that the contractor's liability is discharged out of its own property, and not from any property of the principal. The exercise of set-off, triggered by the deemed debt, thus has the effect of securing the Board's claim against the contractor's assets.

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(ii) Does s. 133 Apply in Bankruptcy?

57 It is apparent that it is the set-off component of this device, s. 133(3), which effects a security interest in property of the contractor. But the right to set-off is triggered — and thus the security interest created — by the Board when it decides to create a deemed debt and impose liability on the principal for the contractor's liability. This right is, of course, perfectly valid outside of bankruptcy. The question is whether it continues to apply or operate in bankruptcy. In order to answer this question, a few words about the operation of set-off in bankruptcy are in order.

(a) The Operation of Set-Off in Bankruptcy

58 In *Lister v. Hooson*, [1908] 1 K.B. 174 (C.A.), Fletcher Moulton L.J. stated what has become one of the most accepted rationales for allowing set-off in bankruptcy (at p. 178):

> The right of set-off in bankruptcy has been dealt with by various statutes, but takes its origin from the fact that the jurisdiction in bankruptcy was from the first an equitable jurisdiction. The successive statutory formulations of the consequence of this principle, embodied in the clauses as to mutual credit, dealings, &c., have never altered this fundamental principle, and, speaking for myself, I cannot see any ground why in the present instance the injustice should be perpetrated of making a person who in the balance is not a debtor to the estate pay in full the sum due to the estate and receive only a dividend on the sums due from the estate.

(See also *Fredericton Co-operative Ltd. v. Smith* (1921), 2 C.B.R. 154 (N.B. K.B.), at pp. 157-58; *Atlantic Acceptance Corp. v. Burns & Dutton Construction (1962) Ltd.* (1970), 14 D.L.R. (3d) 175 (Alta. C.A.), at p. 184; and, for a particularly thorough and helpful discussion of the issues relating to set-off in bankruptcy and insolvency, see Kelly R. Palmer, *The Law of Set-Off in Canada* (1993), at pp. 157-223.)

59 In the bankruptcy context, a right to set-off necessarily has the effect of securing the claim of the party claiming set-off against assets of the bankrupt's estate. This was recently recognized in unambiguous terms by Lord Hoffmann in his speech for the unanimous House of Lords in *Stein v. Blake*, [1995] 2 All E.R. 961. His Lordship stated [p. 964]:

> Bankruptcy set-off ... affects the substantive rights of the parties by enabling the bankrupt's creditor to use his indebtedness to the bankrupt as a form of security. Instead of having to prove with other creditors for the whole of his debt in the bankruptcy, he can set off pound for pound what he owes the bankrupt and prove for or pay only the balance.

60 The security character of set-off is also borne out in several academic authorities. John A.M. Judge and Margaret E. Grottenthaler note in their article "Legal and Equitable Set-Offs" (1991) 70 Can. Bar Rev. 91, in discussing equitable set-off, which alone operates in the context of an assignment (at p. 92):

> The application of equitable set-off answers, in whole or in part, the plaintiff's claim. In this sense it has a self-help remedial aspect. *Because equitable set-off applies as against an assignee, a security interest is effectively created in favour of the defendant which takes priority over the claim of the assignee*. (Emphasis added.)

They later add (at p. 117):

> If successful on his equitable set-off, the defendant's claim will be paid in full, or at least to the extent of the

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> plaintiff's claim. Therefore, equitable set-off in effect gives an unsecured defendant priority over all secured and unsecured creditors.

Similarly, Palmer notes (at p. 204):

> ... by allowing set-off to operate in a bankruptcy, an otherwise unsecured creditor can obtain a secured status and so can be paid the full value of the debt owed by the bankrupt before the general distribution of the estate to unsecured creditors.

Palmer also observes that the operation of set-off has been described as creating a "quasi-lien" against the cross-demand of the estate (Palmer, at p. 206). The operation of set-off in bankruptcy can therefore be said to confer on the party claiming set-off a security interest or "quasi-lien" against assets of the bankrupt's estate.

61 Indeed, as a result of creating a type of security interest in the estate, the operation of set-off in bankruptcy has been the subject of academic criticism: see Palmer, at pp. 204-207; Judge and Grottenthaler, at p. 117; John C. McCoid, "Setoff: Why Bankruptcy Priority?" (1989) 75 Va. L. Rev. 15, and for counterpoint, Philip T. Lacy, "Setoff and the Principle of Creditor Equality" (1992) 43 S. Cal. L. Rev. 951. The central criticism has been that while outside of bankruptcy set-off strikes a fair balance between two parties with mutual obligations, in bankruptcy the material inquiry should be the rights of the estate's creditors inter se. An inquiry which considers the rights of creditors inter se must necessarily consider a broader range of interests than an inquiry limited to ensuring fairness between only two parties (McCoid, supra, at p. 43). Thus, allowing set-off in bankruptcy has been considered as unfairly limiting the class of relevant interests. The concern has also been voiced that allowing set-off in bankruptcy (Judge and Grottenthaler, at p. 117):

> ... is disruptive of a complex and sophisticated system developed for establishing priorities amongst creditors of various types, particularly where registration of a secured interest is required.

This second concern is thus to the effect that allowing set-off gives a claimant the benefit of a security interest without imposing the important concomitant obligation of registering that interest.

62 While this academic debate is undoubtedly interesting, the fact remains that our Parliament has recognized in s. 97(3) of the *Bankruptcy Act* that the "law of set-off applies to all claims made against the estate of the bankrupt". As a result, in the bankruptcy context, the law of set-off allows a debtor of a bankrupt who is also a creditor of the bankrupt to refrain from paying the full debt owing to the estate, since it may be that the estate will only fulfil a portion, if that, of the bankrupt's debt. Consequently, in this limited sense the party claiming set-off has Parliament's blessing for the "reordering" of his priority in bankruptcy by virtue of the operation of the law of set-off.

63 But there is an inherent limit to this deference to the provincial law of set-off. While the operation of set-off is permitted to allow for *the party claiming set-off* to recover from the estate ahead of the stipulated order of his claim under the *Bankruptcy Act*, it most emphatically is not permitted to allow for the operation of provincial legislation to reorder the priorities of third parties against the estate — and by "third parties" I do of course mean the priority of any person other than the person who claims set-off against the estate. If provincial legislation were to have this effect, on the consistent authority of the quartet it must be declared inapplicable in bankruptcy.

64 Indeed, the existence of such an intrinsic constitutional limit to the application of provincial law in rela-

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tion to property and civil rights has also been found in the context of defining secured creditors. The *Bankruptcy Act* defines "secured creditor" in s. 2, but defers to provincial law for the purpose of creating secured claims. The quartet of cases in this Court decided that the provinces are entitled to define secured creditors as they wish for their own purposes, but in bankruptcy those definitions which have the effect of reordering the priorities in the *Bankruptcy Act* are simply without application. In the same vein, the law of set-off is permitted to operate, but only to the extent that provincial legislation purporting to create a set-off does not have the effect of reordering federal priorities with respect to the claims of third parties against the estate. Federal deference to provincial law is thus necessarily limited by the order of priorities in the *Bankruptcy Act*.

65 Differently put, to paraphrase Wilson J. in *Deloitte, Haskins*, supra, at p. 806 (who in turn was discussing the ratio of this Court's decision in *Rainville*, supra), the question in the case at bar is not whether a proprietary interest has been created under the relevant provincial legislation by combining the instruments of deemed debt and set-off. It is whether the provincial legislation, even if it has created a proprietary interest, can defeat the scheme of distribution under s. 136 of the *Bankruptcy Act*. In the case at bar, it will defeat that scheme if it secures against the estate the claims of third parties whom Parliament has given a lower priority under s. 136.

66 The question in this appeal thus reduces to the following: does the operation of s. 133 have the effect of reordering federal priorities with respect to the claims of any third parties against the estate?

(b) Does s. 133 Affect Bankruptcy Priorities?

67 Prior to bankruptcy, the security device created by s. 133(3) and triggered by s. 133(1) is, of course, perfectly within the province's jurisdiction. However, if applicable in the event of bankruptcy, it would enter into conflict with the scheme of distribution under the *Bankruptcy Act*. Parliament has expressly indicated in s. 136(1)(*h*) that "all indebtedness of the bankrupt under any Workmen's Compensation Act" is to rank eighth in the list of preferred claims, to be distributed after the claims of secured creditors. By contrast, the combined effect of s. 133(1) and 133(3) of the Saskatchewan *Workers' Compensation Act* is to secure the Board's claim *against the bankrupt's estate* ahead of its priority under the *Bankruptcy and Insolvency Act*. The two laws in their operation give rise to different and inconsistent orders of priority and are thereby in conflict. They operate as contrary directives as to the way assets on bankruptcy are to be distributed.

68 To explain how this result is effected, it is first important to remember that monies owing to the contractor but withheld by the principal are debts due to the bankrupt. They are thus unquestionably "property of the bankrupt" under the *Bankruptcy Act*, since s. 2 of the Act defines "property" to include "obligations". The monies held back are simply accounts receivable of the bankrupt (see, for example, *Re Invitation Prêt-à-Porter Inc.* (1979), 31 C.B.R. (N.S.) 54 at p. 58 (Que. S.C.); L.W. Houlden and C.H. Morawetz, *Bankruptcy and Insolvency Law of Canada*, vol. 1 (3rd ed., revised 1993), at F§45; Lewis Duncan and John D. Honsberger, *Bankruptcy in Canada* (3rd ed., 1961), at pp. 307-308).

69 Next, it is accepted that where the principal retains monies owing to the contractor, the Board's decision to deem the principal liable for the contractor's assessment has the effect of allowing the principal a right of set-off against the bankrupt estate. This right of set-off allows the principal to realize on a security interest or "quasi-lien" against the estate. However, this process of realization has the *effect* of securing the Board's claim *against the estate*. The estate is diminished to the extent of the contractor's liability to the Board, and the Board is correspondingly enriched by an identical amount. The principal's estate or patrimony remains unaffected. The Board's claim has thus been secured *against the bankrupt estate*, mediated through the legally compelled agency

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of the principal.

70 Nor, incidentally, can this process be justified by reference to the law of set-off. While the law of set-off incorporated by reference in s. 97(3) of the *Bankruptcy Act* would permit the principal to secure its own claim against the estate, it does not permit the province to enact legislation which confers the same benefit on a third party, in this case the Board, since such legislation would have the effect of reordering priorities with respect to an entire class of preferred claims. We have consistently held that the deference to provincial law in the *Bankruptcy Act* does not extend to the reordering of claims against the estate. At that point, provincial law simply ceases to apply for intruding into an exclusive federal sphere. Such, then, must also be the fate of the impugned legislation in this appeal.

71 I therefore respectfully disagree with the conclusion of the Ontario Court of Appeal in *Re Evelyn Stevens Interiors Ltd.* (1993), (sub nom. *Ontario (Workers' Compensation Board) v. Evelyn Stevens Interiors Ltd. (Trustee of))* 100 D.L.R. (4th) 742 at pp. 748-49, in holding that s. 9(3) and (4) of the Ontario *Workers' Compensation Act*, R.S.O. 1980, c. 539 (equivalent to Saskatchewan's s. 133(1), (3) and (4)) are applicable in bankruptcy. The court reasoned (at pp. 748-49):

> The principle is simple. The money owing under s. 9(3) is not property of the bankrupt and never comes into the hands of the trustee. The board is not required to make a claim under s. 136 of the *Bankruptcy Act*. The money comes to it under s. 9 of the *Workers' Compensation Act*. It is the *Bankruptcy Act* itself and not the provincial legislation that recognizes rights of set-off ...
>
> A valid set-off, as defined under provincial law, would inevitably alter the priorities in a bankruptcy but that is what the *Bankruptcy Act* itself contemplates ...
>
> The money in the case at bar has never (or should never have) come into the hands of the trustee. It is money that has been (and should remain) in the hands of the principals to compensate them for money that they are (or will be) bound to pay to the board.

72 The court thus concluded, first, that the principal paid the Board out of its own funds and not from property of the bankrupt. But this is only true in a trivial sense. When the set-off is effected, the estate is diminished to the extent of the indemnity and the principal's patrimony is entirely unaffected. The principal's "personal" liability is thus converted by set-off to a mere bookkeeping entry, and the debt satisfied by the estate. As a result, with respect, here the Ontario Court of Appeal has chosen form over substance.

73 Second, the court appeared to attach considerable importance to the fact that the monies owing should never have come into the "hands of the trustee". But with respect, the relevant question was simply whether these monies were *property of the bankrupt*, and not whether they were or should have been in the hands of the trustee. And since such monies are unquestionably property of the bankrupt, the Board has in effect secured its claim *against the estate*.

74 Third, and perhaps most importantly, the Ontario Court of Appeal concluded that the *Bankruptcy Act* itself recognizes set-off, and this will inevitably alter priorities in bankruptcy. With respect, the Court of Appeal's statement is overly broad. As already indicated, it is true that s. 97(3) allows the principal to secure his claim against the estate, whatever his priority under s. 136. In this limited sense, a "valid set-off, as defined under provincial law, would inevitably alter the priorities in a bankruptcy". Here, however, the effect is much broader, and entails securing by legislation the claim of a third party against the estate, thereby circumventing the order of

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priorities in the *Bankruptcy Act*.

75 Differently put, in the bankruptcy context, the law of set-off simply allows a debtor of a bankrupt who is also a creditor of the bankrupt to refrain from paying the full debt owing to the estate, since it may be that the estate will only fulfil a portion, if that, of the bankrupt's debt. Set-off is simply a defence to the payment of a debt, not a basis for validating statutory security devices which have the effect of securing the claims of *third parties* against the estate. Indeed, the defensive character of set-off is reflected in the wording of s. 97(3) which stipulates that set-off applies to "all claims made against the estate of the bankrupt and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt".

76 As a result, with the greatest respect, the reasoning of the Ontario Court of Appeal is flawed for applying provincial legislation which has the effect of securing against the estate an entire class of claims specifically given a lower priority by the *Bankruptcy Act*.

77 What is more, if the Ontario Court of Appeal's interpretation of s. 97(3) were correct, the consequences would be far-reaching. The provinces would, in effect, be entitled to create property interests which have the effect of subverting the federal scheme of distribution by purporting to validate them as set-offs. Nor is there any reason in principle why the provinces would be limited to rearranging federal priorities with respect to unpaid workers' compensation assessments. Each and every province would be licensed to create similar security devices to secure claims of their choosing, and thereby subvert entirely Parliament's chosen scheme of distribution. This prospect was repudiated by this Court in each of the cases in the bankruptcy quartet. The concerns voiced in those cases apply with equal force to this appeal. To rule otherwise would be to invite a balkanization of the scheme of bankruptcy priorities across the country and to tolerate the evisceration of Parliament's exclusive jurisdiction over bankruptcy conferred by our Constitution. The provinces are not entitled to so proceed, and thereby do indirectly what they are prohibited from doing directly. Our courts must therefore be vigilant to scrutinize the substance of the interests created and not rest content with merely examining their form.

78 I would add that apart from the security device created by the combined effect of s. 133(1) and (3), s. 133(4) also has the effect of intruding into the exclusive federal sphere of bankruptcy. It will be recalled that s. 133(4) states that "all questions as to the right to and the amount of such indemnity shall be determined by the board". If allowed to apply in bankruptcy, this provision would have the effect of empowering a creditor of the estate (here the Board) to determine unilaterally the extent of its claim against the estate. As a result, the Board would be empowered to decide the size of the estate which is to remain available for the other secured, preferred and ordinary creditors. A province cannot empower a creditor of a bankrupt to determine the extent of a bankrupt's estate which is to be available for distribution. Thus, while otherwise perfectly valid provincial law, s. 133(4) is also inapplicable in the event of bankruptcy.

79 At this point, I should perhaps stress that nothing I have said detracts from a province's authority to impose liability on a third party for a bankrupt's debt. What a province cannot do, however, is create a statutory security device which has the effect of reordering the priorities of distribution of the assets in the bankrupt's estate. In such a case, what is otherwise valid provincial legislation is simply without application upon the occurrence of bankruptcy. To repeat, it is the *combined effect* of the statutory deemed debt *and* the right to withhold (and then set off against) property of the bankrupt which secures the Board's claim against property of the bankrupt. It is for this reason that examining the constitutional validity of s. 133(1) separately from s. 133(3) fundamentally obscures the nature of the legal interest created. Such an approach misses that this is nothing but a straightforward security device triggered by the province for securing the Board's claim against the estate, in exactly the

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same way that breaking a contract of pledge into debt and bailment and examining the validity of these legal interests separately would obscure the essential character of pledge as a security device.

80 It is therefore my conclusion that s. 133 is inapplicable in bankruptcy for intruding into an exclusive federal sphere.

81 In the foregoing, I have proceeded on the basis that s. 133(1) operates in tandem with s. 133(3), that is, that the principal has monies owing to the contractor which it can use as a basis for set-off when the Board deems it liable for the contractor's assessment. Where a principal has such monies owing, it was clearly the Legislature's intention that such a right to set-off be exercised in order that the contractor ultimately be responsible for its own assessment. In this sense, where both s. 133(1) and (3) potentially apply on the facts of a given case, it was clearly the Legislature's intention that the right to set-off be exercised. As a result, in such a case s. 133 is inapplicable in toto against the bankruptcy.

82 However, there may be instances where the principal does not hold or retain any monies owing to the contractor. While the Court did not have the benefit of extensive submissions on this point, I believe it is quite plausible to conclude that the principal can then claim from the estate as a preferred creditor under s. 136(1)(*h*), since its claim is comprehended within "indebtedness of the bankrupt under any Workmen's Compensation Act". This would appear to be permis sible because on its plain wording s. 136(1)(*h*) specifies only the nature of the claim and not the identity of the claimant. As a result, if only s. 133(1) applies, the Board has not secured its claim against the estate but recovers only from the principal. The scheme of distribution of assets in the estate is thereby unaffected. In such a case, there is no constitutional reason why full effect should not be given to provincial law within its legitimate sphere of operation. I would therefore only read down s. 133 to the extent that in application it enters into conflict with the scheme of distribution in the *Bankruptcy Act*. Where s. 133(1) alone is engaged in a given case, the Board's claim against the principal continues to be fully applicable.

(c) The Appropriate Remedy: Is s. 133 Inapplicable or Inoperative?

83 I have already concluded that the impugned legislation must be declared inapplicable rather than inoperable in bankruptcy. I should perhaps explain that this is preferable for the simple reason that bankruptcy is an exclusive federal domain within which provincial legislation does not apply, as distinguished from areas of joint or overlapping jurisdiction where federal legislation will prevail, rendering provincial legislation inoperable to the extent of any conflict. However, as bankruptcy is carved out from the domain of property and civil rights of which it is conceptually a part, valid provincial legislation of general application continues to apply in bankruptcy until Parliament legislates pursuant to its exclusive jurisdiction in relation to bankruptcy and insolvency. At that point, provincial legislation which conflicts with federal law must yield to the extent of the conflict (*Tennant v. Union Bank of Canada*, [1894] A.C. 31 (P.C.); *Crown Grain Co. v. Day*, [1908] A.C. 504 (P.C.)) and it becomes inapplicable to that extent. Consistent with the presumption of constitutionality — that the enacting body is presumed to have intended to enact provisions which do not transgress the limits of its constitutional powers — the provincial law should be read down to the extent of the conflict. In other words, it should be interpreted so as not to apply to the matter that is outside the jurisdiction of the enacting body.

84 This, I believe, has been the trend of this Court's approach to matters of applicability and operability. For example, in refusing to apply the paramountcy doctrine in *Deloitte, Haskins*, Wilson J. explained (at p. 807):

> I think rather that the applicable principle is the one stated by Laskin C.J. in *Quebec North Shore Paper Co. v. Canadian Pacific Ltd.*, [1977] 2 S.C.R. 1054, at p. 1065, to the effect that "if the provincial legislation is

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> of general application, it will be construed so as not to apply to such enterprises", *i.e.*, those within federal competence.

She concluded at p. 808:

> I believe that the trend of the more recent authorities favours a restrictive approach to the concept of "conflict" and a construction of impugned provincial legislation, where this is possible, so as to avoid operational conflict with valid federal legislation. Where this is done both provisions can stand and have their own legitimate spheres of operation. In this sense I find no conflict between s. 107(1) of the *Bankruptcy Act* and s. 78(4) of *The Workers' Compensation Act*. I would accordingly answer the question as framed by stating that s. 107(1)(*h*) of the *Bankruptcy Act* applies to determine priorities on a bankruptcy and s. 78(4) of *The Workers' Compensation Act* has no application in such a situation.

85 Another way of explaining this approach is simply to say, with Lamer J. in *F.B.D.B.*, that "in a bankruptcy matter, it is the *Bankruptcy Act* which must be applied" (supra, at p. 1071).

86 This was also the Court's approach in *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121. The case concerned the relationship between *Bank Act* security interests and the provincial procedural requirements for seizure under the Saskatchewan *Limitation of Civil Rights Act*. Speaking for the Court, La Forest J. found the federal and provincial legislation to conflict in operation. However, he added at p. 155:

> I have dealt with this case on the basis of paramountcy to meet the arguments put forward by counsel. *But the issue can, I think, be answered more directly. At the end of the day, I agree with counsel for the Attorney General of Canada that this is simply a case where Parliament, under its power to regulate banking, has enacted a complete code that at once defines and provides for the realization of a security interest. There is no room left for the operation of the provincial legislation and that legislation should, accordingly, be construed as inapplicable to the extent that it trenches on valid federal banking legislation*.
>
> In response to the third question, then, I would hold that ss. 19 to 36 of *The Limitation of Civil Rights Act*, if interpreted to include a s. 178 security, conflict with ss. 178 and 179 of the *Bank Act* so as to render ss. 19 to 36 inoperative in respect of the security taken pursuant to s. 178 by a chartered bank. To put it another way, ss. 19 to 36 of *The Limitation of Civil Rights Act* are inapplicable to security taken pursuant to ss. 178 and 179 of the *Bank Act*. (Emphasis added.)

87 I fully endorse this approach, and am of the opinion that my colleague La Forest J.'s remarks apply mutatis mutandis to the present appeal. Parliament has enacted a complete code in the *Bankruptcy Act*, one which necessarily calls upon provincial law for its operation. But Parliament's invitation stipulates an important limitation at the threshold of its domain, namely, that provincial law simply cannot apply when to do so would entail subverting the federal order of priorities in the *Bankruptcy Act*.

88 I therefore agree with the submissions of the Attorney General for Canada and find that s. 133 is inapplicable in bankruptcy when s. 133(1) operates together with s. 133(3) as it trenches on valid federal bankruptcy legislation.

89 In view of Iacobucci J.'s statement that "[provincial] legislation that is intra vires is permitted to have an incidental and ancillary effect on a federal sphere", I think it appropriate in concluding to summarize my view as to the proper constitutional analysis where federal and provincial legislation potentially conflict. One must first

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determine whether the laws are respectively valid federal or provincial legislation. If so, the actual operation of the laws must be examined to determine whether they are in operational conflict, that is, inconsistent or incapable of being fully complied with in a given situation. If they are in operational conflict, the federal legislation prevails and the provincial legislation is without effect to the extent of this conflict. If the operational conflict is in a field of exclusive federal jurisdiction, the provincial legislation will be inapplicable as being ultra vires to that extent. If the conflict is in an area of concurrent or overlapping jurisdictions, the provincial legislation will remain intra vires but be inoperative. To the extent that there is operational conflict, there is no room for an incidental or ancillary effect of provincial legislation. If, on the other hand, there is no operational conflict, then both laws continue to operate and both continue to have effect to the extent that operational conflict does not arise. Short of operational conflict, provincial law may validly have an effect on bankruptcy, as I have indeed acknowledged in observing that there is no bankruptcy "bottom line" without provincial law (at para. 122). In the present case, I have found clear operational conflict in that s. 133(1) and (3) in their operation together entail a reordering or subverting of the federal order of priorities under the *Bankruptcy Act*. Such an intrusion into an exclusive federal sphere necessarily goes far beyond an incidental and ancillary effect. I believe this proposition runs through my reasons.

D. Residual Issues

90 Finally, as my colleague Iacobucci J. notes, before this Court the Bank of Montreal raised factual and legal issues which had not been raised in the courts below. Specifically, the Bank argued that Husky was not liable under s. 133 for payment of Metal Fab's assessments since the Board was obliged to issue a demand against Metal Fab before issuing one against Husky. Similarly, the Board and the Bank argued that Husky cannot indemnify itself out of funds owing to Metal Fab since Husky received the demand from the Board after Metal Fab had given notice of assignment of its book debts to the Bank of Montreal. Since, as outlined, it is my opinion that s. 133 simply has no application in the event of bankruptcy, these threshold factual questions need not be addressed.

91 With respect to Husky's further argument that it was not in breach of its statutory duty under s. 133 to ensure payment by Metal Fab, again this question need not be addressed since s. 133 has no application upon the occurrence of bankruptcy.

92 The Bank also argued that s. 133 should be interpreted to limit Husky's liability to unpaid workers' compensation assessments with respect to the specific work performed for Husky by Metal Fab, and not for all Metal Fab's outstanding unpaid assessments which includes work for other principals. While it is not necessary to answer this question given my disposition of this appeal, I agree with Iacobucci J. that the liability under s. 133 is limited to unpaid assessments in respect of work performed for Husky. This less Draconian interpretation is confirmed by the recent clarifying amendment to s. 133 which inserted the words "pursuant to this Act with respect to that work" after "contribute to the fund" (*The Workers' Compensation Amendment Act, 1993*, S.S. 1993, c. 63, s. 40).

IV. Disposition

93 For the above reasons, I would answer the constitutional questions posed by Lamer C.J.C. as follows:

> *Question*: 1. Where a contractor as referred to in s. 133 of *The Workers' Compensation Act*, S.S. 1979, c. W-17.1, is in bankruptcy and but for the bankruptcy, the principal as referred to in s. 133 would be liable to pay the assessment due by the contractor under the Act, is s. 133 of the said Act inoperative or inapplicable in

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> whole or in part, by reason of being in conflict with the *Bankruptcy Act*, R.S.C., 1985, c. B-3, and in particular ss. 17(1), 67, 95, 136(1)(*h*), 148, 158(*a*) and 198(*a*) thereof?
>
> *Answer*: Yes. Section 133 is inapplicable in bankruptcy when s. 133(1) operates in tandem with s. 133(3).
>
> *Question*: 2. Was s. 133 of the said Act inoperative or inapplicable in the circumstances of this case?
>
> *Answer*: Yes. Section 133 was inapplicable when Metal Fab entered bankruptcy.

94 I would therefore dismiss the appeal with costs throughout.

Iacobucci J. **(dissenting) (*Sopinka, Cory* and *Major JJ.* concurring):**

95 The broad issue in this appeal is the extent to which a provincial statutory instrument can constitutionally assert itself in the bankruptcy context without entering into operational conflict with the federal *Bankruptcy Act*, R.S.C. 1985, c. B-3. The specific question at issue relates to the constitutional validity of ss. 133(1) and (3) of the Saskatchewan *Workers' Compensation Act, 1979*, S.S. 1979, c. W-17.1. These provisions permit the Workers' Compensation Board ("the Board"), in a situation where a contractor has failed to pay its Injury Fund contributions, to obtain these amounts from a principal of the contractor (subs. (1)). Subsection (3) permits the principal to indemnify itself from the delinquent contractor. It is argued in this case that s. 133(1) and (3) are constitutionally non-operational in a situation where the contractor is bankrupt, especially when that bankrupt has assigned its estate to a secured creditor.

I. Background

96 Husky Oil Operations Ltd. (the principal, hereinafter "Husky") is an owner of a Bi-Provincial Heavy Oil Upgrader at Lloydminster, Saskatchewan. Husky entered into six contracts with Metal Fabricating & Construction Ltd. (the contractor, subsequently the bankrupt, hereinafter "Metal Fab") respecting the construction of the Upgrader. Metal Fab made an assignment in bankruptcy before completing five of those contracts. At the time, Husky owed approximately $800,000 to Metal Fab in the form of hold-backs and contractual debt. These sums were paid into court upon the commencement of the instant legal proceedings.

97 Metal Fab had not paid its required Workers' Compensation Fund contribution for the employees on its payroll. It was alerted to this effect by the Workers' Compensation Board on March 2, 1992 by a Notice of Assessment showing that $208,850.50 was due and payable to the Board. Soon thereafter, the Bank of Montreal (the assignee) acquired a general assignment of book debts from Metal Fab for loans advanced to it. On March 12, 1992, Husky was notified of the Bank's security interest and told that it must pay to the Bank any amounts payable to Metal Fab. The Board was apprised of the ceasing of operations of Metal Fab on March 16, 1992. The Board then looked to Husky since s. 133(1) of *The Workers' Compensation Act* made Husky personally liable in respect of the amounts that Metal Fab had not paid to the Board, but, pursuant to the terms of subs. (3), Husky could recover those sums from Metal Fab. Metal Fab made an assignment in bankruptcy on March 19, 1992. The co-respondent, Deloitte & Touche, was appointed trustee in bankruptcy. Subsequent audits conducted by the Board revealed the amount owing by Metal Fab to the Injury Fund to be $246,745.26. Husky was advised of this increased amount by a letter, dated July 6, 1992. Under the assignment in bankruptcy, Metal Fab assigned a secured debt to the Bank of Montreal in the amount of $1,745,837.

98 Husky and Metal Fab's creditors submit that the operation of s. 133 conflicts with s. 136 of the federal

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Bankruptcy Act, which sets out the priorities of creditors on bankruptcy. Normally in bankruptcy the amount owed by Husky to Metal Fab would be used to satisfy lienholders and the secured creditor Bank of Montreal according to the priorities established in the *Bankruptcy Act*. In the appeal at bar, the Board, given its lower priority, would effectively recover none of the money owed to it by Metal Fab. However, s. 133 of the *Workers' Compensation Act* permits the Board to recover its debt directly from Husky and allows Husky, in turn, to set this off from the amount owed to the bankrupt, thereby effectively reducing the amount of money available to the secured creditor and, it is submitted, improperly affecting the priority scheme established by the *Bankruptcy Act*.

99 The aims of the litigants can be summarized as follows:

(1) Husky wants to avoid the operation of s. 133(1) but, if this provision is found to be valid, argues that s. 133(3) is also operative and, thus, Husky can set off the monies paid to the Board from the monies it owes the bankrupt.

(2) The Bank's position is influenced by the fact that, since it is the principal secured creditor, any funds set-off to Husky are wholly funds that, in the absence of the intervention of the Board, would accrue to the Bank. Consequently, the Bank is principally preoccupied with affirming the non-operability of s. 133(3), realizing, however, that were Husky not to have any liability to the Board then there would be no set-off issue in the first place.

(3) The Board seeks the sums that the bankrupt should have paid to it all along. It relies on s. 133(1) of the provincial legislation and its creation of joint and several liability between the principal and contractor to this effect.

100 By a fiat, dated September 9, 1992, Wedge J. of the Court of Queen's Bench of Saskatchewan held that s. 133 of *The Workers' Compensation Act* was constitutionally inoperative because it altered the scheme of distribution specified in the *Bankruptcy Act*, the ordering of this scheme falling entirely within the legislative competence of Parliament. The Saskatchewan Court of Appeal dismissed the Appellant Board's appeal from that decision. On May 26, 1994, leave to appeal was granted to this Court.

II. Relevant Constitutional and Statutory Provisions

101

Constitution Act, 1867

91.It shall be lawful for the Queen, by and with the Advice and Consent of the Senate and House of Commons, to make laws for the Peace, Order, and good Government of Canada, in relation to all Matters not coming within the Classes of Subjects by this Act assigned exclusively to the Legislatures of the Provinces; and for greater Certainty, but not so as to restrict the Generality of the foregoing Terms of this Section, it is hereby declared that (notwithstanding anything in this Act) the exclusive Legislative Authority of the Parliament of Canada extends to all Matters coming within the Classes of Subjects next hereinafter enumerated; that is to say, —

(21) Bankruptcy and Insolvency.

92. In each Province the Legislature may exclusively make laws in relation to Matters coming within the

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Classes of Subjects next herein-after enumerated; that is to say, —

(13) Property and Civil Rights in the Province.

The Workers' Compensation Act, 1979, S.S. 1979, c. W-17.1

133. — (1) Where a person, whether carrying on an industry included under this Act or not, in this section referred to as the principal, contracts with any other person, in this section referred to as the contractor, for the execution by or under the contractor of the whole or any part of any work for the principal, it is the duty of the principal to ensure that any sum that the contractor or any subcontractor is liable to contribute to the fund is paid and, where the principal fails to do so and the sum is not paid, he is personally liable to pay that sum to the board.

(3) Where the principal is liable to make payment to the board under subsection (1), he is entitled to be indemnified by any person who should have made the payment and is entitled to withhold, out of any indebtedness due to that person, a sufficient amount in respect of that indemnity.

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

97 ...

(3) The law of set-off applies to all claims made against the estate of the bankrupt and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt in the same manner and to the same extent as if the bankrupt were plaintiff or defendant, as the case may be, except in so far as any claim for set-off is affected by the provisions of this Act respecting frauds or fraudulent preferences.

136. (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

(*h*) all indebtedness of the bankrupt under any Workmen's Compensation Act, under any Unemployment Insurance Act, under any provision of the *Income Tax Act* creating an obligation to pay to Her Majesty amounts that have been deducted or withheld, rateably.

III. Judgments Below

(i) Court of Queen's Bench of Saskatchewan, per Wedge J., (1992), 104 Sask. R. 225

102 This decision consisted of a fiat on a non-suit application by Husky that s. 133 of the *Workers' Compensation Act* was inapplicable to it.

103 Wedge J. first reviewed the facts and found that s. 133(1) made Husky personally liable for the payments to the Board yet authorized it to recover these payments from Metal Fab, the contractor. The trial judge then went on to note that the questions at hand were: (1) whether, in a bankruptcy situation, s. 133 encroached upon the exclusive federal jurisdiction over bankruptcy; and (2) whether, if it did not, Husky was entitled to set off the amount it must pay to the Workers' Compensation Board against the monies held in court.

104 Wedge J. answered the first question in the affirmative. She found assistance, in reaching her conclusion, in the decisions of this Court in *Quebec (Deputy Minister of Revenue) c. Rainville*, (sub nom *Re Bourgault*)

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[1980] 1 S.C.R. 35 (later referred to by Wakeling J.A. as *Bourgault v. Quebec (Deputy Minister of Revenue)*), *Deloitte, Haskins & Sells Ltd. v. Alberta (Workers' Compensation Board)*, [1985] 1 S.C.R. 785. *Québec (Commission de la santé et de la sécurité du travail) c. Banque fédérale de développement*, [1988] 1 S.C.R. 1061 ("*F.B.D.B.*"), and *British Columbia v. Henfrey Samson Belair Ltd.*, [1989] 2 S.C.R. 24, colloquially referred to as the "quartet". While acknowledging that [p. 228] "... these decisions are not directly on point where, as here, the claim by the provincial body is against a third party — not the bankrupt", Wedge J. still felt they offered some guidance. In fact, the quartet, combined with some academic authority, led her to conclude that provincial legislative initiatives are invalid simply when they affect the bankruptcy scheme.

105 Reference was also made to the Ontario case of *Re Evelyn Stevens Interiors Ltd.* (1990), 80 C.B.R. (N.S.) 135, where, according to Wedge J. at p. 228, McKeown J. "relied upon the judgment of Madam Justice Wilson in *Deloitte Haskins* for the principle that provincial legislation cannot disturb the priority scheme in s. 136(1) of the *Bankruptcy Act*." It was noted that McKeown J.'s reasoning in *Re Evelyn Stevens Interiors Ltd.* was adopted by Lawton J. in *Serdula Construction Management Inc. v. Saskatchewan (Workers' Compensation Board)*, Q.B.M. 126/91 (April 12, 1992), a case which also involved a claim under s. 133 of *The Workers' Compensation Act*. In *Serdula*, Lawton J. acknowledged that the *Evelyn Stevens* case was being appealed [(1993), 100 D.L.R. (4th) 742], but considered that McKeown J. had been correct. Wedge J. found the facts of the case at bar to be indistinguishable from those in *Serdula*. Ultimately, Wedge J. held that s. 133 of the *Workers' Compensation Act* has no application in a bankruptcy scenario.

106 Wedge J. then turned to the second issue and questioned whether the set-off issue could be separated from the s. 133(1) issue. She concluded at p. 229:

> If Husky does not have to pay the Board out of the monies in court, the amount available to the Trustee is not diminished, the priority scheme in the *Bankruptcy Act* is not altered and there is no conflict between the provincial and federal legislation. It is only subs. (3) of s. 133, taken together with subs. (1) which would have the effect of disturbing the priority scheme. Thus the whole of s. 133 is under attack in the constitutional issue.

107 Wedge J. went on to reject the argument that the set-off provision in s. 133(3) is not in conflict with the *Bankruptcy Act* because, in s. 97(3), the Act itself recognizes rights of set-off. She reasoned at pp. 229-30:

> To interpret the general right of set-off in s. 97(3) as overriding the specific reference to Workers' Compensation payments in the order of priorities would, in my view, ignore the intention of the federal legislation, i.e. the standardization of bankruptcy priorities across Canada.

108 In the end, Wedge J. agreed with Lawton J. in *Serdula*. In the circumstances, she also found it unnecessary to decide the second issue given the interconnection between s. 133(1) and (3), such that the invalidity of the former necessarily triggered the inoperation of the latter.

(ii) Saskatchewan Court of Appeal, per Wakeling J.A. (1993), 116 Sask. R. 46

109 The Court of Appeal for Saskatchewan dismissed the appeal by the Workers' Compensation Board.

110 Wakeling J.A. commenced his analysis by noting, at p. 47, that "this appeal probes the extent to which provincial legislation may affect federal legislation relating to bankruptcy." It was noted that were s. 133 not to exist, the claim of the Board would rank eighth in priority and in many cases would go unpaid; if s. 133 is valid,

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the claim of the Board would be paid by the owner who would then have a claim against the bankrupt estate. According to Wakeling J.A. [p. 48], "the net result is a clear advantage to the W.C.B. as it has managed to assure payment of its claim and leave it to the owner to struggle for repayment under the *Act* either claiming right of set-off or ranking at the bottom of the list of priorities as an unsecured creditor."

111 The observation was then made that the provinces are dissatisfied with the degree of priority s. 136 of the *Bankruptcy Act* provides them. Wakeling J.A., at p. 48, characterized this appeal as but one more attempt by a province "to circumvent the restriction which s. 136 of the *Act* has imposed on the ability of the W.C.B. to collect its claim."

112 Wakeling J.A referred to the "quartet" decisions discussed by Wedge J. and held, at p. 50, that "it is apparent from these cases that the Supreme Court has determined that where the federal powers over bankruptcy have been exercised in the [*Bankruptcy*] *Act*, it is not possible for provincial legislation to change the scheme of distribution which the *Act* has established." Wakeling J.A. rejected the argument according to which s. 133 does not threaten the bankruptcy scheme since it merely permits a right of recovery against a third party surety, not the estate of the bankrupt. He noted that any third party caught by the Board order will want to seek repayment and will use the set-off and indemnification provisions to this effect, thereby interfering with the distribution of the bankrupt's estate. He disagreed with the approach taken by the Ontario Court of Appeal in *Stevens*, supra, in which it was decided that similar legislation which had been contained in the Ontario *Workers' Compensation Act* for many years was not in conflict with the federal bankruptcy scheme. As Wakeling J.A. elaborated, at p. 51:

> It [the Ontario Court of Appeal] concluded that the provincial legislation worked to require the principal to make payment to the Board so that the Board having received payment had no claim under the *Act* against the bankrupt so it did not need to rely on s. 136. The principal then had a right to set off what it had paid the W.C.B. against what it would otherwise pay the trustee in bankruptcy but that the right of set-off did not constitute a conflict with the *Act* as it was specifically provided for under [s. 97(3) of the *Bankruptcy and Insolvency Act*] ...

113 In Wakeling J.A.'s view, s. 97(3) was intended only to acknowledge and accept the application of the common law right of set-off as it has been developed over the years. To read more than a common law right of set-off into s. 97(3) would conflict with the *Belair* decision. Furthermore, he observed that the Ontario Court of Appeal in *Stevens* referred to only three members of the "quartet", failing to make reference to the *F.B.D.B.* case which, in his mind, has considerable relevance to this case. Wakeling J.A. added that the *F.B.D.B.* judgment applied the *Bourgault*, *Belair* and *Deloitte* reasoning to parties not directly involved in a bankruptcy.

114 In the end, Wakeling J.A. concluded, at pp. 52-53, that "there is no way that the bankruptcy pie can be cut as a consequence of this legislation without disturbing the scheme of distribution established under s. 136 of the *Act*." In fact, he held that it could hardly be disputed that without the legislation the distribution would be different.

115 Deeming s. 133(1) to be invalid, Wakeling J.A. basically affirmed the approach taken by Wedge J. regarding the severance of the set-off provision. He found that the provision was to be struck as a whole, given that there is no apparent justification for a conclusion that the legislators would have intended the principal to pay in full whether or not a right of set-off was available.

IV. Issues on Appeal

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116 The issues in this appeal are set out in the constitutional questions stated by the Chief Justice on September 14, 1994:

1.Where a contractor as referred to in s. 133 of the *Workers' Compensation Act*, S.S. 1979, c. W-17.1, is in bankruptcy and but for the bankruptcy, the principal as referred to in s. 133 would be liable to pay the assessment due by the contractor under the *Act*, is s. 133 of the said Act inoperative or inapplicable in whole or in part, by reason of being in conflict with the *Bankruptcy Act*, R.S.C., 1985, c. B-3, and in particular ss. 17(1), 67, 95, 136(1)(*h*), 148, 158(*a*) and 198(*a*) thereof?

2. Was s. 133 of the said Act inoperative or inapplicable in the circumstances of this case?

117 In my view, the gist of the appeal comes down to the following questions, as proposed by the appel- lants:

(a) Is section 133(1) of *The Workers' Compensation Act* inoperative by reason of inconsistency with the *Bankruptcy Act*?

(b) Is section 133(3) of *The Workers' Compensation Act* inoperative by reason of inconsistency with the *Bankruptcy Act*?

(c) If section 133(3) is inoperative, does that render section 133(1) inoperative as well?

V. Analysis

118 For the reasons that follow, I would allow the appeal. Section 133(1) is valid even in a situation where the contractor is or becomes bankrupt; s. 133(3) is also valid in the bankruptcy context and permits the principal to set off the amount paid to the Board from funds that it owes to the bankrupt or assignee thereof. Although I am aware of the fact that the set-off involves monies constituting the property of the bankrupt and that it potentially interferes with the order of priorities established by s. 136, I find that s. 97(3) of the *Bankruptcy Act* eliminates any operational conflict between s. 133(3) and the Act since the cause of action contemplated by s. 133(3) is ordinarily available at law and equity. Further, when s. 133(3) is used simply for purposes of indemnification and this is pursued by the principal joining the ranks of the unsecured creditors then I believe any resultant interference with the bankruptcy scheme to be so incidental that it falls outside of the scope of the "clear conflict" required to trigger invalidation through the paramountcy doctrine.

119 At the outset, I note that the respondent's submissions that s. 133 is in conflict with ss. 17(1), 67, 95, 148, 158(*a*) and 198(*a*) of the *Bankruptcy Act* are of little, if any, merit. Nor were they seriously pleaded before us. The crux of this appeal involves s. 136(1) of the *Bankruptcy Act* and it is on this provision that I shall focus my attention.

A. Paramountcy Doctrine

120 Section 133 of the *Workers' Compensation Act* is valid provincial legislation enacted pursuant to s. 92(13) of the *Constitution Act, 1867*. Similarly, the *Bankruptcy Act* is intra vires the legislative purview of Parliament, specifically s. 91(21) of the Constitution: *Ontario (Attorney General) v. Canada (Attorney General)*, [1894] A.C. 189 (P.C.), at p. 197; *Royal Bank of Canada v. Larue*, [1928] A.C. 187, affirming [1926] S.C.R. 218 . To this end, the constitutional issue herein asks whether s. 133 of the *Workers' Compensation Act* is rendered inoperative by virtue of a conflict with the *Bankruptcy Act*. In a situation where there is clear operational con-

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flict between valid federal and provincial legislation, the doctrine of paramountcy requires that the provincial legislation be, to the extent of the conflict, declared inoperational. It is upon this doctrine that the respondent re- lies.

121 I underscore that, in order to be triggered, the doctrine of paramountcy requires very clear conflict. As noted by Dickson J. (as he then was) in *Multiple Access Ltd. v. McCutcheon*, [1982] 2 S.C.R. 161 at p. 191:

> In principle, there would seem to be no good reasons to speak of paramountcy and preclusion except when there is actual conflict in operation as where one enactment says "yes" and the other says "no" ...

122 Conflict for purposes of paramountcy analysis is found when compliance with the enactment of one level of government entails defiance with that of the other: *McCutcheon*, supra, at p. 191. There must be a situation where one cannot be able to obey the law of one level of government without disobeying the law of the other level of government: *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121.

123 The requirement that clear operational conflict be found effectively narrows the situations in which federal legislation will be deemed to be paramount over provincial enactments. The rationale behind this restrictive use of paramountcy is self evident: governmental regulation in Canada operates through a complex web of federal and provincial legislation. The regimes structuring many areas of public policy, such as bankruptcy, actively involve both levels of government. To this end, barring a situation where obeying the enactment of one level places a citizen in disobeyance of the legislation of the other level, an attempt must be made to read overlapping provincial and federal legislation in a complementary manner.

124 I am buttressed in this approach by the general comments of Dickson C.J.C. in *City National Leasing Ltd. v. General Motors of Canada Ltd.*, [1989] 1 S.C.R. 641. Although the *GM* case specifically involved validating legislation under the federal trade and commerce power, I find the following passage from Dickson C.J.C.'s reasons (at pp. 669-70) to be apposite to this appeal:

> ... it should be remembered that in a federal system it is inevitable that, in pursuing valid objectives, the legislation of each level of government will impact occasionally on the sphere of power of the other level of government; overlap of legislation is to be expected and accommodated in a federal state. Thus a certain degree of judicial restraint in proposing strict tests which will result in striking down such legislation is appropriate ... Both provincial and federal governments have equal ability to legislate in ways that may incidentally affect the other government's sphere of power.

125 In the case at bar, the courts below did not demonstrate the appropriate level of judicial restraint in their application of paramountcy doctrine. In my view, courts should carefully look for co-existence, not strive to find conflict.

B. The History and Purpose of Workers' Compensation Legislation in Canada

126 The disposition of this appeal requires not only a sensitivity to the true nature of the paramountcy doctrine, but also an appreciation of the history and purpose of workers' compensation legislation.

127 Workers' compensation legislation creates a "no fault" system of benefits whereby injured workers are guaranteed compensation in connection with their injuries. As noted by the Workers' Compensation Board of Alberta, the concept of workers' compensation in Canada was introduced in order to elevate Canadian society

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from an industrial "state of nature".

128 In *Medwid v. Ontario (Minister of Labour)* (1988), 48 D.L.R. (4th) 273 (Ont. H.C.), at pp. 280-81, Montgomery J. described this "state of nature" as follows:

> ... in the years before there was workers' compensation. Economic necessity compelled people to work long hours, under conditions more hazardous than they would freely choose and without any opportunity to provide for their own personal safety. The physical conditions, equipment and work methods of the day often increased the likelihood of accidents and decreased the likelihood of recovery in tort. As many as half of the work place accidents were found to result from the hazards of the work place, not from anyone's fault. When an employer was at fault, he could erect the common law defences of contributory negligence and voluntary assumption of risk to insulate himself from liability. Both of those defences, though available generally, operated with particular harshness in the work place, because despite the dangers of the work place and the work tasks there were no real alternatives open to the worker. In addition, employers alone could assert the defence of common employment to neutralize claims based on the fault of a worker's fellow employees. All of these defences operated as absolute bars to recovery; all remain part of Ontario law, except where suppressed or modified by statute. Finally, even successful worker-plaintiffs had no assurance of meaningful recovery. Wealthy employers could often exhaust the worker's resources in a series of appeals. Legal fees and other costs reduced the amount realized from any award. Impecunious employers often could not pay the judgments against them. For slow developing industrial disease claims, workers might find their employers had gone out of business or disappeared.

129 In effect, the workers' compensation system involves an historic compromise. On the one hand, employees give up their rights of action against employers and other workers in exchange for benefits regardless of fault. On the other hand, employers are relieved of certain liabilities involving their employees but are obliged to fund wholly the burden of compensating injured workers through assessments paid to the Injury Fund. This compromise emanated from the 1913 Meredith Report, which constitutes the conceptual base for all workers' compensation legislation in Canada. In *Reference re Workers' Compensation Act, 1983 (Newfoundland)* (1987), 44 D.L.R. (4th) 501, affirmed [1989] 1 S.C.R. 922, the Newfoundland Court of Appeal, at p. 509, summarized the funding scheme proposed by Meredith as follows:

> ... Meredith recommended that Ontario model its legislation after the German system which emphasized the duty of the state to provide sustenance and support to injured workers through a collective, no-fault, industry-funded insurance scheme by means of a regulated accident fund ...

130 The strength of the fund is thus key to the viability of the workers' compensation system. In turn, the financial integrity of the Workers' Compensation program depends on an effective means of ensuring that sufficient monies are paid into the Injury Fund. It is here that s. 133 plays a key role. It, along with other devices such as statutory liens, ensures that the Injury Fund continues to be replenished and remains solvent. This is accomplished by holding principals liable for the unpaid dues of contractors because, from the perspective of the workers, both contractors and principals are "employers". Moreover, from the point of view of rudimentary economic analysis, both gain from the surplus value of the workers' labour. Without the existence of effective methods to finance the Injury Fund, the workers' compensation system is emptied of any content and the "historical compromise" is rendered meaningless. Provisions such as s. 133 further the policy choice to shift losses for unpaid premiums from the Board and workers to principals. Workers' compensation legislation strives to visit the costs of industrial disease, death and injury on the employer community which exposes its workforce to those

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risks. An attempt is made to spread responsibility for those costs amongst multiple employers engaged in a single project.

131 On a related note, I would, with respect, expressly reject Wakeling J.A.'s characterization at p. 48 of this case as "... one more attempt by a province to circumvent the restriction which s. 136 of the *Act* has imposed on the ability of the W.C.B. to collect its claim." To the extent that Wakeling J.A.'s remarks are aimed at criticizing the province for enacting the impugned legislation with that object in mind, I cannot agree. There is no basis in law or history to ascribe such a pejorative intent to s. 133 of the *Workers' Compensation Act*. I note that the original precursor to s. 133 was enacted in 1911 (*The Workmen's Compensation Act*, S.S. 1910-11, c. 9, s. 9), well before the introduction of the *Bankruptcy Act* in 1919 (S.C. 1919, c. 36) and of the original version of s. 136(1)(*h*) which was enacted in 1921 (*The Bankruptcy Act Amendment Act, 1921*, S.C. 1921, c. 17, s. 39).

132 From another angle, the present wording of s. 133 is essentially unchanged from the modifications made to s. 9 of the 1910 Act in the 1929 *Workmen's Compensation Act*, S.S. 1928-29, c. 73, s. 11. Now, s. 11 of the 1929 Act was modelled directly on the contemporaneous provisions of the Ontario *Workmen's Compensation Act*, R.S.O. 1927, c. 179, s. 9, these being originally enacted in 1915 and 1919: S.O. 1914, c. 25, s. 10, as amended by S.O. 1915, c. 24, s. 5, and S.O. 1919, c. 34, s. 4(2). The creation of joint and several liability as between contractors and principals for the contractor's unpaid compensation debts (as well as the concomitant right to indemnification) thus pre-dates the scheme of priorities established by bankruptcy legislation. Consequently, there could not have been, at the time of enacting workers' compensation legislation, a desire to undermine federal bankruptcy arrangements nor circumvent the priority scheme.

133 It is helpful to recall that s. 133 is not addressed specifically to situations in which the contractor is bankrupt, although such a situation may occasionally arise on the facts as it does here. Principally, s. 133 is aimed at granting the Board an alternate route to obtain the funds that, but for the delinquency, absconding or unscrupulousness of the contractor, it would ordinarily have received. Clearly, when the contractor and principal have a working relationship, it is easier for the principal to recover the monies from the contractor than it is for the Board since it is the principal who pays the contractor for work completed.

134 This review of the legislative history and purpose of workers' compensation statutes fails to unearth any indication that s. 133 was enacted for the purpose of improving the ranking of the Board in a bankruptcy. See *Stevens*, supra, at p. 747 for a similar conclusion within the Ontario context.

C. Paramountcy in the Context of Bankruptcy: The "Quartet"

135 On four occasions, this Court has been called upon to affirm the paramountcy of the *Bankruptcy Act* over provincial enactments which directly interfered with the scheme of priorities established by s. 136 of the federal legislation. As was mentioned above, these four cases are commonly referred to as the "quartet". Although they are not directly on all fours with the appeal at bar (since they do not involve the provincial body claiming against a third-party, only the bankrupt), I agree with Wedge J. that they are of significant interpretive assistance.

136 In *Bourgault*, supra, this Court considered s. 30 of the Quebec *Retail Sales Tax Act*, R.S.Q. 1964, c. 71, which provided that "every sum due to the Crown" under that Act constituted "a privileged debt ranking immediately after law costs". The facts of the *Bourgault* case, put briefly, are as follows. Upon the bankruptcy of a debtor, the Deputy Minister of Revenue of Quebec maintained that, by virtue of s. 30 of the *Retail Sales Tax Act* , he was a "secured creditor" within the meaning of the *Bankruptcy Act*, R.S.C. 1970, c. B-3, and was therefore

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entitled to greater priority than normally available for Crown claims under the bankruptcy scheme. This Court rejected the claim on the grounds that s. 107 [now s. 136] of the *Bankruptcy Act* established an elaborate scheme of distribution of a bankrupt's assets, intending to confer a certain priority on Crown claims, and that provincial statutes which attempted to confer a higher priority were inconsistent with the Act. Specifically, Pigeon J., writing for a majority of the Court, stated at p. 44:

> Accordingly, I find that the case turns upon the interpretation of para. 107(1)(*j*) [of the *Bankruptcy Act*] ... It is abundantly clear that this was intended to put on an equal footing all claims by Her Majesty in right of Canada or of a province except in cases where it was provided otherwise, namely, para. (*c*), the levy, and para. (*h*), workmen's compensation or unemployment insurance assessments and withholdings for income tax. Paragraph (*j*) ends with the following words, "*notwithstanding any statutory preference to the contrary* ". The purpose of this part of the provision is obvious. Parliament intended to put all debts to a government on an equal footing; it therefore cannot have intended to allow provincial statutes to confer a higher priority. In my opinion, this is precisely what is being contended for when it is argued that, because the Quebec statute creates a privilege on immovable property effective from the date of registration, the Crown thereby becomes a "secured creditor" and thus escapes the effect of the provision which gives it only a lower priority [Emphasis in original.]

137 Similarly, in *Deloitte, Haskins & Sells Ltd. v. Alberta (Workers' Compensation Board)*, supra, this Court considered s. 78(4)(*a*) of the Alberta *Workers' Compensation Act*, S.A. 1973, c. 87, which provided that any amount owed to the Workers' Compensation Board by an employer constituted a priority charge on that employer's assets. The Court concluded that this provision did not apply in bankruptcy in that it could not provide the Workers' Compensation Board with a security interest within the meaning of the opening words of s. 107(1) of the *Bankruptcy Act*, R.S.C. 1970, c. B-3, so as to defeat the lower priority accorded to claims by Workers' Compensation Boards by s.107(1)(*h*) of the *Bankruptcy Act*. Specifically, Wilson J. (on behalf of herself and two other judges, with Chouinard J. and two others concurring separately) relied on *Re Bourgault*, supra, and *Re Black Forest Restaurants Ltd.* (1981), 37 C.B.R. (N.S.) 176 (N.S. S.C.), in concluding at p. 806 that:

> With respect, the issue in *Re Bourgault* and *Re Black Forest Restaurant Ltd.* was not whether a proprietary interest has been created under the relevant provincial legislation. It was whether provincial legislation, even if it did create a proprietary interest, could defeat the scheme of distribution under s. 107(1) of the *Bankruptcy Act*. These cases held that it could not, that while the provincial legislation could validly secure debts on the property of the debtor in a non-bankruptcy situation, once bankruptcy occurred s. 107(1) determined the status and priority of the claims specifically dealt with in that section. It was not open to the claimant in bankruptcy to say: By virtue of the applicable provincial legislation I am a secured creditor within the meaning of the opening words of s. 107(1) of the *Bankruptcy Act* and therefore the priority accorded my claim under the relevant paragraph of s. 107(1) does not apply to me. In effect, this is the position adopted by the Court of Appeal and advanced before us by the respondent. It cannot be supported as a matter of statutory interpretation of s. 107(1) since, if the section were to be read in this way, it would have the effect of permitting the provinces to determine priorities on a bankruptcy, a matter within exclusive federal jurisdiction.
>
> How then should the constitutional question stated by the Chief Justice be answered?Does s. 107(1)(*h*) of the *Bankruptcy Act* conflict with s. 78(4) of *The Workers' Compensation Act* so as to render the latter provision inoperable?I do not believe so. Section 78(4) does not purport to deal with a bankruptcy situation and, by virtue of the presumption of constitutionality, the provincial legislature is presumed to be legislating

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> within its competence rather than outside it. Faced with the choice of construing the provincial legislation in a way which would cause it to invade the federal sphere, thereby attracting the doctrine of paramountcy, or construing it in accordance with the presumption of constitutionality, I prefer the latter course. I believe also that it accords better with the more recent authorities on the scope of the paramountcy doctrine.

138 In *Québec (Commission de la santé et de la sécurité du travail) c. Banque fédérale de développement*, supra, this Court found that, where a secured creditor took advantage of s. 49(2) of the *Bankruptcy Act*, R.S.C. 1970, c. B-3, and liquidated his security outside the bankruptcy proceedings, the property constituting the security was still property of the bankrupt and the order of payment of creditors from the proceeds of the sale of the security was to be determined by the priorities specified in the *Bankruptcy Act* and not by the provisions of provincial law governing the order of collocation. Writing for the Court, Lamer J. (as he then was) stated at p. 1071:

> In any event, I feel that the decisions in *Re Bourgault* and *Deloitte* are conclusive as to the fate of the appeal. These cases stand for the following proposition: in a bankruptcy matter, it is the *Bankruptcy Act* which must be applied. If a bankruptcy occurs, the order of priority is determined by the ranking in s. 107 of the Act, and any debt mentioned in that provision must therefore be given the specified priority.

Lamer J. went on to note that as provincial statutes cannot affect the priorities created by the federal statute, consistency in the order of priority in bankruptcy situations is ensured from one province to another.

139 Finally, in *British Columbia v. Henfrey Samson Belair Ltd.*, supra, this Court reiterated its position in the three previous cases, holding that a deemed statutory trust created by s. 18(1) of the British Columbia *Social Service Tax Act*, R.S.B.C. 1979, c. 388, over all amounts collected as taxes under the Act could not give the province priority over other creditors under the *Bankruptcy Act*, R.S.C. 1970, c. B-3. The issue was whether the deemed statutory trust could qualify as a trust within s. 47(*a*) of the *Bankruptcy Act* so as to exclude the amounts so held from the property of the bankrupt and instead require them to be given entirely to the provincial government. McLachlin J., writing for the majority, held at p. 33 that:

> To interpret s. 47(*a*) as applying not only to trusts as defined by the general law, but to statutory trusts created by the provinces lacking the common law attributes of trusts, would be to permit the provinces to create their own priorities under the *Bankruptcy Act* and to invite a differential scheme of distribution on bankruptcy from province to province.

140 In *Belair*, no common law trust was found since the monies in the impugned trust had been mixed with other monies. Consequently, the s. 47(*a*) definition of trust was not triggered. However, the important point to be taken from *Belair* is that if the province were to have drafted its tax collection legislation in a way that created a valid trust under the terms of the *Bankruptcy Act*, that money would have been excluded from the property of the bankrupt. From another perspective, the province would be able to affect the outcome of the bankruptcy; yet, because it would not have altered the priorities of distribution, the legislation would have survived paramountcy analysis. In *Belair*, Cory J. dissented regarding the applicability of the questions of law to the specific facts at hand, holding that a valid trust was created and that there was no conflict between the provincial and federal legislation since the *Bankruptcy Act* specifically gave priority to a trust.

141 In my view, the quartet has given rise to two interpretations. One is broad, the other narrow.

142 The respondents in the instant appeal advocate the broad interpretation, according to which any time provincial law affects the final result of a bankruptcy, the province is improperly attempting to alter the priorit-

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ies of distribution. The Attorney General for Saskatchewan refers to this as the "bottom line" approach. Under such an approach, s. 133, since it affects the end result of the bankruptcy process, would be deemed invalid.

143 The appellants, on the other hand, advocate a narrower interpretation: the quartet precludes a province only from altering the position of a creditor vis-à-vis the other creditors claiming from the same estate within the scheme of distribution created by s. 136(1). In other words, the only thing the province cannot do is "jump the queue" set up by Parliament. Consequently, in order to impugn a provincial law affecting the bankruptcy process, there must be an attempt to reallocate the priority scheme by directly creating interests in the property of the bankrupt.

144 In my opinion, the second interpretation is the correct one. The quartet stands for the position that only those provincial laws which directly improve the priority of a claim upon the actual property of the bankrupt over that accorded by the *Bankruptcy Act* are inoperative. This accords with the facts of the cases in the quartet. In each case, the provincial governments endeavoured to change the priorities of preferred creditors in s. 136(1) by elevating a lower ranked claim to a higher rank. In *Re Bourgault* and *Belair*, the province attempted to "queue jump" claims of the Crown ranked last by s. 136(1)(*j*) by declaring such debts to be "privileges" (*Re Bourgault*) or deeming them to be "trust money" and hence outside the distribution scheme (*Belair*). In *Deloitte*, the province attempted to elevate its claim through a proposed security interest and, finally, in *F.B.D.B.*, the province once again endeavoured to use the mechanism of a privilege/lien.

145 In many ways, the broad approach propounded by the respondents would produce unacceptable results since it risks nullifying the broad array of provincial legislation underpinning the *Bankruptcy Act*. I am sensitive to the arguments by the Saskatchewan Attorney General that provincial legislation is deeply involved in determining the priority, registration, and amount of indebtedness in the bankruptcy process. In fact, the proprietary and contractual rights that are regulated by the bankruptcy process are usually created by virtue of provincial law. All of these enactments somehow affect the "bottom line".

146 For example, provincial personal property security legislation establishes security interests (such as that relied upon by the Bank of Montreal in the instant appeal) that create secured creditors and validate claims against the estate of the bankrupt. Of similar import is builders' and mechanics' lien legislation that has been held to be constitutionally valid in *TransGas Ltd. v. Mid-Plains Contractors Ltd.*, [1994] 3 S.C.R. 753; see also *Ecarnot (Trustee of) v. Western Credit Union Ltd.* (1991), 7 C.B.R. (3d) 207 (Sask. C.A.), *John M.M. Troup Ltd. v. Royal Bank*, [1962] S.C.R. 487 at p.494, per Judson J.

147 Other valid provincial legislation invariably affecting the "bottom line" includes: consumer protection and warranties legis lation; land titles statutes; sale of goods laws; and a further array of specific statutes such as *The Saskatchewan Farm Security Act*, S.S. 1988-89, c. S-17.1, s. 44 (protecting and exempting farmland and farm equipment from the property of the bankrupt's estate), the *Forest Act*, R.S.B.C. 1979, c. 140, s. 142, and the *Employment Standards Act*, S.B.C. 1980, c. 10, s. 19.

148 The fact that federal bankruptcy legislation is often contingent on provincial initiatives in the area of property and civil rights has been noted by Professor Hogg (*Constitutional Law of Canada* (3rd. ed., 1992), at p. 639):

> The term "secured creditor" is defined [in federal bankruptcy legislation] ... in terms so general that the validity and effect of "a mortgage, pledge, charge, lien or privilege" is left to be determined under provincial law relating to secured transactions. For example, if a creditor claims to hold a first mortgage on land in

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> Ontario, the trustee in bankruptcy ... will look to Ontario's law of mortgages to determine whether the creditor is indeed a secured creditor and, if so, the extent to which the creditor can resort to the land in priority to all other creditors. *In this way, provincial law has a profound, albeit indirect, effect on the distribution of the bankrupt's assets*. (Emphasis mine.)

To my mind, there is nothing inherently undesirable about this interplay between federal and provincial statutory initiatives in the regulation of the bankruptcy process.

149 The Alberta Court of Appeal has, for its part, also demonstrated a reluctance to invalidate provincial legislation which simply touches upon bankruptcy proceedings. In *Panamericana de Bienes y Servicios S.A. v. Northern Badger Oil & Gas Ltd.*, [1991] 5 W.W.R. 577, the issue before the court was whether the *Bankruptcy Act* prevented a court-appointed receiver-manager of an insolvent and bankrupt oil company from complying with an order requiring that receiver-manager, in the interests of environmental integrity, carry out proper abandonment procedures on seven suspended oil wells. That work would be done at the expense of the secured creditors' entitlement under the *Bankruptcy Act*. At p. 599, Laycraft C.J.A. held for the court:

> In my view, there is no ... direct conflict in this case. The Alberta legislation regulating oil and gas wells in this province is a statute of general application within a valid provincial power. It is general law regulating the operation of oil and gas wells, and safe practices relating to them, for the protection of the public. It is not aimed at subversion of the scheme of distribution under the *Bankruptcy Act* although it may incidentally affect that distribution in some cases. It does so, not by a direct conflict in operation, but because compliance by the receiver with the general law means less money will be available for distribution.

Northern Badger thus echoes the proposition that provincial laws of general application continue to apply in bankruptcy even though they may incidentally alter the amount of proceeds available in the bankrupt's estate for distribution.

150 Provincial law plays a critical role in defining both the number and type of participants in the bankruptcy process and the size of the bankrupt's estate. A number of this Court's decisions have emphasized the value of standardizing bankruptcy priorities across the country. But it is important to remember that a bankruptcy priority is a category. The precise content of that category can and does vary to some extent from one province to the next. It seems to me that s. 72(1) of the *Bankruptcy Act* is an example of the recognition of provincial diversity. Section 72(1) reads as follows:

> 72. (1) The provisions of this Act shall not be deemed to abrogate or supersede the substantive provisions of any other law or statute relating to property and civil rights that are not in conflict with this Act, and the trustee is entitled to avail himself of all rights and remedies provided by that law or statute as supplementary to and in addition to the rights and remedies provided by this Act.

151 Because the federal legislation already contemplates that provincial law will impact upon the bankruptcy process, the respondents must do more than simply show that s. 133 has an effect on a particular bankruptcy. Indeed, in *Robinson v. Countrywide Factors Ltd.* (1977), [1978] 1 S.C.R. 753, Beetz J., commenting on the precursor to s. 72(1) [s. 50(6)], wrote (at pp. 808-809):

> ... I am of the view that s. 50, subs. (6) of the *Bankruptcy Act* [R.S.C. 1970, c. B-3], *provides a clear indication that Parliament*, far from intending to depart from the rule of operational conflict, *did in fact aim at the highest possible degree of legal integration of federal and provincial laws* ... (Emphasis added.)

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152 I conclude that within the context of the bankruptcy process judicial authority and common sense militate in favour of a guarded approach to invalidation under the paramountcy doctrine. When this analysis is applied to the case at bar, it obliges the respondents, in order to prevail, to demonstrate that s. 133 of the impugned provincial Act actually reorders the federally established priority scheme with regard to the property of the bankrupt Metal Fab by directly creating interests therein. I now turn to this issue.

D. Application of the Law to s. 133 of the Saskatchewan Workers' Compensation Act

(i) Validity of s. 133(1)

153 I reproduce s. 133(1), with its important portion underscored:

> 133. — (1) Where a person, whether carrying on an industry included under this Act or not, in this section referred to as the principal, contracts with any other person, in this section referred to as the contractor, for the execution by or under the contractor of the whole or any part of any work for the principal, it is the duty of the principal to ensure that any sum that the contractor or any subcontractor is liable to contribute to the fund is paid and, where the principal fails to do so and the sum is not paid, *he is personally liable to pay* that sum to the board. (Emphasis added.)

154 In my opinion, s. 133(1) has nothing to do with the property of the bankrupt. It creates a strict in personam obligation from the principal owing to the Board. The property of the principal is in no way subject to the *Bankruptcy Act*. The bankrupt is not even involved: there is no concern for the specific monies held by Husky for Metal Fab or owing by Husky to Metal Fab. The provision simply creates a third party guarantee by the principal that the contractor will pay its debts to the Board.

155 The respondent Husky alleges that, regardless of the fact that s. 133(1) does not involve the property of the bankrupt, it remains in operational conflict with the *Bankruptcy Act* since it may have the effect of allowing the Workers' Compensation Board to recover more money for the Injury Fund than it likely could have done by proving a claim in bankruptcy and relying on s. 136. It is suggested that s. 133 permits the Board to jump from eighth place (under s. 136(1)(*h*) of the *Bankruptcy Act*) to first, thereby circumventing the priorities in bank- ruptcy.

156 In response, I note that s. 133(1) only alters the Board's recovery by permitting it to recover from a non-bankrupt third party. There is no direct conflict within the meaning of the quartet or of paramountcy doctrine more generally between s. 133(1) and the *Bankruptcy Act*. There is nothing in the *Bankruptcy Act* which precludes any creditor, even if specifically mentioned in s. 136, from pursuing its remedies against a third-party as well as or instead of proving a claim in bankruptcy, although double recovery would certainly be frowned upon.

157 The Attorney General for Saskatchewan takes this analysis one step further by suggesting two commonplace and intuitively reasonable examples of situations in which third-party liability operates in concordance with a bankruptcy: a situation involving a personal guarantee by a third party, and a plaintiff's claim in an action for negligence against two co-defendants. The Attorney General reasons as follows:

> (a) A lender may loan money on the condition of receiving a personal guarantee from a third party. If the borrower goes bankrupt, the lender has every right to pursue the third party under the guarantee, and may recover the full amount owing. The lender then will have "advanced its position rather dramatically", compared to what it could have received through the bankruptcy process. The net result is a "clear advantage" to

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the lender, who "has managed to assure payment of its claim and leave it to the [third party guarantor] to struggle for repayment under the *Act*," probably as an unsecured creditor of the bankrupt

(b) In the claim of a plaintiff in an action for negligence against two co-defendants, if the plaintiff's claim succeeds there is a judgment owing against the two defendants. The two defendants are jointly and severally liable for the judgment. If one defendant goes bankrupt, the plaintiff is fully entitled to proceed against the other defendant for the full amount of the judgment, and ignore the bankruptcy process entirely. Again, the net result is a "clear advantage" to the plaintiff, authorized by provincial statute: *Contributory Negligence Act*, R.S.S. 1978, c. C-31, s. 3(2).

158 In this case, we are not really dealing with the debt of Metal Fab any more. The legislation has validly created two debts that, although interconnected, are independent: the debt from Husky to the Board as surety of the Injury Fund, and then the debt of Metal Fab to Husky for the sums paid by the latter for the delinquency of the former. There is a great difference between altering the priorities under the *Bankruptcy Act* and statutorily empowering the Board to seek relief from more than one creditor.

159 I do not accept the respondents' submission, supported by Wakeling J.A. on appeal, that the *F.B.D.B.* case extended the "no interference" principle to the relationship between a creditor and a third-party to the bankruptcy. The *F.B.D.B.* decision involved a bank seizing the property of Structal Inc. pursuant to a security agreement. Subsequent to this seizure, Structal made an assignment in bankruptcy. The Workers' Compensation Board of Québec then tried to claim a priority interest *in the seized property* by relying on a provision of the workers' compensation legislation which stipulated that assessments for which the employer Structal was liable amounted to a privileged claim on all the property of the employer. This Court, noting that the property in question was still part of the estate of the bankrupt, deemed the Québec WCB's order to amount to a reordering of the bankruptcy priorities. On this point, Lamer J., held at pp. 1066-67:

In this Court [the Workers' Compensation Board] argued, *inter alia*, that the order of priority set out in ... the *Bankruptcy Act* is not applicable, as the immovable in Royal Trust's possession at the time of the bankruptcy was not part of the estate which passed to the trustee in bankruptcy ...

With respect, I cannot accept this reasoning. The immovable, encumbered to [F.B.D.B.] and seized by *the* trustee, is part of the "property of a bankrupt" mentioned in ... the *Bankruptcy Act*. [Emphasis added.]

160 Regarding the proper interpretation of the *F.B.D.B.* decision, I agree with the following submissions by the Attorney General for British Columbia and the appellant Board, respectively:

[In *F.B.D.B.*] the parties in question were seeking to realize, albeit outside of the bankruptcy proceedings, against property of the bankrupt. But that property was nevertheless subject to the Act and so, therefore, were the creditors who sought to realize against it. Accordingly, the *Federal Business Development Bank* decision does not purport to extend the scheme of priorities of proven claims under the *Bankruptcy Act* to recovery of the underlying indebtedness from a third party.

That [*F.B.D.B.*] analysis does not take the cases "one step further" and apply [them] to parties or property not involved in bankruptcy. To the contrary, it specifically involves a situation where provincial legislation directly creates an interest in the property of the bankrupt. This is very different from the situation involved in this case where Husky's liability under s. 133(1) ... is strictly personal and involves no claim whatsoever against either Metal Fab or the property of Metal Fab. Accordingly, it is submitted that the reasoning of the

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Court of Appeal is a significant and unwarranted extension of the principles established by the leading cases.

161 Section 133(1) does not involve property that is related to or part of the estate of the bankrupt and it is consequently not in operational conflict with the bankruptcy scheme. I am strengthened in this conclusion by the decision of the Ontario Court of Appeal in *Stevens*, supra, and the case of *Re French River Contracting Co.*, [1937] O.W.N. 665. In fact, I prefer the *Stevens* approach over that of both the Saskatchewan Court of Appeal in its decision in the case at bar and the Saskatchewan Court of Queen's Bench in *Serdula Construction Management Inc. v. Saskatchewan (Workers' Compensation Board)*, supra, per Lawton J.

162 In *Stevens*, supra, at p. 748, Grange J.A. held:

> The principle is simple. The money owing under s. 9(3) [Ontario equivalent to s. 133(1)] is not property of the bankrupt and never comes into the hands of the trustee.

163 The Bank of Montreal submits that *Stevens* can be distinguished on the facts. Its argument revolves around the observation that in *Stevens* there was a trustee overseeing a group of unsecured creditors. On the other hand, in the case at bar, there has been an assignment to a secured creditor and the set-off would deplete the funds normally accruing to this secured creditor. I agree that this difference is noteworthy. However, I am not convinced that this difference is sufficient to undermine the persuasive authority of the *Stevens* decision. The *Stevens* court did not mention that the absence of secured creditors affected in any way its decision to uphold the validity of the impugned provision.

164 In sum, s. 136(1)(*h*) encompasses a claim against the property of the bankrupt. The Board claim under s. 133(1) targets a solvent principal. The two provisions are co-extensive, not mutually exclusive. Use of s. 133(1) does not displace s. 136(1)(*h*); it complements it.

165 In closing, although I find there to be no conflict between s. 133(1) and the *Bankruptcy Act*, I posit that, even if there were to be some element of conflict, this must be evaluated in light of the fact that the provincial legislation is intra vires. Legislation that is intra vires is permitted to have an incidental and ancillary effect on a federal sphere. I would emphasize again that this Court has traditionally declined to invoke the paramountcy doctrine in the absence of actual operational conflict. I am uncomfortable with the "water-tight" approach to federal bankruptcy legislation propounded by the respondents. To interpret the quartet as requiring the invalidation of provincial laws which have any effect on the bankruptcy process is to undermine the theory of co-operative federalism upon which (particularly post-war) Canada has been built. In *Deloitte*, supra, at pp. 807-808, Wilson J. recognized it to be appropriate to adopt as narrow a definition of operational conflict as possible in order to allow each level of government as much area of activity as possible within its respective sphere of authority.

166 On a related note, a rather weak argument has been made to the effect that s. 133(1) is inoperative simply because it increases the total amount of the claims being made by creditors. I would respond that even if this were true on the facts, many pieces of provincial legislation achieve precisely the same goal. In fact, as discussed earlier, most claims against a bankrupt's estate are grounded in provincial legislation; I do not see why the *Workers' Compensation Act* should be impugned because it may add a creditor to the list, when nearly all of the other creditors will have been added by virtue of other provincial statutes. Neither increasing the number of claims made nor decreasing the amount of assets in the estate is activity necessarily commensurate with altering the priorities of distribution among the creditors.

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167 To this end, a principal's liability under s. 133(1) is not extinguished by the bankruptcy of the contract- or.

(ii) The Validity of s. 133(3)

168 I find s. 133(1) to be constitutionally valid but because I believe (for reasons outlined infra) that the components of s. 133 are severable, I must evaluate s. 133(3) separately. As mentioned earlier, this provision engages a more direct interference with the bankruptcy scheme since it is the actual property of the bankrupt that is involved in the restitutionary claim launched by the principal. It constitutes, to my mind, the only linkage between the property of the principal and the estate of the bankrupt contractor. Section 133(3) reads as follows:

> (3) Where the principal is liable to make payment to the board under subsection (1), he is entitled to be indemnified by any person who should have made payment and is entitled to withhold, out of any indebtedness due to that person, a sufficient amount in respect of that indemnity.

169 Before proceeding any further, I believe it necessary to subdivide s. 133(3) into two parts because the provision enshrines two different remedies: that of set-off as well as that of indemnification. Clearly, set-off is the more intrusive of the two since it permits the principal to stand first in the priority scheme by taking away the property of the bankrupt before it enters the estate. As to indemnification, any such claim by the principal might have but an ancillary effect on the estate of the bankrupt since it only permits the principal to join the ranks of the unsecured creditors. On this latter point, I note that it has been submitted that s. 136(1)(*h*) might cover the amount owing to the principal; if so, then the principal would rank well above the unsecured creditors. Although it is not necessary to decide this issue, I shall simply assume that s. 136(1)(*h*) does not have such a wide ambit.

170 As will soon become evident, this sub-dividing of s. 133(3) is important: given that paramountcy doctrine operates to invalidate only to the extent of the operational conflict, it could be that because of their varying effects, the "set-off" claim could be struck while the indemnification claim remains operational: *Robinson*, supra, at p. 808; *Vapor Canada Ltd. v. MacDonald*, [1977] 2 S.C.R. 134; Hogg, at p. 434.

171 However, at this point in the analysis we come to s. 97(3) of the *Bankruptcy Act*. Neither claim will be invalid if s. 97(3) of the *Bankruptcy Act* can be interpreted in a way that will reconcile the priority scheme of the Act with the common law of set-off (and, implicitly, of indemnification) *and* if the claims embodied in s. 133(3) can be found to be merely reflective of those common law causes of action. Section 97(3), which provides that the law of set-off is to persist in bankruptcy, reads as follows:

> (3) *The law of set-off applies to all claims made against the estate of the bankrupt* and also to all actions instituted by the trustee for the recovery of debts due to the bankrupt in the same manner and to the same extent as if the bankrupt were plaintiff or defendant, as the case may be, except in so far as any claim for set-off is affected by the provisions of this Act respecting frauds or fraudulent preferences. (emphasis mine)

172 Section 97(3) thus specifically envisions that there will be cases where money owing to the bankrupt will not enter the bankrupt's estate because it will have been set off against a debt owed by the bankrupt to that individual. As Grange J.A. noted in *Stevens* (at p. 748), the money comes to the Board by virtue of the *Workers' Compensation Act*: "it is the *Bankruptcy Act* itself and not the provincial legislation that recognizes rights of set-off". I note in passing that the right of set-off in s. 97(3) includes both legal and equitable set-off: Houlden and Morawetz, *Bankruptcy Law of Canada* (3d ed.) at pp. 4-90 and 4-91. This Court has recognized that legal set-off

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does not operate within the context of an assignment since that assignment destroys the mutuality of the cross-obligations between the parties: *Telford v. Holt*, [1987] 2 S.C.R. 193. In the case at bar, Metal Fab assigned its book debts to the Bank, thereby presumptively eliminating the availability of legal set-off. To this end, my focus shall be limited to equitable set-off.

173 The fundamental question at this juncture is whether s. 133(3) is merely declaratory of the rights to set-off and indemnification that existed at equity. If s. 133(3) creates no new rights of set-off and merely confirms the availability of traditional equitable set-off, it is consistent with the *Bankruptcy Act*. In this regard, I rely on the *Belair* case. In *Belair*, McLachlin J. suggested (at pp. 34-35) that if the statutory device (in that case a trust) shared the characteristics of its common law counterpart, the former would be compatible with the *Bankruptcy Act* even if it affected the distribution scheme. On the other hand, if the statutory device was wider in scope than that available at law or equity, there would be conflict and the device would need to be declared a nullity. In *Belair*, the Court found that the statutory trust shared none of the characteristics of a trust established under the general principles of law; accordingly, it was susceptible to invalidation on the ground of interference with the order of priorities. In this regard (and as shall become evident infra), *Belair* is distinguishable from the case at bar. No "deeming" is necessary to bring Husky within the four corners of the "law of set-off" as that term is used in s. 97(3).

174 I note that set-off operated within the bankruptcy context as early as the time of Elizabeth I. The first specific statutory set-off clause was codified in a 1705 statute: Wood, *English and International Set-Off*, at p. 282. The rationale behind the use of set-off in the bankruptcy context is aptly summarized by Fletcher Moulton L.J. in *Lister v. Hooson*, [1908] 1 K.B. 174 (C.A.), at p. 178:

> The right of set-off in bankruptcy has been dealt with by various statutes, but takes its origin from the fact that the jurisdiction in bankruptcy was from the first an equitable jurisdiction. The successive statutory formulations of the consequence of this principle, embodied in the clauses as to mutual credit, dealings &c., have never altered this fundamental principle, and, speaking for myself, I cannot see any ground why in the present instance the injustice should be perpetrated of making a person who in the balance is not a debtor to the estate pay in full the sum due to the estate and receive only a dividend on the sums due from the estate.

175 In my opinion, s. 133(3) is duplicative of the law of equitable set-off as delineated by this Court in *Telford*, supra, and confers a right that does not go beyond what would be ordinarily available at law or equity. Moreover, under s. 92(13) of the *Constitution Act, 1867*, a province has the competence to codify legal and equitable rules related to set-off. Ostensibly, the motivation behind the codification of these rules in s. 133(3) is to facilitate recovery by principals, many of whom would be more familiar with the terms of a statute than the intricacies of the common law.

176 Regarding the declaratory nature of Husky's claim against the now assigned estate of the bankrupt, I note that, absent s. 133(3), such a claim would exist according to the law of restitution or the law of contract. In terms of restitution, it is settled that a person may claim for recoupment or reimbursement of monies expended by him under compulsion of law if the effect of such a payment is to discharge the liability of another. In other words, A will be allowed to recover from B by way of set-off where A has been required to make a payment to C on B's behalf. I am supported in this conclusion by the following passage cited from *Moule v. Garrett* (1872), L.R. 7 Exch. 101 at p. 104:

> Where the plaintiff has been compelled by law to pay, or, being compellable by law, has paid money which

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> the defendant was ultimately liable to pay, so that the latter obtains the benefit of the payment by the discharge of his liability; under such circumstances the defendant is held indebted to the plaintiff in the amount.

177 This point was addressed in a more detailed manner in the decision of Lord Wright M.R. in *Brooks Wharf & Bull Wharf Ltd. v. Goodman Brothers*, [1937] 1 K.B. 534 (C.A.), at p. 544:

> The essence of the rule is that there is a liability for the same debt resting on the plaintiff and the defendant and the plaintiff has been legally compelled to pay, but the defendant gets the benefit of the payment, because his debt is discharged either entirely or pro tanto, whereas the defendant is primarily liable to pay as between himself and the plaintiff. *The case is analogous to that of a payment by a surety which has the effect of discharging the principal's debt and which, therefore, gives a right of indemnity against the principal* . (Emphasis added.)

178 In the case at bar (assuming that the order was validly made and limited to the liabilities arising from Metal Fab's work for Husky), Husky is eligible for set-off since Husky's liability to pay arose only as a consequence of Metal Fab's default regarding its requirement to make payments to the Injury Fund. Payment by Husky would have the obvious effect of releasing Metal Fab of its liability to the Board. Thus, in light of the fact that Husky is under a clear legal obligation to make the payments in question, it follows that this is a circumstance where Husky is entitled to seek restitution from Metal Fab. In this connection, the Workers' Compensation Board of British Columbia points out that the B.C. legislation does not include an explicit recognition of set-off, but still the B.C. courts appear to have read it in according to the general principles of restitution.

179 The second ground for set-off independent of s. 133(3) arises from the contractual relationship between Metal Fab and Husky. The contracts binding the parties, in cls. 12.01 and 13.01, oblige the contractor to "comply with all laws" and indemnify the principal from any expense arising from the "negligent performance, purported performance or non-performance of the Contract" by the contractors. Given this language, Metal Fab's failure to pay amounts owing to the Board constituted a breach of its contractual obligations to Husky. An indemnification claim rises concomitantly. This claim stands apart from s. 133(3).

180 It is submitted that the fact that the property of the bankrupt has been assigned to the Bank and, thus, that the debt is no longer technically owed to Metal Fab but to the Bank of Montreal, militates against a finding that the law of set-off applies in this case. I disagree. Equitable set-off (unlike legal set-off) can operate within the context of an assignment, even of book debts: *Telford*, supra, at pp. 206-209, affirming *Newfoundland Government v. Newfoundland Railway Co.* (1888), 13 App. Cas. 199 (P.C.). The only prerequisite to set-off against the assignee is that the claim against the assignee is to arise out of the same contract or series of events which gave rise to the original claim or be closely connected with that contract or series of events. As noted by Wilson J. in *Telford*, supra, at p. 211:

> ... cases involving [set-off] debts that arise from the same contract or closely inter-related contracts form an exception to the general rule. In these cases a debt arising out of the contract or closely interrelated contracts may be set-off against the assignee even if the debt accrues after the notice of the assignment.

181 In *Telford*, the two debts arose out of a land-swap. The Telfords and Canadian Stanley Development Ltd. exchanged lands of equal value, each paying the other a different cash sum and each taking back a first mortgage or a second mortgage. The end result of the transaction was that on closing Canadian Stanley would pay the Telfords $50,000 which the Telfords would use for the purpose of financing the construction of a resid-

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ence on their new land. Five days prior to the closing of its deal with the Telfords, Canadian Stanley assigned its mortgage to the Holts to secure the balance of the purchase price on a piece of land the Holts had sold to Canadian Stanley, but failed to notify the Telfords about this assignment before the transaction with them was closed. The Telfords later agreed to a postponement of the Canadian Stanley mortgage resulting in the priority of that mortgage moving from second to third place on title. The Telfords only learned about Canadian Stanley's assignment after trying to tender their first payment on the mortgage. They then indicated that a court application for a discharge of the mortgage would be made. Shortly thereafter, the Holts demanded the payment then due ($50,000 plus interest, for a total of $50,886.60) and filed a statement of claim against the Telfords for the entire amount owing (this being $150,000, independent of the amount owing on the mortgage). This claim was based upon a clause in the Telford mortgage which provided that upon default of any payment of the principal the whole amount would become payable. After receiving notice of the Holts' statement of claim, the Telfords paid the $50,886.60 into court and then counter-claimed for a discharge of the mortgage, alleging that they had the right to set off the debt owed to them by Canadian Stanley against the assignee Holts' claim.

182 Wilson J. permitted the Telfords to use of the doctrine of equitable set-off. It was duly noted that the debts did not accrue until after the assignment. However, Wilson J. did find that equitable set-off could operate since the debts were so closely connected that it would have been unfair to enforce one without allowing the setting off of the other.

183 The specific assignment and the specific bankruptcy extant in the case at bar satisfy the *Telford* test. I note that the debt from Metal Fab to Husky accrued on the date of the demand to Husky by the Board (March 16, 1992). This was four days after Husky was given notice of the assignment to the Bank yet before the occurrence of the actual assignment. However, the *Telford* test is met since Husky's indemnity claim arose out of the very contracts pursuant to which funds are now owing to the Bank of Montreal; in fact, Husky has a direct interest in the bankrupt's property which, by force of the assignment, is now held by the Bank. Moreover, the nexus between the amounts Husky seeks to set off and the assigned debt can be said to be more direct than it has been in other cases where equitable set-off has been allowed: *Hanak v. Green*, [1958] 2 All E.R. 141 (C.A.); *Coba Industries Ltd. v. Millie's Holdings (Canada) Ltd.*, [1985] 6 W.W.R. 14 (B.C. C.A.); *Federal Commerce & Navigation Ltd. v. Molena Alpha Inc.; "Nanfri" (The); "Benfri" (The); "Lorfri" (The)*, [1978] 3 All E.R. 1066, affirmed [1979] A.C. 757 (H.L.).

184 The cause of action specifically contemplated by Husky (i.e., a principal seeking restitution from an assignee for book debts from a assignor whose delinquency prompted the principal's liability in the first place) is of a sufficiently interconnected nexus so as to fit the "closeness" criteria mandated by the *Telford* test. This is especially the case when the assignee knew about the outstanding debts before receiving assignment of the estate. I am not persuaded by the Bank's submission that equitable set-off is not available because the right to indemnification did not arise under the contract. This analysis ignores the essential characterization of the debts. The basis of the indemnification in the appeal at bar is the debt paid by Husky on behalf of Metal Fab which related to the contracts signed between those two parties. Furthermore, according Husky the ability to set off also fulfils what is likely the principal raison d'être of the doctrine of equitable set-off in the first place, namely the promotion of fairness.

185 Lord Denning, in the *Federal Commerce* case, remarks at p. 1078 (C.A.):

> We have to ask ourselves: what should we do now so as to ensure fair dealing between the parties ... This question must be asked in each case as it arises for decision ...

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186 I recognize that, in the appeal at bar, Husky is liable under the terms of s. 133(1). Moreover, s. 133(1) entrenches an absolute liability standard in order to create joint and several responsibility among all employers for the sums that one of them has left unpaid. The question then arises why it would remain "fair" to allow Husky to, in the end, escape the effects of this liability by permitting all of the unpaid dues to flow from the estate of the insolvent bankrupt, to the detriment of the other creditors.

187 My response is twofold: (1) although s. 133 renders the principal and the contractor jointly and severally liable to the Board, as between the principal and contractor it is clear that the primary liability reposes with the contractor and, consequently, the solicitation of contribution for payments made on behalf of that contractor by the principal is consonant with commercial fairness; and (2) Husky's insistence that the contract contain terms obliging Metal Fab to make the payments to the Board and its decision to hold-back funds (this being a standard industry practice), although certainly not relieving it of liability under s. 133, does militate in favour of a finding that Husky's conduct was such that it would be equitable and fair to allow it the right of set-off.

188 Apart from United Kingdom jurisprudence, the most persuasive authority cited to us on the s. 133(3) issue is the Ontario Court of Appeal's decision in *Stevens*. Grange J.A., after reviewing the authorities, concluded that equitable set-off was available to a principal who had become fixed with liability for the contractor's unpaid debts. He concluded at p. 749:

> Whether or not the money was due to the principal before the bankruptcy, it most assuredly "arose out of or was closely connected with the same contract or series of events."

189 The Bank of Montreal also submits that s. 97(3) is not applicable to a situation where there are secured creditors who own the funds of the bankrupt. To this end, although s. 97(3) may have been applicable to the facts in *Stevens*, it is not so to the case at bar. In response, I note that s. 97(3) deems the law of set-off to operate in relation to *all claims made against the estate of the bankrupt*. There is no distinction made regarding the types of claims. And the Bank is the owner of nothing less and nothing more than the "estate of the bankrupt".

190 I thus find that, since s. 97(3) encapsulates the rights ordinarily available to Husky at equity, s. 133(3) is fully operative in the case at bar, as well as to all situations in bankruptcy where the principal would fall within the *Telford* test as I have interpreted it.

(iii) Does the Partial or Total Invalidity of s. 133(3) Render s. 133(1) Inoperative?

191 It is not necessary to consider this issue since I find that subs. (3) is constitutionally valid. However, I would like to offer certain comments on the interplay between s. 133(1) and (3).

192 It is important to recognize that s. 133(1) does not make the principal's obligation to the Board in any way contingent upon the principal's ability to obtain indemnity (through set-off or otherwise) under s. 133(3). There may be many cases in which there is either no indebtedness between the principal and the contractor or insufficient indebtedness to cover the full liability involved. Yet, in either of these situations, s. 133(1) is still fully applicable. To this end, not only does s. 133(1) operate in isolation of the bankruptcy, it also operates independently from s. 133(3). Section 133(1) is the key feature of s. 133 as a whole. It aims at preserving the integrity of the Injury Fund. Section 133(3) is clearly secondary in this regard. Consequently, I do not accept Husky's argument that s. 133(1) was intended solely to operate in conjunction with s. 133(3). Although I might be prepared to find that s. 133(3) and the equitable rights it codifies cannot operate independently from s. 133(1), I have no doubt that s. 133(1) can operate independently from s. 133(3). The legislature contemplated that s. 133(3) may

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not always be available to assist a principal to recoup sums paid under subs. (1).

193 The argument was raised that s. 133(1) cannot stand alone since, without the accompaniment of s. 133(3), it is a draconian, unreasonable provision tantamount to an expropriation. But the point of the matter is that, since s. 133(3) is merely declaratory of law and equity, s. 133(1) does not exist without a right to indemnification (or to set-off).

194 If s. 133(3) were invalid and if the law did not incorporate the equitable right of set-off (as discussed supra), then s. 133(1) would operate to guarantee the Board payment from the principal without a corresponding restitutionary recourse on behalf of the latter. Although this may seem a difficult burden to bear, in a sense it is simply the cost of doing business in a context where, for public policy reasons, the yoke of the contractor's delinquency is placed on the principal's shoulders instead of those of the workers. Although heavy, this burden, in my mind, is not draconian. It is partly attenuated by the fact that Husky, as a sophisticated employer, can be safely assumed to be well-versed in the practice of obtaining clearance certificates to protect itself from principal's liability under s. 133(1). These certificates allow a principal to determine in advance of releasing funds to a contractor whether that contractor has outstanding indebtedness to the Board. However, even if it created a draconian burden, there is nothing barring the legislature from passing such legislation. The following passage from La Forest J.A. (as he then was) in *Re Estabrooks Pontiac Buick Ltd.* (1982), 44 N.B.R. (2d) 201 at p.214, is pertinent:

> The courts should not ... place themselves in the position of frustrating regulatory schemes or measures obviously intended to reallocate rights and resources simply because they affect vested rights. For legislation almost invariably affects vested rights.

195 The legislature can even pass expropriation legislation (much more onerous that s. 133(1)) as long as the language is clear: *TransGas Ltd.*, supra; *Manitoba Fisheries Ltd. v. R.* (1978), [1979] 1 S.C.R. 101.

196 There are also policy reasons as to why s. 133(1) ought to be viewed as operating independently from s. 133(3). The Workers' Compensation Board of Alberta argues convincingly:

> ... it is submitted that to not construe section 133(1) ... separately from section 133(3) would allow mischief to creep into industrial practices. An unscrupulous employer could incorporate a subcontractor to provide all its labour services. Thereafter if that former employer (now a principal) could not be held liable under section 133(1) where the subcontractor is allowed to go into or assigns itself into bankruptcy, the Accident [Injury] Fund is at risk. Ultimately, if such a practice became widespread, the efficacy of the workers' compensation system could be undermined.

197 In sum, I respectfully disagree with the trial judge's and Court of Appeal's conclusions that s. 133 is to be treated as an indivisible whole. Although this finding is not necessary to dispose of this appeal, I hope that it may settle any extant, and preclude any future, confusion regarding the operation of s. 133, as well as its counterparts in the laws of the provinces other than Saskatchewan.

E. Some Residual Issues

198 The view of this Court was principally solicited for the purpose of answering the constitutional questions. However, several of the parties raise threshold factual issues which were not pleaded at trial which I should like to address, albeit briefly.

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199 The Bank of Montreal submits that Husky was not liable under s. 133 for payment of Metal Fab's assessments. Husky itself raises a similar issue. This follows, it is alleged, from the following argument: within the context of s. 133, assessments should relate only to the work done by the delinquent contractor for the impugned principal. In the case at bar, it is submitted that there is no indication the assessments against Husky were specific only to the work completed for Husky by Metal Fab; in fact, some affidavit evidence is now tendered to the contrary. This evidence alleges that the assessment sent to Metal Fab by the Board was not related to any particular work, but calculated in accordance with an annual payroll estimate supplied by the contractor to the Board.

200 In response, I note that both the trial judge and the appeal judges found that the order under s. 133 had been validly issued. This finding was not contested in the courts below. Leave was not granted by this Court to hear this issue. For these reasons, I believe that this issue should not now be heard for the first time. The general practice of this Court is, given the lack of considered reasons of the courts below, to refuse to consider new matters raised for the first time, especially where, had the issue actually been raised, the parties may have been in a position to present relevant evidence and submissions: *Vickery v. Nova Scotia (Prothonotary of the Supreme Court)*, [1991] 1 S.C.R. 671; *R. v. Amway of Canada Ltd.*, (sub nom. *R. v. Amway Corp.)* [1989] 1 S.C.R. 21.

201 A far preferable procedure would be to permit this argument to be raised at the new trial that, given the constitutionality in bankruptcy of s. 133, shall be ordered pursuant to the disposition of the instant appeal. At that point, evidence can be adduced as to the exact sources of the $246,745.26 allegedly owed by Metal Fab to the Board. A trial judge, when properly presented with all of the material evidence, will be in a far better position to sift through the records and ascertain the true amount of Metal Fab's unpaid contributions for which Husky could be held liable. Although it could very well be that the extant assessments reveal Husky's true liability, at this juncture I am not prepared to make such a finding.

202 However, although not in a position to determine whether the assessments made against Husky by the Board involved unpaid contributions stemming from work Metal Fab completed for principals other than Husky, this Court can, as a question of law, determine whether s. 133 could permit the recovery of such amounts. I find it does not. The liability of the principal is to be limited to the specific work that was completed for it by the delinquent contractor.

203 It is unfortunate that the wording of s. 133 in the 1979 version of the statute was amended in an ambiguous form. In cases of ambiguity, courts are to rely on the principle of statutory interpretation according to which statutes purporting to pay the debts of one person out of the property of another are to be given a restrictive interpretation: *Driedger on the Construction of Statutes* (3rd ed.), at p. 370; *Homeplan Realty Ltd. v. Avco Financial Services Realty Ltd.*, (sub nom. *Industrial Relations Board v. Avco Financial Services Realty Ltd.)* [1979] 2 S.C.R. 699.

204 I am further fortified in this regard by the fact that the grandfather of s. 133, s. 9 of the 1910 *Workmen's Compensation Act*, limited the principal's liability to the actual work executed for it by the delinquent contractor: see also s. 11 of the 1928 legislation. In any event, gauging from the submissions made before this Court by the Appellants and some of the Interveners, such appears to be the practice of the provincial Boards when issuing notices under s. 133 and its companion provisions. This accords with common sense, as it would appear counterintuitive to hold Husky liable for *all* of Metal Fab's outstanding debts to the Board. Under such a regime, liability could be virtually limitless since it might encompass all of the shortfall accruing to the contractor independent of the particular principal under whose contracts that shortfall actually arose.

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205 However, I note that, although relevant to the amount of the assessment in the appeal at bar, this issue is not of wide public importance given that the Saskatchewan legislation was once again amended in 1993 (S.S. 1993, c. 63, s. 40) to provide expressly that the liability be limited to the specific work performed. As I see it, the 1993 amendment supports my conclusion that the liability of the principal be limited to the unpaid funds arising out of the specific work completed for it since this amendment appears to be intended as a clarification of the law, not as a substantive change.

206 I also find that limiting s. 133(1) to the debts arising out of the actual work completed for the principal permits the subsection to operate in tandem with subs. (3). As was discussed supra, subs. (3), in order to be valid in the bankruptcy context, must be interpreted to permit only set-off to the extent allowed at law or equity. I believe that the law of set-off would only allow the restitution of the sums paid by the principal to the Board that actually involved monies that the delinquent contractor was liable to pay by virtue of its nexus with the princip- al.

207 The Workers' Compensation Board and the Bank of Montreal raise a further issue. It is suggested that s. 133(3) does not entitle Husky to indemnify itself out of funds owing to Metal Fab because it received the demand for payment from the Board after it had been notified that Metal Fab had given notice of assignment of book debts to the Bank of Montreal. There was thus no "indebtedness towards the contractor", but only towards the assigned party.

208 Again, I note that this issue was not argued fully in the courts below; in fact, no questions were raised regarding the factual ability of Husky to indemnify itself from the property of the bankrupt. It thus comes as no surprise that the factual record to which this Court can turn to resolve this question is somewhat bare. I therefore conclude that this issue should not be decided at this point. It is better left to be determined by a trial court, perhaps even by fiat. I would suggest, however, that the fact that s. 133(3) is but declaratory of equitable set-off (as discussed supra), in which set-off can operate after the assignment has occurred, be seriously taken into account in the eventual disposition of this issue.

209 Husky argues that it did not breach its statutory duty to ensure payment by the contractor under s. 133(1) because it held back certain sums (in excess of the unpaid assessments) and ensured that Metal Fab would be contractually bound to pay the WCB fund. Until this point in the litigation, it was settled that Husky was, barring the non-operation of the statute, liable to pay the Board. There is no reason for this Court now to review the findings of the trial and appellate judges in this matter, especially, once again, given the paucity of the factual record advanced in favour of this proposition.

210 In any event, I note that the duty created by s. 133(1) is not one of due diligence. The statutory language has encumbered the principal with absolute liability. Nothing short of actually ensuring payment will discharge the duty. Husky's reading of s. 133(1) ignores the true purpose of the provision, namely the maintenance of the viability of the Injury Fund through the creation of joint and several liability among employers for the contributions.

211 Finally, on a related note, it is submitted that once the property passed into the hands of the assigned Bank, Husky was no longer in any position of control or supervision over Metal Fab. Therefore it no longer operated under the statutory duty to ensure that Metal Fab paid its assessments. For this reason, the ability of the Board to collect under s. 133(1) could not be invoked. Husky also submits that, were it to encourage the bankrupt to pay the amounts due to the Board, it would infringe s. 158 (obligation of a bankrupt to deliver all of the

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property to the trustee) and thereby effectively aid and abet in the commission of an offence contrary to s. 198(*a*) of the *Bankruptcy Act*. I reject this submission. A bankrupt's obligations under s. 158 are necessarily qualified by other provisions of the Act such as s. 72(1) (allowing interplay with provincial legislation) and s. 97(3) (recognizing rights of set-off against the bankrupt's estate). There is no operational conflict between ss. 133(1) and 158(*a*). I also note that s. 133(1) creates a situation in which, ab initio, the principal is liable for any debt owed to the Board by the contractor. It does not matter whether, ex post facto, control over the contractor's estate passes into other hands.

VI. Conclusions and Disposition

212 By way of summary, it may be helpful to state my conclusions:

1. There is no conflict between s. 133(1) of the Act and the *Bankruptcy Act*. Consequently, s. 133(1), although not primarily designed for the bankruptcy context, is applicable and operative if and when the contractor whose delinquency gave rise to the Board's order against the principal files an assignment in bankruptcy.

2. There is no conflict, as the term is understood in paramountcy analysis, between s. 133(3) and the *Bankruptcy Act*, regardless of whether s. 133(3) is used for purposes of set-off or indemnification from the estate of the bankrupt. Section 133(3) is declaratory of the equitable right of set-off and indemnification. Such an equitable right arises upon the facts of this case and is reconcilable with the *Bankruptcy Act* by virtue of s. 97(3).

3. In terms of constitutional analysis, the simple fact that a provincial undertaking may have an effect upon a bankruptcy does not necessarily mean that such an undertaking is to be nullified under paramountcy analysis. Further, the fact that the Board might be able to recover more money as a result of s. 133 does not mean that this provision is in operational conflict with the *Bankruptcy Act*. Operational conflict means that compliance with the provincial statute means offending the federal one. But the two pieces of legislation involved here are complementary.

4. The Court of Appeal erred in law in asserting that the "quartet" of Supreme Court of Canada cases, *Bourgault*, *Deloitte*, *Belair*, and *F.B.D.B.*, are to be interpreted as invalidating any provincial law that affects the outcome of a bankruptcy.

213 I would answer the constitutional questions as follows:

1. Where a contractor as referred to in section 133 of the *Workers' Compensation Act*, S.S. 1979, c. W-17, is in bankruptcy and but for the bankruptcy, the principal as referred to in s. 133 would be liable to pay the assessment due by the contractor under the *Act*, is section 133 of the said *Act* inoperative or inapplicable in whole or in part, by reason of being in conflict with the *Bankruptcy Act*, R.S.C. 1985, c. B-3, and in particular sections 17(1), 67, 95, 136(1)(h), 148, 158(a) and 198(a) thereof?

No.

2. Was section 133 of the said *Act* inoperative or inapplicable in the circumstances of this case?

No.

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214 Consequently, I would allow the appeal with costs throughout and set aside the judgment of the Saskatchewan Court of Appeal. I would remit the matter to trial in order to determine whether, on the facts of this case, the Board notice to pay was properly tendered under s. 133(1), whether Husky can (despite the assignment and the timing of the notice thereof) indemnify itself from the property of the bankrupt, and whether the amounts assessed were actually those which arose out of Metal Fab's work for Husky. If so, then the Board is statutorily entitled to recover the unpaid contributions from Husky and Husky, in turn, can set off these amounts from the hold-backs it has regarding the property of the bankrupt, which has been assigned to the Bank of Montreal. In the unlikely event of a shortfall between the contributions owing and the amount held back, Husky is entitled to file a claim for this shortfall as an unsecured creditor, unless it wishes to present legal submissions as to why it should be able to claim under s. 136(1)(*h*).

215 After these reasons were prepared, I had the benefit of reading the reasons of my colleague Gonthier J. I would like to offer a response on certain points. I am uncomfortable with reliance upon secondary sources — even sources as allegedly succinct and helpful as the article by Roman and Sweatman — for *interpretation* of this Court's decisions. I believe that it is preferable to refer directly to the decisions, particularly when I find that the article in question advances propositions which I find problematic in the so-called "effect" aspect, which I will now discuss.

216 My understanding of the concept of "effect" in this Court's federalism jurisprudence is that both vires and paramountcy analyses hinge upon the *extent* of the effect. "An" effect on a federal sphere is, by itself, insufficient to invalidate provincial legislation. Rather, there must be a relatively substantial effect (i.e., an effect that is more than incidental or ancillary). Where this is so, the operational conflict must be express, as I have mentioned in these reasons; upon finding such an operational conflict, the provincial legislation will yield to the federal legislation to the extent of the conflict. In so far as my colleague has introduced some further refinements on this traditional analysis, dealing with exclusive as opposed to concurrent or overlapping jurisdictions, and invoking a separate concept or doctrine of "applicability" in this context, I, with respect, find this somewhat confusing. In short, it seems to me to confuse the doctrines of vires and paramountcy, as these have been traditionally understood, and I do not read the *Deloitte, Haskins* and *Bank of Montreal* cases as supporting such a departure.

Appeal dismissed.

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Re Polly Peck International plc (in administration)

CHANCERY DIVISION (COMPANIES COURT)

ROBERT WALKER J

22, 23, 24 NOVEMBER, 6 DECEMBER 1995

Company - Winding up - Proof and ranking of claims - Rule against double proof - Holding company using subsidiary to issue bonds and on-loan funds raised - Holding company and subsidiary both going into liquidation - Subsidiary and bondholders lodging claims under holding company's scheme of arrangement in respect of bond funds - Whether claims in respect of the same debt - Whether rule against double proof precluding payment of dividend to subsidiary.

Company - Corporate personality - Lifting corporate veil - Holding and subsidiary companies - Whether subsidiary the agent or nominee of holding company - Whether subsidiary and holding company should be treated as one economic unit.

Between 1987 and 1990 a holding company, PPI, set up a special purpose, wholly-owned subsidiary in the Cayman Islands in order to raise finance to develop the group's business activities by means of a number of bond issues. The subsidiary, PPIF, issued the bonds to a group of foreign banks which managed the issues and also acted as principal paying agents. PPIF's repayment obligations were guaranteed by PPI and all funds received by PPIF were on-loaned to PPI. Each bond issue included inter alia a provision for PPI to be substituted for PPIF as the principal obligor and was formally documented by a public bond issue agreement, a guarantee agreement and a prospectus. In practice, once PPIF had formally joined in a bond issue, its subsequent involvement was minimal; in particular, it had no current account at a bank and all payments of interest, fees and costs in connection with the bonds were made by PPI. In October 1990 PPI went into administration and in May 1995 a scheme of arrangement was approved, which included a provision prohibiting any creditor from proving more than once in respect of any scheme claim. In March 1995 PPIF itself was placed in creditors voluntary liquidation in the Cayman Islands and its liquidators thereafter submitted a notice of claim to the scheme supervisors of PPI, claiming £485m in respect of the sums on-loaned. The banks as bondholders also lodged claims amounting to £85m against PPI pursuant to the guarantees. After admitting the bulk of the banks' claims, the supervisors applied to

the court seeking directions as to (i) whether PPIF was entitled to maintain a claim in the arrangement separate to those of the banks in respect of what was, in substance, the same debt, or alternatively (ii) whether the rule against double proof precluded PPIF from receiving a dividend in addition to that payable to the banks.

Held - In determining whether two claims were so closely connected as to be, in substance, claims in respect of the same debt, the court would look to the legal substance of the relevant transaction and not to the economic substance, if different. It was not open to the court to disregard the principle of separate corporate personality and to treat a closely-integrated group of companies as a single economic unit on the basis merely of perceived injustice, particularly where

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the separate legal existence of those companies assumed greater importance once they became insolvent. Having regard to the legal documents entered into on the occasion of each bond issue, it was impossible to conclude that a relationship of agency or nomineeship could be inferred between the companies, with the result that the on-loan could not be eliminated as a significant part of the composite transaction. Further, since PPIF was clearly more than a mere facade and there was no legal basis on which the PPI group could be regarded as a single economic unit, it followed that the claims were not, in substance, claims in respect of the same debt and were not precluded by the rule against double proof. Both claims would accordingly be admitted in full as scheme liabilities (see p 444 *d e j* to p 445 *a j* to p 446 *c j*, p 447 *g j* and p 448 *e* to *j*, post).

Notes

For provable debts and the rule against double proof to claims in respect of guarantees, see 7(2) *Halsbury's Laws* (4th edn reissue) paras 1747, 1758.

For piercing the corporate veil, see 7(1) *Halsbury's Laws* (4th edn reissue) para 90.

Cases referred to in judgment

Adams v Cape Industries plc [1991] 1 All ER 929, [1990] Ch 433, [1990] 2 WLR 657, Ch D and CA.

AG Securities v Vaughan, Antoniades v Villiers [1988] 3 All ER 1058, [1990] 1 AC 417, [1988] 3 WLR 1205, HL.

Aslan v Murphy (Nos 1 and 2), Duke v Wynne [1989] 3 All ER 130, [1990] 1 WLR 766, CA.

Bank of Tokyo Ltd v Karoon [1986] 3 All ER 468, [1987] AC 45, [1986] 3 WLR 414, CA.

Barclays Bank Ltd v TOSG Trust Fund Ltd [1984] 1 All ER 628, [1984] AC 626, [1984] 2 WLR 49, CA; *affd* [1984] 1 All ER 1060, [1984] AC 626, [1984] 2 WLR 650, HL.

Canada Rice Mills Ltd v R [1939] 3 All ER 991, PC.

Chow Yoong Hong v Choong Fah Rubber Manufactory Ltd [1961] 3 All ER 1163, [1962] AC 209, [1962] 2 WLR 43, PC.

Ellis v Emmanuel (1876) 1 Ex D 157, [1874-80] All ER Rep 1081, CA.

Firestone Tyre and Rubber Co Ltd v Lewellin (Inspector of Taxes) [1957] 1 All ER 561, [1957] 1 WLR 464, HL.

Ford & Carter Ltd v Midland Bank Ltd (1979) 129 NLJ 543, HL.

Furniss (Inspector of Taxes) v Dawson [1984] 1 All ER 530, [1984] AC 474, [1984] 2 WLR 226, HL.

Gilford Motor Co Ltd v Horne [1933] Ch 935, [1933] All ER Rep 109, CA.

Helby v Matthews [1895] AC 471, [1895-9] All ER Rep 821, HL.

Hoey, Re, ex p Hoey (1918) 88 LJKB 273, DC.

IRC v Duke of Westminster [1936] AC 1, [1935] All ER Rep 259, HL.

Jones v Lipman [1962] 1 All ER 442, [1962] 1 WLR 832.

Liverpool, The (No 2) [1960] 3 All ER 307, [1963] P 64, [1960] 3 WLR 597, CA; *rvsg* [1960] 1 All ER 465, [1963] P 64 [1960] 2 WLR 541.

McEntire v Crossley Bros Ltd [1895] AC 457, [1895-9] All ER Rep 829, HL.

Melton, Re, Milk v Towers [1918] 1 Ch 37, [1916-17] All ER Rep 672, CA.

Meridian Global Funds Management Asia Ltd v Securities Commission [1995] 3 All ER 918, [1995] 2 AC 500, [1995] 3 WLR 413, PC.

Moss, Re, ex p Hallet [1905] 2 KB 307, [1904-7] All ER Rep 713, DC.

Oriental Commercial Bank, Re, ex p European Bank (1871) LR 7 ChApp 99, LJJ.

Palette Shoes Pty Ltd v Krohn (1937) 58 CLR 1, Aust HC.

Prudential Assurance Co Ltd v Newman Industries Ltd (No 2) [1982] 1 All ER 354, [1982] Ch 204, [1982] 2 WLR 31, CA.

Salomon v Salomon & Co Ltd, Salomon & Co Ltd v Salomon [1897] AC 22, [1895-9] All ER Rep 33, HL.

Sass, Re, ex p National Provincial Bank of England [1896] 2 QB 12.

Welsh Development Agency v Export Finance Co Ltd [1992] BCLC 148, CA.

Woolfson v Strathclyde Regional Council 1978 SLT 159, 1978 SC 90, HL.

Cases also cited and referred to in skeleton arguments

British Eagle International Airlines Ltd v Cie Nationale Air France [1975] 2 All ER 390, [1975] 1 WLR 758, HL.

Company, Re a (No 002470 of 1988), ex p Nicholas [1991] BCLC 480, Ch D; sub nom *Nicholas v Soundcraft Electronics Ltd* [1993] BCLC 360, CA.

De Salaberry Realties Ltd v Minister of National Revenue (1974) 46 DLR (3d) 100, Can Fed Ct.

DHN Food Distributors Ltd v Tower Hamlets London Borough [1976] 3 All ER 462, [1976] 1 WLR 852, CA.

FG (Films) Ltd, Re [1953] 1 All ER 615, [1953] 1 WLR 883.

Holdsworth (Harold) & Co (Wakefield) Ltd v Caddies [1955] 1 All ER 725, [1955] 1 WLR 352, HL.

Revlon Inc v Cripps & Lee Ltd [1980] FSR 85, Ch D and CA.

Scottish Co-op Wholesale Society Ltd v Meyer [1958] 3 All ER 66, [1959] AC 324, HL.

Smith Stone & Knight Ltd v Birmingham Corp [1939] 4 All ER 116.

Summons

By summons dated 31 July 1995 Christopher John Barlow, Ian Douglas Barker Bond and Christopher Morris, the supervisors of a scheme of arrangement in respect of Polly Peck International plc (in administration) (PPI), sought directions under the scheme in relation to the notice of claim of the respondents, Polly Peck International Finance Ltd (PPIF) (a subsidiary of PPI, incorporated in the Cayman Islands) and the claims of Arab Banking Corporation-Daus & Co GmbH, appointed by the court on 1 August 1995 to represent a number of banks holding bonds issued by PPIF and guaranteed by PPI. On 5 September 1995 Mr Registrar Buckley ordered the hearing of a preliminary issue as to whether the respondent could maintain a separate claim in the arrangement from that of the bondholders, or whether the rule against double proof precluded it from receiving a dividend in addition to the dividend payable to the bondholders. The facts are set out in the judgment.

Leslie Kosmin QC and David Chivers (instructed by Cameron Markby Hewitt) for the applicants.

Gabriel Moss QC (instructed by Lovell White Durrant) for the respondents.

Cur adv vult

6 December 1995. The following judgment was delivered.

ROBERT WALKER J.

Polly Peck: the scheme of arrangement

In the late 1980s Polly Peck International plc (PPI) was the holding company of a fast-growing group with a diversified range of interests. The group's core activities were agriculture and food production but they extended to electrical

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consumer goods, textiles, pharmaceuticals, cosmetics and tourism. PPI had subsidiaries in many countries including England, north Cyprus, Turkey, Hong Kong, the United States, Switzerland and Liberia.

PPI ran into severe financial difficulties in 1990 and on 25 October 1990 it went into administration. The purposes of the administration order made by Morritt J were those specified in s 8(3)(a) and (d) of the Insolvency Act 1986, but it is now clear that PPI is not going to be able to trade out of its difficulties. The purposes of the administration have been extended to seeking approval of a scheme of arrangement, and after a creditors' meeting on 26 April 1995 a scheme of arrangement was approved on 11 May 1995 and took effect on 18 May.

The scheme provides (para 2) for the usual moratorium and (para 3) for the collection and realisation of PPI's assets. Scheme claims were to be notified to the scheme supervisors who could admit or reject them in whole or part, or refer them to the court. Paragraph 7(i) provides that the supervisors are not to admit any claim which would not be admissible in a liquidation if PPI had gone into compulsory liquidation on the date when the scheme took effect.

Paragraph 9 of the scheme provides for the distribution of the scheme assets (after provision for costs and preferential claims and subject to some special provisions as to the so-called club banks) rateably between scheme creditors whose claims have been admitted. Paragraph 9.9 is in these terms:

> 'No scheme creditor shall be entitled to receive an amount in the scheme which exceeds the amount of his scheme claim nor to prove more than once in respect of any scheme claim, and for the avoidance of doubt the rule against double proof shall apply in respect of all distributions and reserves made in the scheme.'

The scheme is therefore on familiar lines, providing for a sort of notional liquidation in advance of any actual liquidation, with a view to saving costs.

The matter which I have to decide is a preliminary issue (ordered by Mr Registrar Buckley on 5 September 1995) on a summons seeking directions under the scheme. The issue is as to the application of the rule against double proof. The circumstances in which the issue arises are connected with a subsidiary of PPI, Polly Peck International Finance Ltd (PPIF), which was incorporated in the Cayman Islands on 20 May 1987.

The bond issues

Between June 1987 and February 1990 there were no fewer than eight bond issues which raised a total of SwF 665m and DM 100m--a total of over £400m at current exchange rates--for the PPI group. Except for some points of difference summarised below, all eight issues were arranged on the same general lines: they comprised unsecured, unsubordinated fixed-rate bearer bonds issued by PPIF and guaranteed by PPI. The lead manager for the Swiss franc issues was SG Warburg Soditic SA (Warburg SA) and for the single DM issue, Arab Banking Corporation-Daus & Co GmbH (ABC-Daus). ABC-Daus assumed the position of trustee for the bondholders under the DM issue. Each of these lead managers also acted as principal paying agent.

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The eight bond issues were as follows.

Amount		Payment date	Rate	Redemption
1	SwF 65m	7 July 1987	3%	1997
2	SwF 75m	13 Aug 1987	6%	1992
3	SwF 50m	19 Nov 1987	61/4%	1990
4	SwF 100m	7 April 1988	53/4%	1993
5	DM 100m	20 April 1988	6%	1993
6	SwF 125m	20 Sept 1989	55/8%	1994
7	SwF 100m	1 March 1989	61/4%	1996
8	SwF 200m	1 March 1990	83/4%	1997

In the event only SwF 150m was raised under the last issue.

There were two main differences between the issues. The first issue was convertible into ordinary shares of PPI (a right reflected in the interest rate) and the whole issue was in fact converted into PPI ordinary shares, or (as to a small balance) redeemed, before PPI crashed. The first issue is nevertheless significant because in other respects it set the pattern for later issues. The DM issue was established with ABC-Daus as a trustee--a feature not found in the SwF issues--and it did not in terms provide for PPI to be liable as a principal obligor (although PPI's obligations as guarantor

were stated in cl 3 of the guarantee agreement to be 'autonomous and independent'). It is however common ground that nothing turns on any difference between PPI's obligations under the SwF issues (which were governed by Swiss law) and its obligations under the DM issue (which was governed by German law).

The first issue was discussed at a meeting at 42 Berkeley Square, London W1 (then PPI's head office) on 5 May 1987. It was chaired by Mr David Fawcus, then PPI's finance director, and attended by representatives of Warburg SA, two firms of London solicitors, and Stoy Hayward (PPI's auditors) as well as by PPI personnel. It considered a board paper (prepared by Mr Wood, the group treasurer) which proposed 'that the bonds be issued in the name of a new Cayman Islands subsidiary under the guarantee of [PPI]' in order to avoid onerous listing requirements in London, and achieve certain tax advantages. The board paper estimated the costs of the issue:

> 'In simple terms, front end costs are likely to be about £1.6m or just under 4% of total raised. Annual costs will be about 3·433% or 6·430%, inclusive of hedging expenses, for tranche A and B respectively.'

(The two tranches had different coupons and conversion terms.) The board paper assumes, but does not refer to the proceeds of the issue being lent on to PPI.

PPI, through its London solicitors, then took advice from Cayman attorneys as to the formation and use of a Cayman financial vehicle. The Cayman attorneys gave full written advice in a faxed letter dated 11 May 1987. Their advice included

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the following advice as to the on-loan from PPIF (as it was named on its incorporation) to PPI:

> 'It is usually the case that commercial paper issues and traditional forms of Eurocurrency financing can be structured so as not to constitute "banking business". However, some care needs to be paid to the manner in which funds are raised and are then on-lent to the parent or other companies within the relevant group. Thus, the on-lending arrangements should be evidenced by appropriate documentation (which can of course be relatively brief given the in-house nature of the transactions). In particular those on-lending arrangements should be structured so that the repayment of the loans is not simply on a demand basis. Other clients at this firm have not met any difficulty meeting these parameters. Cayman Islands' Companies Law follows English legal principles. Thus a company should only enter into transactions intended for its benefit and the directors must act in good faith in the interests of the company. As a result, the financing arrangements should be structured so as to produce a profit (albeit small) for the Cayman Islands' company. Generally-speaking this is achieved by the company charging a rate of interest when on-lending these funds which is higher than the rate it pays on the borrowed funds or by the company charging a fee.'

On 13 May 1987 there was a board meeting of PPI at 42 Berkeley Square attended by Mr Asil Nadir (the chairman and chief executive of PPI), Mr Ellis (a senior executive), Mr Fawcus (the finance director) and others. The board considered the paper on the convertible SwF issue and approved it, subject to approval by certain other interests. PPIF was then incorporated with Mr Moon (a Cayman attorney), Mr Nadir, Mr Ellis and Mr Fawcus as its directors. It had an authorised

capital of SwF 1m, divided into shares of SwF 1; 25,000 of them were issued and credited as fully paid. PPIF has always been a wholly-owned subsidiary of PPI. Mr Moon resigned as a director at the first board meeting of PPIF held on 28 May 1987. Thereafter the board of PPIF consisted solely of individuals who were also PPI directors, meeting at 42 Berkeley Square. There was never any attempt to argue that PPIF's directing mind was outside the United Kingdom or that the company was non-resident for United Kingdom tax purposes (indeed, its residence in the United Kingdom was necessary for purposes of group relief).

There are some features common to all the bond issues which call for mention, because they were relied on by counsel in their submissions. Each of the bond issues stated in its prospectus that the proceeds of the issue were to be used for refinancing and development of the Polly Peck group's business activities. The form of words used varied to some extent (the exact words of each prospectus are quoted in para 16 of an affidavit sworn on 27 September 1995 by Mr David Kidd, a partner in the firm of solicitors acting for the scheme supervisors); but the general effect did not vary much.

Each of the Swiss bond issues also included in its conditions a provision for PPI or another non-Swiss subsidiary of PPI to be substituted for PPIF as the principal obligor, with the consent of Warburg SA, such consent not to be unreasonably withheld so long as the bondholders' interests were adequately protected (especially as regards tax). The DM bond issue contained a similar provision for substitution in a manner satisfactory to ABC-Daus.

The on-loan from PPIF to PPI

The Cayman attorneys' advice that the on-lending arrangements should be evidenced by appropriate (if brief) documentation was not carried through, so far

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as the administrators' scrutiny of PPI's papers has revealed. In October 1987 London solicitors sent instructions to tax counsel to settle a draft loan agreement for the on-loan from PPIF to PPI. That was after the second SwF issue had been completed and when the third issue was about to be completed. After some supplementary instructions had been sent and a consultation had been held in January 1988, tax counsel settled the draft agreement on 29 February 1988 in a form which recited an on-loan from PPIF to PPI of approximately SwF 135·4315m, the balance of SwF 4·4385m (representing the costs of the first two SwF issues totalling SwF 140m) being treated as an arrangement fee payable by PPI to PPIF. The draft provided in advance for similar treatment of future costs of the first two issues. (The lawyers were in fact being rather overtaken by events, because by the time the draft was settled the third SwF issue had also been completed and the fourth SwF issue, and the DM issue, must have been in the pipeline.) The draft loan agreement provided for the on-loan to carry interest--

> 'payable half-yearly at the rate of 1/4 per cent above the rate of interest payable by PPIF in respect of the corresponding tranche of the Bonds [viz the first two issues] or at such other rate or rates as shall from time to time be agreed between the parties.'

As I have said, no executed loan agreement between PPIF and PPI (either in the above or in any other form) has been found and there is no evidence (either in the form of board minutes or in any other form) that any such loan agreement ever existed. The draft settled by tax counsel provides some evidence at least as to the transaction having had the character of a loan.

In practice, once PPIF had formally joined in a bond issue, its involvement in the subsequent management of the issue seems to have been minimal. It had no current account at a bank (though the proceeds of each issue do seem to have been held briefly to an account in PPIF's name at the lead manager's bank.) In practice all payments of interest, fees and costs in connection with the bonds seem to have been made by PPI, and the state of account between PPI and PPIF can be determined only by internal accounting records kept at PPI's offices and from PPIF's financial statements. There are financial statements of PPIF for the accounting period to 31 December 1988, signed by Mr Nadir and Mr Fawcus and audited by Stoy Hayward, which show PPIF as having a revenue reserve of SwF 696,000 at 31 December 1988. This appears to reflect the 1/4% turn (provided for in the draft loan agreement) on outstanding bonds to the amount of about SwF 435m; this was on the basis that PPI had borne initial costs of bond issues which by then amounted to SwF 10m. PPI's practical responsibility for servicing the bonds was also reflected in communications from the principal paying agents: Warburgs SA sent demands for interest direct to PPI, and ABC-Daus sent them to PPIF 'care of' PPI.

Another scrap of evidence is a letter that Mr Spencer of Stoy Hayward wrote to Mr Fawcus on 29 September 1987. Mr Spencer referred to an election under the Income and Corporation Taxes Act 1970, s 256 (group relief) which was outstanding and advised that--

> 'if you are funding the interest payment from PPI it is important initially that this will be in the form of an interest-free advance which can be set off against the interest payment due and payable once we have formally received clearance from the Inland Revenue.'

Mr Fawcus wrote on the letter a manuscript note to Mr Wood:

[1996] 2 All ER 433 at 440

> 'A lot of garbage. Just note that PPI should not pay interest to PPIF until tax status of PPI is cleared. Until then payments should take the form of an advance.'

So despite his initial comment Mr Fawcus seems to have understood and accepted the essential

point of the advice.

Apart from its involvement in the bond issues PPIF was a party to two other group transactions. On 4 November 1987 it provided security to Banque Paribus (Suisse) SA for an advance of SwF 15m. On or about 19 October 1987 it joined with PPI in a joint and several guarantee to a Hong Kong group creditor, BSR International plc. Both these seem to have been short-term transactions which give rise to no continuing liability.

I have gone into these factual matters at what would be, in other circumstances, excessive detail because of the submission made to me by Mr Leslie Kosmin QC (who appears with Mr David Chivers for the supervisors) that PPIF was, in relation to the bond issues, a cipher, agent or nominee. That submission is controverted by Mr Gabriel Moss QC, who appears for both the respondents, PPIF and ABC-Daus. They have a common interest in resisting the conclusion that this is a case of double proof (if they fail in that their interests will diverge as to which claim should be rejected; but the order for a preliminary issue recognises that that second stage may not be reached).

Before making any finding on the secondary issues of fact (that is whether PPIF was a cipher, agent or nominee) I must summarise the claims that have been put in, and then turn to the questions of law that have been argued before me.

The notices of claim

PPIF was placed in creditors' voluntary liquidation in the Cayman Islands on 23 March 1995. It has two chartered accountants as joint liquidators, one practising in the Cayman Islands and one in London. On 24 May 1995 the London-based liquidator, Mr Beirne, submitted to the scheme supervisors a notice of claim (as at 15 May 1995) approximately as follows:

	SwF	DM	total (£)
principal	600m	100m	361m
interest	209m	32m	124m
total	809m	132m	485m

The claim for interest was based on the bond rates, plus 1/4%, for periods starting in late 1989 or in 1990.

On 9 June 1995 ABC-Daus gave notice of a claim (as at 15 May 1995) for about £64·4365m, about £44m of which represented principal (the rest was for interest, including £7m default interest under the German civil code, and £170,000 legal costs). It has been agreed that Warburg SA should act as agent for the Swiss bondholders, who have claims against both PPIF and PPI. The total claims

against PPI so far notified by Warburg SA amount to about £421m.

When Mr Kidd swore his affidavit on 27 September 1995 the position was that the bulk of the ABC-Daus claim had been admitted by the scheme supervisors,

apart from the default interest, and the Warburg SA claim had been admitted almost in its entirety. Mr Moss tells me, no doubt correctly, that the default interest has since been admitted. Bondholders' admitted claims against PPI as guarantor are therefore of the order of £485m. PPIF's unadmitted claim is approximately the same size. Apart from these claims and the 'club bank' claims, there are other scheme claims against PPI amounting to a sum of the order of £1bn. The double proof point does therefore have a significant effect on the distribution of assets.

A dividend of 1·431p in the pound has already been paid under compromise arrangements approved by Mr Registrar Buckley on 19 October 1995. The scale of further dividends will, I understand, depend on the outcome of pending litigation.

The issue which I have to decide is put this way in para 44 of Mr Kidd's affidavit.

> 'Having investigated PPIF's claim in the Scheme, the Supervisors have become concerned that, due to what appeared to them to be the lack of separate corporate personality on the part of PPIF, the Court might hold that the corporate veil should be lifted so preventing PPIF from maintaining a claim separate from the bondholders' claims against PPI. Alternatively, even if PPIF is entitled to a separate claim, such a claim might be held to arise out of what is, in substance, the same debt (being the debt to the bondholders), so that PPIF would be barred from receiving a dividend in addition to that payable to the bondholders by the rule against double proof. In these circumstances the Supervisors have decided, on the basis of legal advice that they should seek directions from the Court before paying any dividends to both the bondholders and PPIF.'

The rule against double proof

The rule against double proof is a long-standing principle of the law of bankruptcy, and has applied in the winding up of companies since the Companies Act 1862 (see *Re Oriental Commercial Bank, ex p European Bank* (1871) LR 7 Ch App 99). It has often been described in terms of straightforward and obvious fairness, depending on substance, not form. Thus in that case Mellish LJ said (at 103-104):

> 'But the principle itself--that an insolvent estate, whether wound up in Chancery or in Bankruptcy, ought not to pay two dividends in respect of the same debt--appears to me to be a perfectly sound principle. If it were not so, a creditor could always manage, by getting his debtor to enter into several distinct contracts with different people for the same debt, to obtain higher dividends than the other creditors, and perhaps get his debt paid in full. I apprehend that is what the law does not allow; the true principle is, that there is only to be one dividend in respect of what is in substance the same debt, although there may be two separate contracts.'

See also *Re Moss, ex p Hallet* [1905] 2 KB 307 at 312, [1904-7] All ER Rep 713 at 715, *Re Melton, Milk v Towers* [1918] 1 Ch 37 at 60, [1916-17] All ER Rep 672 at 682-683, *Re Hoey, ex p Hoey* (1918) 88 LJKB 273 at 274, *The Liverpool (No 2)* [1960] 3 All ER 307 at 313, [1963] P 64 at 84 and *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] 1 All ER 628 at 636 and 653-654, [1984] AC 626 at 636 and 659-660 per Oliver and Slade LJJ respectively. In the last case Kerr LJ said ([1984] 1 All ER 628 at 645, [1984] AC 626 at 649):

[1996] 2 All ER 433 at 442

> 'The rule against double proof is highly technical in some facets of its application, but ultimately it is based on what the court regards as justice between all the creditors.'

It appears that the most technical facet which Kerr LJ had in mind was the distinction (discussed in the judgment of Oliver LJ ([1984] 1 All ER 628 at 641-642, [1984] AC 626 at 643-644), between the guarantee of a part of a debt, and the guarantee of the whole debt subject to a limitation on the guarantor's liability. I will call this the *Ellis v Emmanuel* distinction (see *Ellis v Emmanuel* (1876) 1 Ex D 157, [1874-80] All ER Rep 1081; also, *Re Sass, ex p National Provincial Bank of England* [1896] 2 QB 12). In *Barclays Bank Ltd v TOSG Trust Fund* the Court of Appeal had the difficult task of applying the *Ellis v Emmanuel* distinction, by analogy, to unusual and complicated facts (on which the House of Lords then took a different view, so that no question of double proof arose).

Much the commonest situation in which the rule against double proof applies is that of suretyship. Indeed it has been said that it applies only in a situation which actually is, or is analogous to, that of suretyship (the latter category includes the old cases on negotiable instruments considered in *Re Oriental Commercial Bank, ex p European Bank)*. It is therefore convenient to set out some very elementary rules as to suretyship, shorn of complications arising from the provision of security or from the *Ellis v Emmanuel* distinction. In what follows, C is the principal creditor, D the principal debtor, and S the surety (and all are companies).

(1) So long as any money remains due under the guaranteed loan, C can proceed against either D or (after any requisite notice) S.

(2) If D and S are both wound up, C can prove in both liquidations and hope to receive a dividend in both, subject to not recovering in all more than 100p in the pound.

(3) S's liquidator can prove in D's liquidation (under an express or implied right of indemnity) only if S has paid C in full (so that C drops out of the matter and S stands in its place).

(4) As a corollary of (3) above, S's liquidator cannot prove in D's liquidation in any way that is in

competition with C; though S has a contingent claim against D (in the event of C being paid off by S), S may not make that claim if it has not in fact paid off C.

The situation in (2) above is what insolvency practitioners call a 'double-dip', which is permissible; the situation in (4) above is the simplest case of what would be double proof, which is not permissible.

So far as the basis of the rule needs (or indeed allows of) further explanation it is that the surety's contingent claim is not regarded as an independent, free-standing debt, but only as a reflection of the 'real' debt--that in respect of the money which the principal creditor had loaned to the principal debtor. Similarly in the cases analogous to a suretyship situation: in *Re Hoey* the only true debt, in substance, was to the mortgagee, Mr O'Brien, and Dr Hoey's covenant with his wife (when he conveyed the mortgaged property to her) to pay off the mortgage was merely a reflection of his existing liability to Mr O'Brien, and of his aspiration that he (Dr Hoey) would bear it, in exoneration of the mortgaged property. Similarly in *The Liverpool (No 2)* (the most distant analogy for application of the rule, since it was an admiralty case) the Court of Appeal concluded that the only true liability, in substance, was that arising from the negligent navigation of the tanker, and that the claim against the owners of the beached coaster (which the Mersey Docks and Harbour Board had under its statutory powers) was in

[1996] 2 All ER 433 at 443

substance a partial reflection of the primary liability--in short, part of the same debt.

In *Barclays Bank Ltd v TOSG Trust Fund Ltd* (where the Court of Appeal were also ready to extend the suretyship analogy some way, though on a view of the facts which the House of Lords held to be mistaken) Oliver LJ said in a passage which I have referred to but not yet set out ([1984] 1 All ER 628 at 636, [1984] AC 626 at 636), that it was a fallacy to argue--

> 'that, because overlapping liabilities result from separate and independent contracts with the debtor, that, by itself, is determinative of whether the rule can apply. The test is in my judgment a much broader one which transcends a close jurisprudential analysis of the persons by and to whom the duties are owed. It is simply whether the two competing claims are, in *substance*, claims for payment of the same debt twice over.' (Oliver LJ's emphasis.)

'Substance', corporate personality and the corporate veil

Mr Kosmin relied strongly on this passage in contending that the bond issues by PPIF (guaranteed by PPI) and PPIF's on-lending to PPI were so closely connected as to result in the bondholders' claim against PPI as guarantor and PPIF's claim against PPI as principal creditor being 'in substance, claims for payment of the same debt twice over'. Mr Kosmin developed his argument in various ways which naturally involved some overlap; but I hope I can fairly summarise the way he

put his case as follows: (1) that on a correct view of the facts, PPIF was in effecting the bond issues (a) an agent or nominee for PPI or alternatively (b) a cipher or facade for PPI; (2) that even if PPIF acted as an independent principal, the on-lending within the Polly Peck group was still so much a part of the same composite transaction as not to rank, in substance, as a separate debt. Mr Kosmin accepted that there is no authority illustrating the application of the rule against double proof in this sort of situation (that is, indebtedness within a group of companies) but called in aid the words of Kerr LJ in *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] 1 All ER 628 at 647-648, [1984] AC 626 at 652:

> '... sometimes, in new situations, the court has to find a just solution which stems simply from the nature of the transaction, the relationship between the parties and their presumed common intention.'

Mr Moss for his part says, rightly, that this sort of transaction of guaranteed borrowing and on-lending by a special-purpose financial vehicle is a commonplace occurrence in capital markets (this point is borne out by the letter from the Cayman attorneys, which seems to be giving fairly standard advice in a fairly standard situation). Mr Moss goes on to submit that the double proof point, if sound, would introduce a new and alarming element of uncertainty into capital markets. I think this argument in terrorem may be a bit overstated, since investors in unsecured bonds issued in this way must be relying on the credit rating of the guarantor, and not on some calculation of the chances of a 'double-dip' against the guarantor and the financial subsidiary in the event of default. Nevertheless the point raised is a novel point of some commercial importance.

Before I examine more closely the different ways in which Mr Kosmin puts his case it may be helpful to make some preliminary points. First, as to substance. In *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 at 185

[1996] 2 All ER 433 at 444

Staughton LJ said (in the context of deciding whether a commercial document effected a sale or a charge):

> 'The problem is not made any easier by the variety of language that has been used: substance, truth, reality, genuine are good words; disguise, cloak, mask, colourable device, label, form, artificial, sham, stratagem and pretence are "bad names", to adopt the phrase quoted by Dixon J in *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1 at 28. It is necessary to discover, if one can, the ideas which these words are intended to convey. One can start from the position that statute law in this country, when it enacts rules to be applied to particular transactions, is in general referring to the legal nature of a transaction and not to its economic effect. The leading authority on this point, albeit in a case from Malaya, is the advice of Lord Devlin in *Chow Yoong Hong v Choong Fah Rubber Manufactory Ltd* [1961] 3 All ER 1163 at 1167, [1962] AC 209 at 216: "There are many ways of raising cash besides borrowing ... If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money."'

Those were statutory contexts (registration of charges and regulation of moneylending) but I think they also support the general proposition that when the law is looking for the substance of a matter,

it is normally looking for its legal substance, not its economic substance (if different). As Robert Goff LJ put it in *Bank of Tokyo Ltd v Karoon* [1986] 3 All ER 468 at 486, [1987] AC 45 at 64, we are concerned not with economics but with law.

Second, the House of Lords affirmation in *Salomon v Salomon & Co Ltd, Salomon & Co Ltd v Salomon* [1897] AC 22, [1895-9] All ER Rep 33 of the separate legal personality of even a 'one-man' company does not of course mean that registered companies have all the characteristics of, and no characteristics not shared by, natural persons. One aspect of this has recently been explained by Lord Hoffmann in giving the opinion of the Privy Council in *Meridian Global Funds Management Asia Ltd v Securities Commission* [1995] 3 All ER 918, [1995] 2 AC 500. Another aspect is that whereas natural persons do not (since the abolition of slavery and the passing of the Married Women's Property Acts) own the persons or property of other human beings, commercial companies do have owners. Their shareholders have an economic interest in their commercial success. Although the shareholders do not own their company's assets, a wrong to the company (if uncompensated) may cause them economic loss. But in general the shareholders will have no direct right of action in respect of such loss (see *Prudential Assurance Co Ltd v Newman Industries Ltd (No 2)* [1982] 1 All ER 354 at 367, [1982] Ch 204 at 223). This point was not mentioned in argument, being neither controversial nor directly relevant; but I think it worth mentioning both in order to identify and distinguish another corporate 'double recovery' problem which does not arise here, and because it leads on to the topic of intra-group indebtedness, which is directly relevant in this case.

The third point is that where there is a group of companies and they are all solvent, a claim by one group company against another, even though sound in law, is likely to have only marginal economic effects (it may have some, for instance in connection with taxation). But as soon as both companies go into insolvent liquidation, any claim between them assumes much greater importance (unless by an extraordinary coincidence both have identical creditors with identical claims, which is certainly not the case here). That is, I think, the point

[1996] 2 All ER 433 at 445

that Lord Wilberforce must have had in mind when he said in *Ford & Carter Ltd v Midland Bank Ltd* (1979) 129 NLJ 543 at 544:

> 'When creditors become involved, as they do in the present case, the separate legal existence of the constituent companies of the group has to be respected.'

This important effect of group insolvency needs to be underlined because it has sometimes been suggested (eg in *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] 1 All ER 628 at 637-637, [1984] AC 626 at 636-637 per Oliver LJ) that it is useful to test a disputed case of double proof by reference to the situation as it would be if all parties were solvent. In circumstances of all-round

group insolvency that may not be a wholly reliable test. It is not now open to PPI's administrators to pay off the bondholders in full and, by doing so, to discharge its obligation to PPIF (and, simultaneously, PPIF's obligation to the bondholders).

Issue 1(a): was PPIF an agent or nominee?

In *Salomon v Salomon & Co* the House of Lords roundly rejected the conclusion of the lower courts that Salomon & Co was a 'mere nominee or agent' of Mr Aron Salomon, or his 'alias', or that his fellow shareholders were 'dummies' (see [1897] AC 22 at 35, 42, 43, [1895-9] All ER Rep 33 at 39, 43). There are of course many cases in which it has been held, on the facts, that a company has acted as an agent or nominee, either for its principal shareholder or for some other party, and several of them were cited to me (eg *Canada Rice Mills Ltd v R* [1939] 3 All ER 991 and *Firestone Tyre and Rubber Co Ltd v Lewellin (Inspector of Taxes)* [1957] 1 All ER 561, [1957] 1 WLR 464). But neither agency nor nomineeship--nor, still less, sham or something akin to sham--is to be inferred simply because a subsidiary company has a small paid-up capital and has a board of directors all or most of whom are also directors or senior executives of its holding company.

Mr Kosmin does not, as I understand his submissions, contend that the arrangements between PPI, PPIF and the lead mangers were a sham (I will return below to 'cipher' and 'facade'). He does contend that a variety of factors lead to an inference of agency or nomineeship. The most important of these factors (which are all set out in the detailed skeleton argument prepared by Mr Kosmin and Mr Chivers) are the following: (i) PPIF was incorporated solely for the purpose of the bond issues; (ii) it had no separate, independent management; (iii) it had a very small paid-up capital; (iv) it did not pay the costs of the transactions and could not have done so; (v) it had no normal bank account and no separate financial records (in practice PPI saw to everything and acted as PPIF's banker and bookkeeper); (vi) the terms of the on-loan were not independently negotiated, did not serve any commercial purpose and in any case were never finally agreed, nor was the 1/4% turn paid otherwise than as a paper transaction; and (vii) no lender could or would have relied on PPIF's covenant, as opposed to PPI's (which could substitute itself as principal debtor if it got the approval of the principal paying agents).

In short, Mr Kosmin submits that PPIF had only a nominal role in the arrangements, and that as a matter of substance PPI should be recognised as having borrowed direct from the original bondholders, so depriving the on-loan of any legal significance (or indeed existence). To come to that conclusion I would have to find that that was the effect, not merely of what was informally arranged in the boardroom at 42 Berkeley Square, but also of the formal legal documents which were entered into on the occasion of each bond issue. On the second SwF issue (which is typical since it was the first issue of non-convertible bonds) the

formal documents consisted of (i) a public bond issue agreement between PFIF, PPI and Warburg SA as lead managers on behalf of a consortium including 26 other banks (the agreement annexed the form of the bearer bonds and the terms of their issue); (ii) a guarantee agreement between PPI, Warburg SA and the consortium; and (iii) a 42-page prospectus. All these documents made clear that the bond issue was to be made by PPIF and that PPIF's obligations were to be guaranteed by PPI subject to the provision for substitution which I have already mentioned. The documentation on the later loans was essentially similar, subject to small variations (already mentioned) on the DM issue.

In the face of these documents I find it impossible to conclude that the factors that Mr Kosmin relies on establish a relationship of agency or nomineeship. Mr Moss referred me to some passages from the speeches in *McEntire v Crossley Bros Ltd* [1895] AC 457, [1895-9] All ER Rep 829 quoted by Dillon LJ in *Welsh Development Agency v Export Finance Co Ltd* [1992] BCLC 148 at 160-161. Lord Herschell LC said:

> '... there is no such thing, as seems to have been argued here, as looking at the substance, apart from looking at the language which the parties have used. It is only by a study of the whole of the language that the substance can be ascertained.' (See [1895] AC 457 at 463, [1895-9] All ER Rep 829 at 831.)

Similarly Lord Watson said:

> 'The substance of the agreement must ultimately be found in the language of the contract itself. The duty of the court is to examine every part of the agreement, every stipulation which it contains, and to consider their mutual bearing upon each other; but it is entirely beyond the function of a court to discard the plain meaning of any term in the agreement unless there can be found within its four corners other language and other stipulations which necessarily deprive such term of its primary significance.' (See [1895] AC 457 at 467, [1895-9] All ER Rep 829 at 834.)

(It is interesting to note that less than three weeks after judgment was given in *McEntire v Crossley Bros*, Lord Herschell LC said almost exactly the same thing in another well-known case, *Helby v Matthews* [1895] AC 471 at 475, [1895-9] All ER Rep 821 at 823; and it was his observations in the latter case that were cited to and discussed by the House of Lords in the leading tax case on the substance of a transaction, *IRC v Duke of Westminster* [1936] AC 1 at 20, [1935] All ER Rep 259 at 268. The on-loan in this case might be thought to have at least a passing resemblance to the on-transfer that was considered by the House of Lords in another leading tax case, *Furniss (Inspector of Taxes) v Dawson* [1984] 1 All ER 530, [1984] AC 474. But neither counsel suggested that I could get any guidance from that specialised and difficult area of authority, and probably they were right not to do so.)

Some of the factors on which Mr Kosmin relies do tend to show that the Polly Peck personnel who were concerned with the matter at 42 Berkeley Square were (to say the least) less than meticulous in their administrative procedures. I make no specific finding about that. But even blatant and

reprehensible 'cutting of corners' (if it occurred) could not, it seems to me, retroactively alter the character of the transactions embodied in the formal documents by which the bond issues were effected. The factors which Mr Kosmin relies on cannot and do not in my judgment establish PPIF's role as that of agency or nomineeship, and so they do not eliminate the on-loan as a significant part of the composite transaction.

[1996] 2 All ER 433 at 447

Issue 1(b): sham, pretence, cipher, facade

My conclusion that there was no conventional relationship of agency or nomineeship is not conclusive of the case, because Mr Kosmin had further submissions. On what I have called his point (1)(b) and his point (2) I was referred to quite a lot of authority touching on what is sometimes called lifting (or piercing) the corporate veil. That is a vivid but imprecise metaphor which has possible application in several different contexts, some far removed from this case. The most relevant, it seems to me, is where corporate personality is (in the words of Lord Keith in *Woolfson v Strathclyde Regional Council* 1978 SLT 159 at 161) used as 'a mere facade concealing the true facts'.

Sham, pretence, cipher and facade are all (as was said by Dixon J in the passage already quoted) 'bad names' implying a value judgment of disapprobation. 'Sham' was at least half way to becoming a term of art (requiring an intention common to all parties) but has now, it seems, been supplanted (at least in the context of licence or tenancy) by 'pretence' (see *Aslan v Murphy (Nos 1 and 2), Duke v Wynne* [1989] 3 All ER 130 at 133, [1990] 1 WLR 766 at 770 and *AG Securities v Vaughan, Antoniades v Villiers* [1988] 3 All ER 1058 at 1067-1069, [1990] 1 AC 417 at 462-465). Mr Kosmin did not rely on sham or pretence. He did submit (orally) that PPIF was a 'cipher' and (in his skeleton argument) that it was a 'facade'. I think that his use of 'cipher' was to add colour and force to his submission on agency or nomineeship (which I have already considered). 'Facade' (or 'cloak' or 'mask') is perhaps most aptly used where one person (individual or corporate) uses a company either in an unconscionable attempt to evade existing obligations *(Gilford Motor Co Ltd v Horne* [1933] Ch 935, [1933] All ER Rep 109 and *Jones v Lipman* [1962] 1 All ER 442, [1962] 1 WLR 832) or to practise some other deception (a sort of unilateral sham, since the corporate facade has no independent mind). In *Adams v Cape Industries plc* [1991] 1 All ER 929, [1990] Ch 433 the establishment and interposition of the Liechtenstein corporation referred to as AMC was a facade in this sense, and 'no more than a corporate name', though the new Illinois corporation, CPC, was not. But the notion that regular sales of large volumes of South African asbestos to an United States purchaser were being effected through a lawyer's office in Vaduz is to my mind of a quite different order of artificiality from the function of PPIF as a single-purpose financial vehicle (I am not overlooking the two other isolated transactions entered into by PPIF; but they add little to its independent reality). In my judgment PPIF was more than a mere facade.

Issue (2): single economic unit

It is on this part of the case that I have found Mr Kosmin's submissions most persuasive, though I am not ultimately persuaded by them. The arguments for considering a closely-integrated group of companies as a single economic unit were fully considered (principally in the context of corporate presence as founding jurisdiction) in *Adams v Cape Industries plc* [1991] 1 All ER 929 at 965, [1990] Ch 433 at 476-477, both by Scott J and, with a full citation of authority, in the judgment of the Court of Appeal (see [1991] 1 All ER 929 at 1016-1020, [1990] Ch 433 at 532-537). Both passages merit careful study. The Court of Appeal concluded that--

> 'save in cases which turn on the wording of particular statutes or contracts, the court is not free to disregard the principle of *Salomon v Salomon & Co Ltd* [1897] AC 22, [1895-9] All ER Rep 33 merely because it considers that justice so requires.' (See [1991] 1 All ER 929 at 1019, [1990] Ch 433 at 536.)

[1996] 2 All ER 433 at 448

Mr Kosmin seeks to add to these exceptions (turning on particular statutes or contracts) a further exception where a rule of law founded in public policy (the rule against double proof) would be frustrated by ignoring the economic reality of the single group. In that submission Mr Kosmin can and does call in aid the words of Oliver LJ in *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] 1 All ER 628 at 636-637, [1984] AC 626 at 636 that the test is 'a much broader one which transcends a close jurisprudential analysis of the persons by and to whom the duties are owed'.

Nevertheless I am not persuaded by the argument. I can accept that as a matter of economic reality the bondholders (whose presumed intentions may be material) must have intended to rely on the credit-rating and covenant of PPI, whether as guarantor or (after substitution) as principal obligor. It is doubtful whether even the most far-sighted of them can have calculated that in the event of a crash, PPIF might have fewer unsecured creditors than PPI, and a claim against PPI under an on-loan. It was perfectly possible, consistently with each prospectus, that the proceeds of some or all of the bond issues would be loaned on, not to PPI, but to other group subsidiaries. It is also possible, though less likely, to imagine a situation in which PPIF lent on to another subsidiary, with PPI guaranteeing that borrowing also, and the second subsidiary then lending on to PPI. Each of those sequences of events would be likely to produce a different result in the event of a crash of the whole group, whether or not the rule against double proof has any application. The possibility of there being subsidiaries which were not wholly-owned subsidiaries adds to the range of imaginable variations.

Were I to accede to Mr Kosmin's submission it would create a new exception unrecognised by the Court of Appeal in *Adams v Cape Industries plc* and that is not open to me. Moreover I think that Mr Kosmin is in one sense assuming what he seeks to prove, since the unjust or inequitable result which he asserts does not occur unless the group is recognised as being in substance a single economic entity, whose constituent members' internal rights and obligations are to be disregarded. But the authorities to which I have already referred show that substance means legal substance, not economic substance (if different), and that (as Lord Wilberforce said in *Ford & Carter Ltd v*

Midland Bank Ltd) the separate legal existence of group companies is particularly important when creditors become involved. Injustice may be in the eye of the beholder, but I do not perceive any obvious injustice--certainly not such as the court can remedy--in the unpredictable consequences that may follow from the unforeseen insolvency of a large international group of companies such as the Polly Peck group.

Conclusion

For these reason I will answer the question posed in para (1) of the preliminary issue in terms of sub-para (i)--that is, that both claims should be admitted in full as scheme liabilities.

As I understand it para (2) then also falls to be answered in terms of sub-para (i)--that is that a dividend should be paid on both claims. But I do not recall any submissions specifically directed to para (2), and if there is some subtlety that I have missed, counsel will no doubt explain it to me.

Order accordingly.

Carolyn Toulmin Barrister.

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(1871) L.R. 7 Ch.App. 99

[COURT OF APPEAL IN CHANCERY]

In re ORIENTAL COMMERCIAL BANK. Ex parte EUROPEAN BANK.

1871 Nov. 24.

SIR G. MELLISH and SIR W. M. JAMES, L.JJ.

Winding-up - Double Proof - Letter of Credit - Accommodation Bills - Liability of Drawer to Proof both by Holder and Acceptor.

Bills of exchange were accepted by the *E. Company*, at the request of the *O. Company*, upon an undertaking by the *O. Company* that they would provide funds to meet the bills at maturity. The bills were indorsed by the *O. Company*, and discounted; but before they arrived at maturity both the *E*. and *O. Companies* had stopped payment, and were in process of liquidation, and the bills were dishonoured. The holders of the bills recovered the amount due on them by proofs against the estates of both companies under their respective windings-up:-

Held (reversing the decision of *Bacon*, V.C.), that the *E. Company* were not entitled under the contract of indemnity to prove as creditors against the *O. Company* for the amount that had been recovered from the estate by the holders of the bills.

The rule in bankruptcy that there cannot be a double proof against the same estate in respect of the same debt, *held* to apply in cases of winding-up under the *Companies Act*, 1862.

THIS was an appeal from a decision of Vice-Chancellor *Bacon*, made in the winding-up of the *Oriental Commercial Bank, Limited* (1). The facts were shortly as follows:-

On the 12th of March, 1866, Mr. *D. Pappa*, the manager of the

(1) Law Rep. 12 Eq. 501.

Oriental Commercial Bank, wrote to the manager of the *European Bank* as follows:-

> "We beg to advise you that our *Galatz* correspondent, Mr. *E. Constantinidi*, has valued upon your establishment for our account in the sum of £15,250, as per particulars at foot, which drafts please honour on presentation for our account, on the usual understanding that we furnish you with funds to meet the same at maturity."

In consequence of this undertaking, Mr. *Constantinidi* drew bills to the amount of £8800, which were accepted by the *European Bank*, and handed to the *Oriental Commercial Bank* as agents of the drawer, and indorsed by them to the *Agra Bank*, who discounted them.

When the bills became due all the three banks had stopped payment, and were in process of liquidation; and as no funds had been provided to the *European*, the bills were dishonoured.

The *Agra Bank*, the holders of the bills, proved against the *European Bank* for £8804 1*s.* 6*d.*, and received a first dividend of 3*s.* 4*d.* in the pound, amounting to £1467 6*s.* 11*d.* They then proved against the *Oriental Commercial Bank*, as the indorsers, for the balance of £7336 14*s.* 7*d.*, and received from their estate a dividend of 13*s.* in the pound. They subsequently received a further dividend of 6*s.* 8*d.* in the pound from the *European Bank* on their original proof. The result was that they recovered the full amount of their debt; half being paid by the *European*, and half by the *Oriental Commercial Bank*.

The *Oriental Commercial Bank* afterwards paid the *European Bank* 13*s.* in the pound on the sum of £1467 6*s.* 11*d.*, and 2*s.* in the pound on the whole amount of the bills; so that they altogether paid 15*s.* in the pound on the whole amount of the bills, which was the amount of dividend paid to their other creditors.

The liquidators of the *European Bank* afterwards sought to be admitted creditors against

the estate of the *Oriental Commercial Bank* for the sum of £4402 0*s.* 9*d.*, which they had been compelled to pay through the breach of the undertaking to provide them with funds to meet the bills at maturity. The Vice-Chancellor

admitted the proof; and the liquidators of the *Oriental Commercial Bank* appealed from this decision.

Mr. ***De Gex, Q.C.***, Mr. ***Kay, Q.C.***, and Mr. ***Jackson***, for the Appellants:-

The effect of the Vice-Chancellor's decision is to fix the *Oriental Commercial Bank* with a double liability, and to make them pay dividends twice over on the same debt. If the *European Bank* had remained solvent, and had paid the bills at maturity in full, they could then have proved against the *Oriental Commercial*, and would have received the same dividend as the other creditors, and the *Oriental Commercial Bank* would have been subject to no claim from the holders of the bills. This claim is contrary to the settled rule in bankruptcy. In the ordinary case of an accommodation bill, where the drawer and acceptor are both bankrupt, the holder of the bill can prove against both estates, but the acceptor cannot prove against the drawer on the implied contract that he would meet the bills at maturity, without giving credit for what the estate of the drawer has paid to the bill holder; and to this extent we have not disputed their right, and have paid them so much as, with the amount which we paid to the *Agra*, makes up the same dividend (15*s.* in the pound) which we have paid to our other creditors: *Byles* on Bills (1); *Ex parte Biddulph* (2); *Ex parte Carne* (3). It can make no difference that the *Oriental Commercial Bank* were not the drawers, but had entered into an express contract with the acceptors, instead of an implied one. The same rule is applied in bankruptcy in the case of the joint and separate estates of partners. It is a reasonable rule, and is applicable to the administration of estates in the winding up of companies, as well as in bankruptcy: *Rigby v. Macnamara* (4); *Companies Act*, 1862, ss. 133, 158.

Mr. ***Eddis, Q.C.***, and Mr. ***Graham Hastings***, for the European Bank:-

This is different from the ordinary case of an accommodation

(1) 10th Ed. p. 450.

(2) 3 De G. & Sm. 587; 6 D. M. & G. 795.

(3) Law Rep. 3 Ch. 463.

(4) 2 Cox. 415.

bill, in which the implied contract is, that the acceptor shall be borne harmless: *Reynolds v. Doyle* (1). Here the bills were accepted upon the undertaking that before they arrived at maturity a sum sufficient to meet them should be lodged with the acceptors. The holders could not have proved at all against the *Oriental Commercial Bank* unless they had indorsed the bills. The case, therefore, turns upon this special contract, not upon the ordinary relationship of debtor and creditor: *Prehn v. Royal Bank of Liverpool* (2); *Yates v. Hoppe* (3). The essence of the rule against double proof is the identity of the debt; but here the debts are totally distinct. The contract was, in fact, broken before the bills came to maturity, and we are entitled to prove for the damage sustained by the breach of that contract.

SIR G. MELLISH L.J. , after shortly stating the facts of the case, continued:-

It is quite obvious that if this proof is allowed the *Oriental Commercial Bank* will pay a double dividend on the same debt. It appears to me clearly that it is substantially the same debt; because if all parties had been solvent, whatever sums the *Oriental Commercial Bank* might have paid to the *Agra Bank*, although they would have paid it, no doubt, for the purpose of performing the contract they had entered into by their indorsement, yet, substantially, whatever sums they might have paid to the *Agra Bank* would have gone in reduction of the sum which the *Oriental Commercial Bank* had promised to pay to the European Bank. In that case the *Oriental Commercial Bank* could never have been called upon to pay these bills twice over. It would have made no difference that they had entered into two contracts with two separate parties that they would pay the bills - namely, with the *European Bank* as acceptors, and with the *Agra Bank* as holders. It is clear that they would have performed both contracts by paying the bills once, because they had guaranteed the acceptors; and, in fact, the acceptance having been an acceptance for their use, their payment to the *Agra Bank* would, in substance and in point of law, have been a payment by the acceptors.

(1) 2 Scott, N. R. 45.

(2) Law Rep. 5 Ex. 92.

(3) 9 C. B. 541.

(1871) L.R. 7 Ch.App. 99 Page 103

Then the question is, whether, the parties being insolvent, the *Oriental Commercial Bank* can be liable to pay two dividends on the same debt? It has been the law for a great number of years with reference to proofs in bankruptcy, that if an acceptor accepts bills for the accommodation of the drawer, and the drawer enters into a contract, either express or implied (and I do not think there is any difference between the two), that he will provide for the bills when they become due, and then the drawer becomes bankrupt, there cannot be a double proof against his estate, namely, one proof by the holder of the bill, and the other proof by the acceptor of the bill on the contract of indemnity. Then the real question before us is this: Does it make any distinction that the *Oriental Commercial Bank* were not drawers, but entered into the contract with the acceptors, and afterwards became liable for the bills as indorsers? It appears to me that that ought not to make any distinction, although I do not find any precise decision upon the point. The case of *Rigby v. Macnamara* (1) tends to shew that this rule against double proof applies in the Court of Chancery as well as in the Court of Bankruptcy, and therefore would apply equally where companies are being wound up. It seems to me that the principle is a perfectly sound one. Authorities have been cited to shew that there cannot be double proof against joint and separate estates. That is really carrying the same principle still further, for in that case the proof is not twice against the same estate, but against different estates though belonging to the same person. As to that application of the principle, some Judges have said that it should not be carried any further. But the principle itself - that an insolvent estate, whether wound up in Chancery or in Bankruptcy, ought not to pay two dividends in respect of the same debt - appears to me to be a perfectly sound principle. If it were not so, a creditor could always manage, by getting his debtor to enter into several distinct contracts with different people for the same debt, to obtain higher dividends than the other creditors, and perhaps get his debt paid in full. I apprehend that is what the law does not allow; the true principle is, that there is only to be one dividend in respect of what is in substance the same debt, although there

(1) 2 Cox, 415.

may be two separate contracts. Therefore, upon the whole, with great respect to the Vice-Chancellor, I am of opinion that this proof should not be allowed.

SIR W. M. JAMES, L.J. :-

I entirely concur.

Solicitors for the *Oriental Commercial Bank*: Messrs. *Uptons, Johnson, & Co*.

Solicitors for the *European Bank*: Messrs. *Argles & Rawlins*.

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county or union of counties for municipal purposes, plus a town separated from a county or union of counties for municipal purposes. The word is used in the Act in a special sense. The Temperance Act was brought into force in the united counties of Leeds and Grenville, and the effect of using the words in the sense of the Act of Parliament was that the municipal territory of Leeds and Grenville, plus the town of Brockville, was a "county" within its meaning.

In that state of things the order-in-council of the 29th of September was passed, and it orders that the penalties received or enforced under the Canada Temperance Act within any city or county which has adopted the said Act which would otherwise belong to the Crown be paid to the treasurer of the city or county as the case may be for the purposes of the Act.

I think it is plain that the Governor-in-Council has used the words "city or county" in the same sense as the Act of Parliament, which was there before him, and that the words "*county which has adopted the said Act*" describes accurately the counties of Leeds and Grenville and the town of Brockville taken together.

Then is there any difficulty with the other words "be paid to the treasurer of the city or county?" In my humble judgment there is none. There were really two treasurers in the county in the present case, the county's treasurer and the town treasurer, each of them being an officer of a "local authority which wholly or in part" was bearing within the county the expenses of administering the Temperance law. The sole defect in the order-in-council as applied to a case like the present is in not determining the proportions in which the penalties are to be divided. I do not see why that difficulty should be serious in any case, but I understand it is agreed in the present case that if the defendants are entitled at all, the sum which they claim is their just proportion.

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The appellants subsequently moved for judgment, showing that the Crown declined to interfere, and BURTON, J. A., then joined in allowing the appeal.

Appeal allowed with costs, MACLENNAN, J. A., *dissenting*.

MARTIN V. MCMULLEN ET AL.

Principal and surety—Guarantee—Floating balance—Ultimate balance—Bankruptcy and insolvency—Dividends.

The plaintiff's testator gave a guarantee in the following form: "In consideration of the goods sold by you on credit to M., and of any further goods which you may sell to M. upon credit during the next twelve months from date, I hereby undertake to guarantee you against all loss in respect of such goods so sold or to be sold; provided I shall not be called on in any event to pay a greater amount than $2,500."

M. made an assignment for the benefit of his creditors, being then indebted to the guaranteed creditors in the sum of $5,556.23. They filed their claim therefor with the assignee and afterwards received from the plaintiff the full amount covered by the testator's guarantee.

The plaintiff contended that he was entitled to rank upon the estate for so much of the debt as had been thus paid by him.

Held, [OSLER, J. A., dissenting] that the guarantee was one of the whole debt incurred, or to be incurred, with a limitation of the liability to $2,500, and, therefore, that the plaintiff was not subrogated to the rights of the secured creditors or entitled to receive the dividends in respect of that part of their debt which he had paid under the guarantee.

Per OSLER, J. A., the guarantee was a continuing guarantee, limited in amount, to secure a floating balance, and so a guarantee of part of the debt only, the dividends on which, the surety having paid it, he was entitled to receive. *Ellis* v. *Emmanuel*, 1 Ex. D. 157, considered.

Judgment of the Queen's Bench Division, 20 O. R. 257 reversed, and that of STREET, J., at the trial, 19 O. R. 230, restored.

Statement.

THIS was an appeal by the defendants from the judgment of the Queen's Bench Division, reported 20 O. R. 257.

The plaintiff was the executor of one Jonathan Martin and the defendant McMullen was the assignee for the benefit of creditors of the firm of McGachie Bros. This firm were customers of the defendants Ogilvy, Alexander & Anderson, and on the 8th of March, 1888, Martin gave to Ogilvy, Alexander & Anderson, the following guarantee:

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Statement.

"Dear Sirs:—In consideration of the goods sold by you on credit to McGachie Bros., of Woodstock, and of any further goods which you may sell to McGachie Bros. upon credit during the next twelve months from date, I hereby undertake to guarantee you against all loss in respect of such goods so sold or to be sold, provided I shall not be called on in any event to pay a greater amount than twenty-five hundred dollars. You shall have the right to accept and release collateral securities, to release securities, to extend the time for payment, to take notes or bills in settlement for goods sold or to be sold, and renew same, compromise or compound the said indebtedness or any part thereof, either during the said period or afterwards without notice to me."

At the time of McGachie Bros.' assignment, they owed $5,556.23 to Ogilvy, Alexander & Anderson, who duly filed their claim for that amount. Ogilvie & Co. also called upon the plaintiff to make payment under the guarantee, and received from him $2,500. The plaintiff then filed a claim against the estate for the $2,500, paid by him; but this claim was disputed and this action was thereupon brought to establish the right to rank.

The action was tried before STREET, J., at Woodstock, on the 14th of March, 1890, who subsequently dismissed it with costs, holding that the guarantee was one to secure an ultimate balance. This judgment was reversed by the majority of the Queen's Bench Divisional Court, and this appeal by the defendants from the judgment of the Divisional Court, came on to be heard before this Court [HAGARTY, C. J. O., BURTON, OSLER, and MACLENNAN, JJ.A.] on the 3rd of June, 1891.

Geo. C. Gibbons, Q. C., for the appellants.

W. Nesbitt, and *A. W. Aytoun-Finlay*, for the respondent.

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HAGARTY, C.J.O.

September 15th, 1891, HAGARTY, C. J. O.:—

The case rests upon the law as laid down by Lord Hatherley in *Hobson* v. *Bass*, L. R. 6 Ch. 792, and by Lord Blackburn, delivering the judgment of himself, Lord Cairns and the present Master of the Rolls, in *Ellis* v. *Emmanuel*, 1 Ex. D. 157.

The distinction is pointed out between the two classes of guarantees, one where the contract is to be construed as a security for a part only of the debt, and the other where it is to be construed as a security for the whole amount due or to become due with a provision limiting the surety's liability to pay any amount beyond a named sum.

I am compelled on the authorities to hold that the guaranty before us belongs to the latter class. The distinction between the two classes is admitted to be both artificial and technical, but as we are bound to hold that it is distinctly recognized as existing and to govern, we cannot refuse to act upon it. The words used seem to me to clearly shew a suretyship for the whole debt due or to become due of the principal debtors, and an indemnity against loss thereon, limiting the ultimate liability of the guarantor to the named sum.

I regret having to arrive at this conclusion, as I cannot believe that two ordinary contracting parties could possibly have contracted with the knowledge of this artificial distinction. The common understanding would naturally have been that, in the event of the debtor's insolvency, the guarantor would have the right to rank on his estate for the amount he would have to pay, and the creditor for the uncovered portion of his claim.

Of course, the Ogilvy firm had a clear right to prove for their whole claim, nothing having then been paid on the guaranty, and to receive dividends thereon.

BURTON, J. A.:—

The whole question in this case turns upon the construction to be given to the guarantee, and upon the state of things existing at the time it was given.

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If this guarantee was a guarantee of the whole debt incurred, or to be incurred, with a limitation of the liability to $2,500, the judgment of my brother Street was correct, and should be restored. If on the contrary, the true construction is, "I will be liable to that extent only upon the goods you may supply," it is a guarantee of that part only, and upon payment the surety would be subrogated to the rights of the principal as to that part.

I am hardly disposed to agree with my brother Street that the distinction is a narrow one, and entirely of form and not of substance; on the contrary, I incline to regard it as a most substantial distinction.

Whilst I quite agree that where the surety has given a continuing guarantee, limited in amount to secure a floating balance which may from time to time be due and *nothing more*, the *primâ facie* construction is, that it is intended to be security for a part of the debt only, co-extensive with the amount of the guarantee, here, however, there is a good deal more. There is a reference to goods already sold, which it was contended on the part of the respondents, was ambiguous and might mean goods then being sold, and not a past sale, which might be of importance if that particular lot of goods formed the consideration for the guarantee.

It formed in fact no part of the consideration, and might be read thus: "I hear that you have sold goods to McGachie Bros. of Woodstock, and in consideration of your continuing to supply them, etc., I hereby undertake to guarantee you against all loss in respect of such goods so sold, or to be sold, provided I shall not be called on in any event to pay a greater amount than $2,500."

There was no necessity for extrinsic evidence for the purpose of deciding whether it was or was not a valid guarantee, but in order now to ascertain whether the guarantee was for the whole debt with a limitation as to the amount, or for a part only of the debt, it becomes necessary to ascertain what the fact was at the time the guarantee was entered into. It was stated before us, and

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not disputed, that there was at that time an indebtedness exceeding the amount of the guarantee; but if there had been an omission to give evidence of that fact, there could be no difficulty in supplying that omission at any time.

It being then established that the debt then existing exceeded the guarantee, how can it be contended with any hope of success that the guarantee was for a specific part of that indebtedness? It comes within the very words of Lord Blackburn, in *Ellis* v. *Emmanuel*, 1 Ex. D. 157, 168, where he says: "There is no case that I am aware of which lays down that where the suretyship limited in amount is for a debt already ascertained which exceeds that limit, it is *primâ facie* to be construed as a security for part of the debt only. And I have failed to see any principle on which such a *primâ facie* construction ought to be adopted," and I do not see how that is at all weakened by the fact that the guarantee applied also to debts to be afterwards incurred.

I think, with great respect, that Mr. Justice Street's judgment was correct and should be restored.

MACLENNAN, J. A.:—

I am with great respect of opinion that this appeal should be allowed.

The guarantee was on the 8th of March, 1888, and it was against all loss in respect of goods sold, and of goods to be sold during the following twelve months, the surety however not to be called upon in any event to pay a greater amount than $2,500.

The debtor made an assignment for the benefit of creditors under the Ontario Act on the 27th of May, 1889. The creditor proved his claim on the 7th of June following, and it has never been contested. On the 13th of July, 1889, the creditor called on the surety for payment, and on the 3rd of October he paid the $2,500. Having done that, he sought to prove a claim upon the estate for that sum, and the question is whether he can do so. In strictness the

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plaintiff has an undoubted right to prove, for if the estate is sufficient to pay everybody, the plaintiff must be paid as well as others. The real question is how the plaintiff is to rank in respect of dividend, whether he is to take the place of the creditor, and to stand in his shoes in respect of the dividend on $2,500, parcel of the debt, or whether he is excluded altogether from dividend until the creditor has been paid the balance due to him, allowing for what he has received from the surety.

If the plaintiff had paid the $2,500 before the creditors had proved their claims, it must be conceded that the plaintiff could have proved for the $2,500, and Ogilvy & Co. could only have proved for the balance, for to the extent of that sum the latter would have ceased to be creditors, and the plaintiff would have become a creditor in their place.

The matter is entirely different however after Ogilvy & Co. had proved. The moment they had done so they obtained a vested right to a rateable proportion of the trust estate, in proportion to their whole debt, to be applied in satisfaction of it, and that right could not be qualified or impaired by subsequent payment of part by the plaintiff. It is true that the plaintiff upon payment of the amount of his guarantee became a creditor of the principal debtor, and could sue him at once for it, but it does not follow that he could claim a share of the trust estate otherwise than *sub modo* as above indicated, and so as not to interfere with the rights of other creditors, or with those which Ogilvy & Co. acquired by their proof. It would be a violation of the terms of the trust that dividends should be paid to two persons in respect of the same debt or the same part of a debt.

The question we have to determine is this: the creditor having before any payment by the surety obtained security for his debt, or part of it, in the form of a proportionate share of the debtor's estate, whether the surety can, upon afterwards paying the amount of his liability, claim to participate in that security before the creditor has been paid in full.

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The cases which have been cited are cases in which the creditor had proved or had obtained dividends on the bankruptcy of the debtor, but the principle involved seems to be a general principle of equity, applicable to all cases of suretyship.

In *Thornton* v. *M'Kewan*, 1 H. & M. 525, before Lord Hatherley, a case of administration of the estate of a deceased debtor, and not one of bankruptcy, the principle is thus expressed in the head note: "Where a limited guarantee has been given, and the limit has been exceeded by the guarantee, who afterwards receives from the estate of the principal debtor a dividend, the guarantor is entitled to the benefit of a proportional part of that dividend on the amount guaranteed, notwithstanding that the unpaid debt greatly exceed the amount of such guarantee."

This statement of the law is approved by Jessel, M. R., in *Goodwin* v. *Gray*, 22 W. R. 312, and it is stated in similar terms in Coote's Law of Mortgages, 5th ed., p. 1227, and De Colyar on Guarantees, 2nd ed., p. 299.

The sole question here, therefore, is whether this is a guarantee of a limited part of the debt, or a guarantee of the whole debt with a liability limited to $2,500. See the language of Lord Blackburn, *Ellis* v. *Emmanuel*, 1 Ex. D. at pp. 163-4.

After the most careful consideration of the language of this instrument as applied to the state of matters at the time it was given, I have come to the conclusion that it is a guarantee of the whole debt with a limited liability. It is against all loss in respect of goods sold, or goods to be sold within twelve months from date. I think the instrument is in terms made applicable to the state of the account between the parties at its date, whatever that was. If the surety did not know how the account stood when he signed the guarantee, he took the risk of it whatever it was, and I think we are bound to construe it with reference to the actual state of affairs. Then there is a date named beyond which there is to be no further liability. But as regards goods supplied before the making

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of the instrument, and others supplied during the following twelve months, the surety guarantees the creditor against all loss. I do not know how the parties could have employed stronger language to indicate that the whole of the debt to the end of the twelve months, including the old account, was intended to be secured. Then came the limiting words. It is not that he is only to pay a part of the debt or of the loss, but no greater amount than $2,500. I think the words "against all loss," are entitled to great weight as indicating that it was not merely part of the debt which was to be secured.

Agreeing as I do with the very able judgment of my learned brother Street, it is not necessary for me to repeat what he has said. I think that the appeal should be allowed, but that the original judgment should be varied by allowing the proof of the plaintiff qualified as above indicated.

OSLER, J. A.:—

We have the authority of Lord Cairns, Lord Blackburn and the present Master of the Rolls, in *Ellis* v. *Emmanuel*, 1 Ex. D. 157, for saying that when there is a limited suretyship to secure a floating balance, the suretyship is *primâ facie* at least to be construed as a security for part of the debt co-extensive with the amount of the guarantee; and that in such a case the ordinary rule applies (which is fully and clearly stated in Burge on Suretyship, p. 326) that when a surety is only surety for part of the debt, and has paid that part, he is entitled to receive the dividend which the principal debtor pays in respect of that sum which the surety has discharged. It is said also that "if a creditor taking a limited security for a floating balance, means it to be a security for the whole of the debt, and not merely for a part, he should take care that this is clearly expressed, for the *primâ facie* construction is the other way." Lord Hatherley's observations in *Hobson* v. *Bass*, L. R. 6 Ch. 792, are approved of, where he says: "If

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a person guarantees a limited portion of a debt, all the authorities shew that if he pays that portion, he has in respect of it all the rights of a creditor. The question is, whether the guarantee means 'I will be liable for £250 of the amount which A. B. shall owe you,' or 'I will be liable for the amount which A. B. shall owe you, subject to this limitation, that I shall not be called upon to pay more than £250.'"

Where, however, the suretyship, limited in amount, is for a debt already ascertained which exceeds that limit, the *primâ facie* construction referred to, does not prevail. "In such a case," says Lord Blackburn, "it is a question of construction on which the Court is to say whether the intention was to guarantee the whole debt, with a limitation on the liability of the surety, or to guarantee a part of the debt only."

Taking this instrument simply as it is expressed, it appears to be a limited security for a floating balance in respect of goods already sold, or to be sold during the next succeeding twelve months. Certainly it is not *expressed* in the terms of Lord Hatherley's second example: "I will be liable for the amount which M. shall owe you, subject to this limitation, etc." Is that its meaning? Does its language necessarily require that construction to be placed upon it? With all respect, I think that to give it that construction or meaning is to convert the loose and common terms of a business document into a formal technical expression of liability, involving consequences which neither party ever dreamt of. We are not justified in paraphrasing the simple expression "guarantee you against all loss in respect of such debt," into a formal contract to be liable for the whole debt. The instrument is to be looked at as a whole in order to ascertain whether that was the guarantor's meaning—his clearly expressed intention—and, if there is nothing more than that expression combined with a limitation, however worded, of the guarantor's liability, the general rule, founded on the principle so fully explained (though not applied) in *Ellis* v. *Emmanuel*,

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1 Ex. D. 157, and other authorities there cited, for the construction of the instrument is that it must be taken to be a guarantee of part of the debt only. We are not to make nice verbal distinctions on the words used, and the ordinary rule—the *primâ facie* construction—must apply, unless the surety has clearly contracted himself out of what would otherwise be his right—unless, to adopt the language of Mellish, L. J., in *Gray* v. *Seckham*, L. R. 7 Ch. 680, we can infer from the form of the contract or the circumstances of the case, that he has agreed that any dividend which he might otherwise be entitled to in the event of the debtor's making an assignment, should go to the secured creditor until he had received one hundred cents in the dollar.

It is certainly remarkable that the distinction referred to has not been held to exist as against the surety in any of the reported cases from *Ex parte Rushforth*, 10 Ves. 409 (1806), down to *Ellis* v. *Emmanuel*, 1 Ex. D. 157, (1876), a strong indication to my mind that, in construing informal instruments of guaranty, such as we are here concerned with, containing no express stipulation in favour of the creditor, the substance of the transaction has always been regarded and the general rule applied and acted on. Mellish, L. J., in the case of *Gray* v. *Seckham*, L. R. 7 Ch. 680, points out that, while it is now not unusual for contracts of guaranty to be expressly worded so as to shew that it is intended that dividends may be retained by the creditor, yet that the introduction of such provisions is a modern invention.

I think we cannot infer that in this guaranty the surety meant to become technically liable for the whole debt and thus to abandon his rights—to contract himself out of his equity as it has been said—merely because it is expressed as being a guaranty "against all loss" in respect of the goods sold or to be sold, or because the limitation comes in as a proviso following the obligatory part of the instrument—the whole being informally and loosely expressed. Apart from its being a guaranty in respect of goods

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already sold, it is not fairly distinguishable from the guaranty in *Thornton* v. *McKewan*, 1 H. & M. 525, the words of which were: "In consideration of your advancing to S. the sum of £5,000 from time to time as he may require, I hereby guarantee and hold you harmless *against any loss* that may arise to you in consequence of such advances, and this obligation shall be a continuing guaranty to the extent of £300." Page-Wood, V. C., held that there was nothing sufficiently special in the guaranty to take it out of the general rule. No effect was given to the words "guarantee you against any loss in consequence of such advances" as extending the surety's liability or restricting his rights. They are strictly the equivalent of the expression "guarantee you against all loss in respect of such goods," which seems to be alone relied upon in the able judgment of Street, J., as shewing an intention to guarantee the whole debt. The application of the guaranty to past advances or to goods already sold does not necessarily make a difference in its construction as is shewn by such cases as *Ex parte Rushworth*, 10 Ves. 409; *Paley* v. *Field*, 12 Ves. 435; *Raikes* v. *Todd*, 8 A. & E. 846, and many others which might be referred to.

In what I have said I have dealt, as I understand my learned brother Street to have done, simply with the terms of the guaranty. I hold it to be a continuing guaranty limited in amount to secure the floating balance which may be due to the creditor on the dealings guaranteed, and I find no words in it which take it out of the general rule—the *primâ facie* construction—to be applied to such an instrument in reference to the question which is raised in this action. I refer to *Ex parte Miles*, 1 DeG. 623; *Ex parte Hope*, 3 M. D. & D. 720; *Midland Banking Co.* v. *Chambers*, L. R. 4 Ch., 398, and *Ex parte National Provincial Bank*, 17 Ch. D. 98.

With regard to the state of the principal debtor's account as bearing upon the construction or meaning of the guaranty, my learned brother Street does not refer to it, and the learned Chief Justice says: "No evidence was given at the

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Judgment. — OSLER, J.A.

trial of the circumstances under which this guaranty was given, nor of the state of accounts at that time existing between Ogilvy & Co. and McGachie Bros., nor whether the guarantor had any knowledge of the state of such accounts." He, therefore, held that the guaranty was to be construed without any extrinsic aid. In this I entirely agree. No such evidence was given at the trial, though the plaintiff's counsel very earnestly pressed upon our attention an exhibit, which is said to have been filed in the Divisional Court, though no member of the Court alludes to it in his judgment. But it carries the case no further. It is not explained or vouched in any way, nor is it self-explanatory. Moreover, even if it could be said (which it cannot) that it shews a debt at the date of the guaranty already ascertained, which exceeded the limit—and it is used for that purpose so as to bring the case within the principle of *Ellis* v. *Emmanuel*, 1 Ex. D. 157, yet there is no evidence that the surety knew what was the state of the account or what was then due for goods already sold. In the absence of such evidence, no inference unfavourable to the surety can be drawn. Unless he meant formally to guarantee the whole debt restricting his liability, it was of no consequence that he should know the amount of that already incurred, as he would naturally deem himself sufficiently protected by the express limitation, and unless he did know it, there is nothing extrinsic to the guarantee to shew an intention on his part to waive or abandon what, upon its face, I must hold to be his ordinary right. But whether there was a debt exceeding the limitation due at the date of the guarantee or not, the case differs from *Ellis* v. *Emmanuel*, 1 Ex. D. 157, in this, that the guaranty is nevertheless for the floating balance on that debt and the subsequent dealing between the parties. In *Ellis* v. *Emmanuel*, 1 Ex. D. 157, the security was given for the whole of an ascertained debt expressed in the instrument, and the Court arrived at the conclusion from the express and special terms used, that the intention of the several sureties was to guarantee the whole with a limitation upon

Judgment. — OSLER, J.A.

the liability of each. As regards the power to compromise the debt without affecting the surety's liability, I agree with the learned Chief Justice of the Queen's Bench that it does not control or extend the meaning of the guaranty. It amounts to no more than a permission to the creditors to do what in the absence of such power would have discharged the surety, and merely shews that in the case of a compromise between debtor and creditor, the surety still holds himself liable for the balance of the debt to the extent of $2,500. On the whole, it appears to me that the judgment is right, and that we should dismiss the appeal.

Appeal allowed with costs, OSLER, J. A., *dissenting*.

Index No. 6

1943 CarswellAlta 63, [1943] 3 W.W.R. 297

I.O.F. v. Lethbridge Northern Irrigation District

Independent Order of Foresters v. Board of Trustees of Lethbridge Northern Irrigation District and Provincial Treasurer for Alberta

Alberta Supreme Court

O'Connor, J.

Judgment: July 10, 1943

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Counsel: *G. H. Steer, K.C.* , for plaintiff.

W. S. Gray, K.C. , for defendant, board of trustees.

H. J. Wilson, K.C. , for defendant, provincial treasurer.

Subject: Corporate and Commercial

Execution --- Priorities among execution creditors — Creditors' Relief Act — In garnishment proceedings.

Power of Court to Deal With Situation According to Equity.

Sec. 6 (*d*) of *The Execution Creditors Act* , 1934, ch. 8 (now R.S.A., 1942, ch. 122) which provides that money paid into Court under garnishee proceedings shall be available for distribution among the execution creditors of the debtor whose debt is garnished, except "(*d*) when it is otherwise ordered by a court or judge," and sec. 12, which provides the order of priority for payment out of moneys received by the sheriff in respect of an execution where they are not sufficient to pay the claims of creditors and the executions with costs in full, are intended to permit the Court to do justice between the parties according to settled principles of law and equity.

The province of Alberta guaranteed payment of the principal and interest of the bonds in question herein. It defaulted

on that guarantee. The plaintiff was an execution creditor of the principal debtor, an irrigation district. Its execution was issued on a judgment for interest accrued on the bonds. Under its execution it seized other bonds owned by the district; and by garnishee summons it attached moneys in a bank to the credit of the district. The provincial treasurer was also an execution creditor of the district under a judgment for interest, etc., paid by the province under said guarantee.

Held that the provincial treasurer was not entitled by virtue of his judgment and execution to any right under said Act to share with the plaintiff in moneys attached or which may be attached by garnishee summons or realized or which may be realized under executions against the district. *Ex parte Corry; In re Fothergill* (1876) 3 Ch. D. 445 , 45 L.J. Bk. 153, and other cases, applied.

O'Connor J. **:**

1 This is a special case to determine questions of law.

2 The plaintiff and the defendant treasurer are both execution creditors of the defendant irrigation district. The plaintiff disputes the right of the treasurer to share with the plaintiff in moneys (*a*) attached by the plaintiff under a garnishee summons or (*b*) which may be realized under the plaintiff's execution against the district.

3 The plaintiff contends that as the province of Alberta has guaranteed payment of the irrigation district's debentures held by the plaintiff and as these debentures are a charge on the assets of the defendant district, including the moneys and bonds in question, it is inequitable to permit the defendant treasurer to share in moneys realized under the plaintiff's garnishee and execution. The plaintiff says that the province, having defaulted under the guarantee, should not prevent the plaintiff from realizing on the irrigation district's assets. Counsel for the plaintiff points out that this may result in a multiplicity of actions since if the defendant treasurer takes part of the moneys realized under the plaintiff's garnishee the plaintiff must then realize this sum from the province of Alberta.

4 The plaintiff's execution for $7,181.81 was issued on judgments for interest accrued due on debentures of the irrigation district. The province of Alberta guaranteed payment of principal and interest of the whole debenture issue of $5,400,000. The treasurer's execution for $3,657,920.52 was issued under a judgment for interest paid by the province under this guarantee and for moneys paid into the sinking fund to retire the principal of the debenture issue.

5 The plaintiff's garnishee summons attached moneys held by the Canadian Bank of Commerce at the credit of the defendant irrigation district and the sheriff seized under the plaintiff's execution certain bonds issued by the province of Saskatchewan and held in a safety deposit box in the Canadian Bank of Commerce rented by the defendant irrigation district.

6 (1) The plaintiff claims that as it has a charge on the moneys attached and the bonds seized it is inequitable to permit the defendant treasurer to share in the proceeds thereof. Sec. 37 of *The Irrigation Districts Act* , 1920, ch. 14 (Alta.) is as follows, viz.:

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The debentures shall be sufficient when signed by two of the trustees of the district to bind the board and in the hands of any *bona fide* holder thereof shall be a charge or lien upon all the land (including the buildings and improvements thereon) appearing upon the assessment roll, other than land exempt from taxation by the province, and upon all the property of the board and all rates levied under the provisions of this Act in the district; but shall not have any priority over any charges, liens, mortgages or encumbrances upon such land created or coming into existence prior to the issue of such debentures.

7 The province is subrogated to the position of the holders of the debentures it pays under the guarantee. Subsec. (2) of sec. 4 of *The Lethbridge Northern Irrigation District Act, 1921* , ch. 63 (Alta.) is as follows:

Any payment by the province of principle or interest due under the said debentures, pursuant to the guarantee thereof, shall not in any event be taken to effect the liability of the said district therefor under the said debentures, but such liability shall remain unimpaired and enforceable by the province against the said district. The province shall be subrogated as against the said district to all rights, privileges and powers to which the holders of the debentures, in respect of which principal or interest or both has been so paid, were entitled by virtue of such debentures, prior to payment by the province under its guarantee, and shall with respect to the debentures in respect of which principal or interest or both has been so paid be in the same position as a holder of debentures upon which the district has made default.

8 This subrogation is effective against the district and as each debenture is paid in full the province stands in the place of the former debenture holder.

9 Counsel for the treasurer points out that the plaintiff holds only 3.35 per cent of the debenture issue and it would be inequitable to pay the money to the plaintiff.

10 (2) Counsel for the plaintiff contends that it is inequitable to pay the money to the treasurer since the province has guaranteed payment of the debentures.

11 A surety who compromised, at 4s. on the pound, his liability for his principal's debt, was held not to be entitled to share in a dividend of debentures which the creditor had obtained in the bankruptcy of the principal debtor: *Ex parte Corry; In re Fothergill* (1876) 3 Ch. D. 445 , 45 L.J. Bk. 153. James, L.J. said (p. 155):

In this case, the surety has paid 4s. in the pound. What is his equity against the creditor? If the surety has paid 20s. in the pound, he may exercise whatever right the principal debtor had against the creditor. But the creditor may first require payment of 20s. in the pound, and all that the surety can say is 'You have got something very valuable under the arrangement. I am willing to discharge my obligation to you by paying 20s. in the pound and when I have done that you must hand me over the security.' That seems to me to be the sole equity.

12 In *In re Coughlin & Co.*, [1923] 3 W.W.R. 1179, 33 Man. R. 499, 4 C.B.R. 294 , Fullerton, J.A. said, p. 1179:

In considering the right of a surety who has made payment to rank upon the estate the cases draw a distinction

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between two classes of guarantees, one where the contract is to be construed as a security for a part only of the debt and the other where it is to be construed as a security for the whole amount due or to become due with a provision limiting the surety's liability to pay any amount beyond a named sum. ... In a case of a guarantee of the latter class the creditor is entitled to rank for the whole amount as the surety cannot be permitted to compete with the creditor for dividends in respect of a debt which the surety himself has guaranteed.

13 Dennistoun, J.A., said p. 1182:

It is to be noted that it is the 'debt' which is provable. There may be several claimants in respect to the 'debt,' but there is only one debt, and double proof in respect to it is not permitted.

14 The principle is not limited to bankruptcy.

15 In *In re Oriental Commercial Bank; Ex parte European Bank* (1872) L.R. 7 Ch. 99 , 41 L.J. Ch. 217, Mellish, L.J. said, p. 218:

Upon the main question the case of *Rigby v. Macnamara* (1795) 2 Cox Eq. Cas. 415, tends to show that the rule in bankruptcy against double proof applies also in the Court of Chancery, and consequently applies in case of companies being wound up.

16 In *Martin v. McMullen* (1891) 18 O.A.R. 559 , Maclennan, J.A. said, p. 565:

The cases which have been cited are cases in which the creditor had proved or had obtained dividends on the bankruptcy of the debtor, but the principle involved seems to be a general principle of equity, applicable to all cases of suretyship.

17 See also *In re Sass; Ex parte National Provincial Bank of England*, [1896] 2 Q.B. 12 , 65 L.J.Q.B. 481.

18 (3) Counsel for the plaintiff further contends that if the treasurer is excluded from participation in the moneys attached and the proceeds of the bonds seized, this will save multiplicity of actions, and cites clause (*g*) of sec. 34 of *The Judicature Act* , R.S.A., 1942, ch. 129, in support of the Court's jurisdiction to do this. He cites sec. 3 of *The Execution Creditors Act* , 1934, ch. 8 [now R.S.A., 1942, ch. 122] and, as to the garnishee, sec. 6, and, as to the execution, sec. 12 of the said Act, which sections are as follows:

3. Except only in the cases where it is otherwise specifically provided by this Act, all property seized or attached by virtue of any writ of execution, writ of attachment, garnishee proceedings or proceedings in the nature of equitable execution shall be deemed to have been attached on behalf of all creditors who are entitled by this Act to share in any money received by the sheriff by reason of such seizure or attachment; and all moneys realized thereby shall be dealt with and distributed by the sheriff of the district in which such seizure or attachment is made under the provisions of this Act.

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6. Where any money is paid into court under any garnishee proceedings in the Supreme Court of Alberta or any District Court, the same shall be available for distribution by the sheriff amongst the execution creditors of the debtor whose debt is garnished except only in each of the following cases, namely:

(*a*) When the money paid into Court is not liable to attachment;

(*b*) When the amount paid into court does not exceed the sum of twenty-five dollars;

(*c*) When by virtue of any statute or Rule of Court the money is required to be paid to the debtor as being exempt from attachment; and

(*d*) When it is otherwise ordered by a court or judge.

12. When the amount received by the sheriff in respect of an execution is not sufficient to pay the claims of creditors and the executions with costs in full, the sheriff shall firstly retain his fees, and secondly, in the event of any creditor being entitled under the provisions of this Act to priority for costs, the sheriff shall pay such costs to that creditor, and thirdly, shall pay the claim of any person who is entitled to be paid in preference to any other creditor, and fourthly, shall distribute the balance (if any) rateably amongst such execution creditors as are entitled to share therein under the provisions of this Act.

19 The cases of *Tobin v. Commercial Inv't Co.* (1916) 10 W.W.R. 123, 22 B.C.R. 481, 34 W.L.R. 23 ; *Knight v. Knight* (1734) 3 P. Wms. 334, 24 E.R. 1088 , and *McGowan v. Middleton* (1883) 11 Q.B.D. 464 , 52 L.J.Q.B. 355, show that the Court will adapt its procedure to prevent multiplicity of actions but the plaintiff's right to prevent the defendant from sharing in the moneys in the hands of the sheriff must depend on substantive law. It is not a question of procedure.

20 It is contended that sec. 6, clause (*d*), permits the Court to do justice between the parties. Counsel for the defendant treasurer argues that clause (*d*) is intended to permit the Court to order payment to a garnishee creditor in cases where it is obvious that the other execution creditors would not be entitled to the money under the Act; for example, where there were no subsisting writs of execution in the sheriff's hands, or where the garnishing creditor was a wage carner or was otherwise entitled to be paid the money in priority to other claims. He relies on *Bowerman v. Phillips* (1888) 15 O.A.R. 679 , in which it was held that the Ontario *Creditors Relief Act* did not permit one creditor to attack the judgment of another if the debt was *bona fide* .

21 I find the sections are intended to permit the Court to do justice between the parties, according to settled principles of law and equity.

22 Secs. 6 and 12 were intended to enable the Court to deal with such a case as this according to law.

23 I find the debenture holders of the irrigation district are exclusively entitled under their charge to the money and bonds of the irrigation district which are now or may hereafter come into the hands of the sheriff.

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24 I answer the question submitted as follows:

Has the Honourable the Provincial Treasurer by virtue of the said judgment in his favour and the execution issued thereunder a right under *The Execution Creditors Act* to share with the plaintiff in moneys

(*a*) attached or which may be attached by garnishee summons, or

(*b*) realized or which may be realized under Writs of Execution against the said Lethbridge Northern Irrigation District,

and if so with respect to what amount and to what extent?

A. (*a*) No. (*b*) No. The plaintiff is entitled to 3.35 per cent of each. The sheriff should hold the balance and pay it to the debenture holders as they establish their claims.

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1944 CarswellAlta 8, [1944] 1 W.W.R. 206

Independent Order of Foresters v. Lethbridge Northern Irrigation District

Independent Order of Foresters (Plaintiff) Appellant v. Board of Trustees of Lethbridge Northern Irrigation District and Provincial Treasurer for Alberta (Defendants) Respondents and Cross-Appellants

Alberta Supreme Court, Appellate Division

Harvey, C.J.A., Ford, Lunney, Ewing and Howson, JJ.A.

Judgment: January 21, 1944

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Counsel: *G. H. Steer, K.C.*, for plaintiff, appellant.

W. S. Gray, K.C., for Board of Trustees of Lethbridge Northern Irrigation District, defendant, respondent.

H. J. Wilson, K.C., Deputy Attorney-General, for the Provincial Treasurer, defendant, respondent.

Subject: Family

Family law.

Execution Creditors Act — Principal and Surety — Right of Defaulting Guarantor with Judgment to Share With Another Judgment Creditor in Moneys Attached and Seized by Execution — Defaulting Guarantor the Province of Alberta — Special Case Under R. 218 — Powers of Court — Duty of Crown to Obey Law.

Both the plaintiff and the defendant provincial treasurer were execution creditors of the defendant irrigation district. The plaintiff's execution was issued on a judgment for interest due on bonds issued by the district. The bonds had been guaranteed by the province as to both principal and interest, and the treasurer's judgment was for interest paid by the province under this guarantee and for moneys paid into the sinking fund to retire the principal. The province later defaulted under the guarantee. On a special case O'Connor, J. *held* ([1943] 3 W.W.R. 297) that the treasurer was not entitled by virtue of his judgment and execution to any right under *The Execution Creditors Act*, 1934; ch. 8 (now R.S.A., 1942, ch. 122) to share with the plaintiff in moneys it had attached or might attach by garnishee summons or which it might realize under its execution; but he declared, by what is referred to as a "rider," that the plaintiff was entitled to 3.35 per cent of the moneys attached, or which might be attached by garnishee summons, or realized, or which might be realized, under execution against the defendant, and that the balance of

such moneys should be held by the sheriff to be paid to other bondholders as they established their claims. The plaintiff appealed against the "rider," and the defendants, the district and the treasurer, cross-appealed from the whole judgment, but, alternatively, supported the "rider."

Held that the plaintiff's appeal should be allowed by varying the judgment with respect to the "rider," and the cross-appeal should be dismissed. The plaintiff was given the costs of both the appeal and cross-appeal to be taxed under double column 5.

When a surety is liable to the creditor for the whole amount of the debtor's liability the surety is not permitted to compete with the creditor in the realization of the assets of the principal debtor. While this principle finds its usual application in bankruptcy it is one of general application, applicable to all cases of suretyship. There is nothing in *The Execution Creditors Act, supra*, which prevents its application where, as here, the surety is attempting to compete with the creditor, whose debt has been guaranteed in full, by a judgment obtained in reliance upon see. 4 (2) (quoted *infra*) of *The Lethbridge Northern Irrigation District Act*, 1921, ch. 63. The fact that the surety is the province is no obstacle to the application of the principle, and does not prevent the Court from doing justice as between the Crown and a subject.

The contention cannot be sustained that in order to make the declaration involved in a negative answer to the question submitted the Court must necessarily find that the Crown in the right of the province of Alberta owes money to the plaintiff under the guarantee, and that there has been no judicial finding to that effect and that such a finding cannot be made in this issue or otherwise than by petition of right, for which a fiat is required, and that, since no fiat has been obtained, the making of such a finding would be doing indirectly what it is impossible to do directly. It cannot be said that, while the Court might have the right to answer affirmatively, it cannot answer negatively the question which the Crown through its proper officer has joined in submitting for its opinion under Rule 218. Under that Rule the question of law could not have been stated without the concurrence of all parties to the issue. The present case is distinguishable from *Lovibond v. G.T.R. Co.*, [1936] 2 W.W.R. 298 (P.C.), 1936 Can. Abr. 173, 859; and *Royal Trust Co. v. Atty.-Gen. for Alta.*, [1936] 2 W.W.R. 337 (Alta.), 1936 Can. Abr. 861.

"The non-existence of any right to bring the Crown into Court, such as exists in England by petition of right, and in many of the colonies by the appointment of an officer to sue and be sued on behalf of the Crown, does not give the Crown immunity from all law, or authorize the interference by the Crown with private rights at its own mere will ... It is the duty of the Crown and of every branch of the Executive to abide by and obey the law. If there is any difficulty in ascertaining it the Courts are open to the Crown to sue, and it is the duty of the Executive in cases of doubt to ascertain the law, in order to obey it, not to disregard it:" *Eastern Trust Co. v. Mackenzie, Mann & Co.*, [1915] A.C. 750, 84 L.J.P.C. 152, 11 Can. Abr. 12.

To give effect, in the present proceeding, to the equities as between the province as surety and the plaintiff as the primary creditor, by answering the question submitted in consonance with the principle stated, does not amount to a setting aside, directly or indirectly, or the impeaching of the judgment obtained by the surety. The point involved in the question is not whether the judgment was properly obtained but whether the judgment creditor, a surety for the whole debt, is entitled, as against the plaintiff, to share in what is realized under the plaintiff's executions and garnishee summonses. Nor does the giving effect, in the present proceeding, to the equities as between the surety and the principal creditor, nullify, "virtually" or at all, the provisions of *The Execution Creditors Act, supra. Bowerman v. Phillips* (1888) 15 O.A.R. 679, 19 Can. Abr. 449, does not assist the defendants.

It was not open to the Judge to deal with the question of the right of the plaintiff to the proceeds to be realized from the property

seized. This question has not been asked and cannot be answered until the issue out of which the special case arose is determined. The question submitted relates solely to the legal rights of the defendant in the issue, the provincial treasurer. The relative rights of the plaintiff and other debenture holders is not involved in either an affirmative or negative answer. Such relative rights cannot be determined in proceedings to which the other debenture holders are not parties, and without there being before the Court sufficient material to determine them. The other debenture holders are not made parties, either by representation or otherwise, and there was no, or no sufficient, material before the Court to determine such relative rights. Furthermore, there is no machinery provided in *The Execution Creditors Act, supra*, for carrying out the direction to divide the proceeds of the property attached as directed by the learned trial Judge. There is no provision in the Act for the sheriff holding such proceeds for an indefinite time, to enable persons, who may or may never advance their claims, to establish them. True it is that the statute modifies the maxim *vigilantibus, non dormientibus, jura subveniunt*, but, subject to the provisions as to preferences, it is only those who establish their claims in accordance with the Act, and within the time fixed thereby, who have the right to share in the sheriff's distribution.

Semble said *Execution Creditors Act* makes no provision for one execution creditor contesting the claim of another execution creditor in a summary proceeding before a District Court Judge.

Appeal from part of the judgment of O'Connor, J. ([1943] 3 W.W.R. 297). Appeal allowed; cross-appeal dismissed; costs to the appellant of both the appeal and cross-appeal, to be taxed under double column 5.

The judgment of the Court was delivered by *Ford, J.A.*:

1 This is an appeal by the plaintiff and a cross-appeal by the defendants from the judgment of the Honourable Mr. Justice O'Connor: [1943] 3 W.W.R. 297.

2 This is another step in the series of attempts of the Independent Order of Foresters to secure payment of the interest agreed to be paid on bonds or debentures, held by it, issued in May, 1921, by the Lethbridge Northern Irrigation District and guaranteed by the province of Alberta. It is a sequence to the litigation commenced in January, 1937, the earlier history of which may be found in the report of the decision of the Judicial Committee of the Privy Council, in *I.O.F. v. Lethbridge, Nor. Irr. Dist.;* , [1940] 1 W.W.R. 502, [1940] A.C. 513, 109 L.J.P.C. 68 , which, affirming judgments in the Trial Division ([1937] 3 W.W.R. 424, and [1939] 1 W.W.R. 275) and of this Division ([1938] 2 W.W.R. 194, and [1939] 1 W.W.R. 700) held to be *ultra vires The Provincial Guaranteed securities Interest Act*, 1937, ch. 12, which purported to reduce by one-half the interest on securities guaranteed by the province of Alberta; *The Provincial Securities Interest Act, 1937*, ch. 13, which purported to reduce to, in general, half the agreed interest rates; and *The Provincially Guaranteed Securities Proceedings Act*, 1937, ch. 11, which purported to prohibit any proceedings in Alberta for the recovery of money due in respect of guaranteed securities without the consent of the Lieutenant-Governor in Council.

3 After the issuing of the executions and garnishee summonses of the Independent Order of Foresters and the seizures and attachments made thereunder, as well as the execution of His Majesty the King, represented by the Honourable the Provincial Treasurer of Alberta, as set out in the stated case, out of which this appeal arises, an order was made by Mr. Justice Macdonald in action No. 27728, therein referred to, directing an issue as to the effect in law of the judgment of the Independent Order of Foresters and to determine whether the property attached under the executions and garnishee summonses was legally attached. This order was made with the consent of the provincial treasurer.

4 In the issue the Independent Order of Foresters was to be plaintiff and the Board of Trustees of the Lethbridge Northern Irrigation District and the Honourable the Provincial Treasurer of the Province of Alberta were to be defendants.

5 The plaintiff delivered a statement of claim, and both defendants delivered statements of defence.

6 Before the determination of the issue it appeared to counsel for the parties that it might be advisable first to have determined the question as to whether the Crown in the right of the province was entitled to share, with the plaintiff in the issue, in moneys realized by garnishee or under writs of execution. For that purpose a special case was agreed upon and signed by solicitors for all three parties to the issue.

7 I quote the special case, omitting the documents attached thereto:

```
      In The Supreme Court of Alberta
       Judicial District of Edmonton

Between:

       Independent Order of Foresters,
                                      Plaintiff,

                  --and--

    Board of Trustees of the Lethbridge
    Northern Irrigation District and the
    Honourable The Provincial Treasurer
    of The Province of Alberta,
                                  Defendants.
```

The Special Case

1. The parties to the above cause concur in stating certain questions of law arising therein in the form of a special case for the opinion of the Court.

2. The facts necessary to enable the Court to decide the questions raised are as follows:

(*a*) The plaintiff is a body corporate incorporated in accordance with the provisions of *The Independent Order of Foresters Consolidated Act*, 3 and 4, George V (Canada), Chapter 113, being chapter 113 of the Statutes of Canada, 1913; has its head office in the City of Toronto, in the Province of Ontario, and is duly licensed to do business in the Province of Alberta pursuant to the provisions of *The Alberta Insurance Act, 1926*.

(*b*) The first named defendant is a body corporate incorporated pursuant to the provisions of *The Irrigation Districts Act, 1915*, being Chapter 13 of the Statutes of Alberta, 1915. By virtue of the provisions of *The Irrigation Districts Act, 1920*, being Chapter 14 of the Statutes of Alberta, 1920 (R.S.A., 1942, chapter 98), the said defendant was continued and it was provided that it should be subject to the provisions of the said Statute as if it had been formed thereunder.

(*c*) The first named defendant under and by virtue of *The Irrigation Districts Act, 1920*, being chapter 14 of the Statutes of Alberta, was empowered with the written assent of the Minister of Public Works for the Province of Alberta, to raise a loan upon the credit of the District and to issue debentures to secure the repayment thereof.

(*d*) In compliance with all the provisions of *The Irrigation Districts Act, 1920*, being chapter 14 of 1920, and with the written assent of the Minister of Public Works for the Province of Alberta, dated the 30th day of October, A.D. 1920, the first named defendant raised a loan upon the credit of the district and issued debentures to the aggregate principal amount of Five Million, Four Hundred Thousand ($5,400,000.00) Dollars, dated May 2nd, 1921, and thereby and therein promised to pay to the bearers or, if registered, to the registered owners thereof, on the first day of May, A.D. 1921, the principal amount of the said debentures in gold coin of or equivalent to the standard of weight and fineness fixed for gold coins at the date thereof by the laws of the United States of America, with interest thereon at the rate of six per cent (6%) per annum, payable half-yearly on the first day of May and the first day of November in each and every year during the currency thereof in like money according to the tenor of and upon presentation and surrender of the coupons thereto attached as the same severally become payable. It was further provided that payment of both principal and interest would be made at the holders' option at the principal office of the Imperial Bank of Canada in the cities of Toronto, Montreal or Edmonton, in the Dominion of Canada or at the offices of the Bank of Manhattan Company in the City of New York, U.S.A.

(*e*) The plaintiff, at its head office in the City of Toronto, in the province of Alberta, is the bearer, *bona fide* holder and owner of debentures so issued as aforesaid in the aggregate principal amount of One Hundred and eighty-one thousand ($181,000.00) Dollars, each of the said debentures being of the principal amount of One Thousand ($1,000.00) Dollars.

(*f*) Prior to the issue of the said debentures the first named defendant was legally formed and constituted and all the formalities in respect to such loan and the issue of debentures therefor had been fully complied with. All acts, conditions and things necessary to be done and to exist precedent to and in the issuance of the said debentures were properly fulfilled and performed and existed in regular and due form as required by the laws in the Province of Alberta and the Dominion of Canada and by the by-laws and regulations of the Lethbridge Northern Irrigation District and the said debentures are a good and indefeasible security in the hands of the plaintiff.

(*g*) The said debentures were guaranteed as to the payment of principal and interest by the Province of Alberta, by virtue of powers conferred by *The Lethbridge Northern Irrigation District Act, 1921*, being chapter 63 of the Statutes of Alberta, 1921, and constituted securities in which the plaintiff was by law entitled to invest.

(*h*) On or about February 22nd, 1937, the plaintiff in an action numbered in this Court 27728 between it, as plaintiff, and the Board of Trustees of the Lethbridge Northern Irrigation District and L. C. Charlesworth, Official Trustee

thereof, as defendants, recovered judgment against the defendant, The Lethbridge Northern Irrigation District in the sum of $5,430.00 on which said judgment there was due and unpaid as of June 29th, 1942, the sum of Three Thousand Three Hundred Dollars and twenty cents ($3,300.20) in respect of Interest coupons of the said debentures so guaranteed as aforesaid.

(*i*) On or about October 29th, 1937, in an action numbered in this Court 28079 between the plaintiff herein, as plaintiff, and the said Board of Trustees and the said L. C. Charlesworth, as defendants, the plaintiff herein recovered a judgment against the said Board of Trustees for the sum of Five Thousand Four Hundred and Thirty ($5,430.00) Dollars, upon which as of June 29th, 1942, there was due and unpaid the sum of Three thousand eight hundred and fifty-seven dollars and seven cents ($3,857.07) in respect of interest coupons of the said debentures so guaranteed as aforesaid.

(*j*) On or about June 29th, 1942, the plaintiff caused to be issued in the two said actions numbered respectively 27728 and 28079 Garnishee Summonses directed to the Canadian Bank of Commerce at Lethbridge in the Province of Alberta, and on or about July 10th, 1942, the said Garnishee filed replies in the two said actions to the said Garnishee Summonses, which Replies were in the following terms, namely:

At the time of the service of the Garnishee Summons herein upon the Canadian Bank of Commerce the Canadian Bank of Commerce held to the credit of the defendant the Board of Trustees of the Lethbridge Northern Irrigation District a sum sufficient to pay the plaintiff's judgment herein in the sum of $3,300.20 (in action No. 28079 $3,857.07) which said moneys, however, are claimed by the Province of Alberta as its property and which said sum of $3,300.20 (in action No. 28079 $3,857.07) therefore may or may not be attachable.

The sum of $10,000.00 is being held by the said garnishee by agreement of the parties hereto pending the outcome of these proceedings and is to be deemed for the purposes of this special case to be held by the sheriff as having been paid to him pursuant to Section 8, and as being distributed pursuant to Section 31 of *The Execution Creditors Act*. There are no garnishee summonses or Writs of Execution outstanding with respect to debts owing by the defendant Board of Trustees save as herein set out, except an execution for approximately Twenty-five ($25.00) Dollars based on a coupon for interest in respect of the bond issue hereinbefore referred to.

(*k*) On or about August 22nd, 1940, the plaintiff in this issue caused to be issued in the two said actions numbered respectively Nos. 27728 and 28079 Writs of Execution for the sum of Two thousand two hundred and Sixty-two dollars and fifty cents ($2,262.50) with interest and costs and the sum of Two Thousand eight hundred and seventy-seven dollars and forty-four cents ($2,877.44) with interest and costs.

(*l*) On or about June 30th, 1942, the sheriff of the Lethbridge Judicial District caused to be seized under the two said Writs of Execution to satisfy the claim of the plaintiff in this issue amounting to the sum of Seven thousand one hundred and eighty-one dollars and eighty-one cents ($7,181.81) together with the sum of $4.75, his costs, all or sufficient of the bonds of the Province of Saskatchewan, contained in a safety deposit box in the name of the Lethbridge Northern Irrigation District in the Canadian Bank of Commerce, Lethbridge, to satisfy the above claim. For the purpose of this special case, but for no other purpose the said bonds are by agreement between the parties to be deemed to be properly seized and in the hands of the sheriff.

3. In an action in the Supreme Court of Alberta, Judicial district of Lethbridge, His Majesty the King as represented by the Honourable the Provincial Treasurer of Alberta, on or about the 18th day of September, 1942, recovered judgment against the Lethbridge Northern Irrigation District for the sum of Three million, Six hun dred and fifty-seven thousand, nine hundred and twenty dollars and fifty-two cents ($3,657,920.52), and on or about the 18th day of September, 1942, issued execution thereon and placed the same in the hands of the sheriff of the Judicial District of Lethbridge of which the sum of Two million, two hundred and eighty-nine thousand, and sixty-six dollars and two cents ($2,289,066.02) was for money paid pursuant to the said guarantee and the balance amounting to One million, three hundred and eighty-six thousand, eight hundred and fifty-four dollars and fifty cents ($1,386,854.50) was for money paid into a sinking fund to retire the principal of the bonds at maturity.

4. On or about the 25th day of September, 1942, the Independent Order of Foresters recovered judgment against the Board of Trustees of the Lethbridge Northern Irrigation District and P.M. Sauder, Official Trustee of the Lethbridge Northern Irrigation District, in the sum of Sixty-one Thousand five hundred dollars and thirty cents ($61,500.30) and issued execution thereon in respect of interest coupons of the said debentures so guaranteed as aforesaid.

5. Nothing has been paid to the plaintiff on account of any of the said judgments and executions other than the amounts which had been paid into Court by the Provincial Treasurer under the two first mentioned judgments, being the amounts owing on the judgments as hereinbefore set out.

6. Attached hereto as part of this case are:

(*a*) Statement showing how the sum of Three Million six hundred and fifty-seven thousand nine hundred and twenty dollars and fifty-two cents ($3,657,920.52) representing the judgment in favour of the Provincial Treasurer is made up;

(*b*) A copy of the Order in Council guaranteeing the said bonds;

(*c*) By-Law No. 5 of the Lethbridge Northern is attached.

7. The question of law arising from the foregoing facts is as follows:

Has the Honourable the Provincial Treasurer by virtue of the said judgment in his favour and the execution issued thereunder a right under *The Execution Creditors Act* to share with the plaintiff in moneys

(*a*) attached or which may be attached by Garnishee Summons, or

(*b*) realized or which may be realized under Writs of Execution against the said Lethbridge Northern Irrigation district,

and, if so, with respect to what amount and to what extent?

Dated at the City of Edmonton, in the Province of Alberta, this 21st day of May, A.D. 1943.

Geo. H. Steer,
Solicitor for the Plaintiff.

W. S. Gray,
Solicitor for the Defendant,
the Board of Trustees.

H. J. Wilson,
Solicitor for the Defendant,
the Provincial Treasurer.

8 The special case was considered by the Honourable Mr. Justice O'Connor who, as set out in the formal judgment, found and declared:

> I Find and Declare that the answer to the question submitted to me by the said Special Case is 'no,' but that the plaintiff is entitled to 3.35 per cent of moneys attached, or which may be attached by garnishee summons, or realized, or which may be realized under writs of execution against the defendant, Lethbridge Northern Irrigation District, and that the balance of any such moneys is to be held by the sheriff to be paid to other debenture holders as they establish their claims.

9 In his reasons for judgment the learned Judge answered "No" to both parts of the question designated (*a*) and (*b*), but added a "rider" as follows:

> The plaintiff is entitled to 3.35 per cent of each. The sheriff should hold the balance and pay it to the debenture holders as they establish their claims.

10 The plaintiff, appellant, confines its appeal to one against what is called the "rider." In all other respects the appellant supports the judgment, contending that the answer to the question should be a simple "no."

11 The defendants, respondents, gave notice of cross-appeal from the whole judgment, claiming that the answer of the learned Judge should have been "yes;" but, alternatively, they support the rider to the judgment. As summarized in the factum on behalf of the provincial treasurer their submissions are as follows:

> (1) *The Execution Creditors Act* does not permit the Court to grant priority to one execution creditor at the expense of another except as provided by the Act;
>
> (2) Alternatively, the plaintiff cannot claim priority in respect of the portion of the judgment which does not represent monies paid under the guarantee;
>
> (3) In the further alternative, the learned Trial Judge was right in limiting the plaintiff to realization of 3.35% of the amount

levied under the execution and garnishee summons.

12 It is stated in the factum on behalf of the irrigation district that:

> This respondent, being the Execution Debtor, is desirous of the proceeds of any of its assets, which may be disposed of under execution, being distributed *pro rata* between the Provincial Treasurer and all the bondholders, as the Provincial Treasurer is the largest creditor of the respondent district.

13 On the hearing of the appeal a further ground of appeal was set up and argument developed thereon. It is contended that, in order to make the declaration involved in a negative answer to the question submitted by the special case, the Court must necessarily find that His Majesty the King in the right of the province of Alberta owes money to the Independent Order of Foresters under the guarantee. It is said that there has been no judicial finding to that effect and that such a finding cannot be made in this issue or in any action other than one by way of petition of right for which a fiat is necessary.

14 It is argued that to make such a finding would be, by indirect means, doing something which it is impossible to do directly, no fiat to sue the Crown having been obtained. In support of this, reliance is placed upon *Royal Trust Co. v. Atty.-Gen. for Alta.* (No. 3) [1936] 2 W.W.R. 337, in which *Lovibond v. G.T.R. Co.*, [1936] 2 W.W.R. 298, 45 C.R.C. 162 (P.C.) was applied.

15 I deal first with the cross-appeal.

16 By par. 2 (*g*) of the special case it is stated, as a fact, that:

> The said debentures were guaranteed as to the payment of principal and interest by the Province of Alberta, by virtue of the powers conferred by *The Lethbridge Northern Irrigation District Act*, by Chapter 63 of the Statutes of Alberta, 1921.

17 The province of Alberta became surety for the whole debt without limitation. Where a surety is liable to the creditor for the whole amount of the debtor's liability there is a principle running through the cases, sufficient of which are referred to in the judgment appealed from, which does not permit of the surety competing with the creditor in the realization of the assets of the principal debtor. While this principle finds its usual application in bankruptcy it is one of general application, applicable to all cases of suretyship.

18 There is, in my opinion, nothing in *The Execution Creditors Act*, R.S.A., 1942, ch. 122, the relevant portion of which is set out in the learned trial Judge's reasons, which prevents the application of this principle, where, as here, the surety is attempting to compete with the creditor, whose debt has been guaranteed in full, by a judgment obtained in reliance upon subsec. (2) of sec. 4 of *The Lethbridge Northern Irrigation District Act, 1921*, ch. 63. This subsection is as follows:

> (2) Any payment by the province of principal or interest due under the said debentures, pursuant to the guarantee thereof, shall not in any event be taken to affect the liability of the said district therefor under the said debentures, but such liability shall remain unimpaired and enforceable by the province against the said district. The province shall be subrogated as against the said district to all rights, privileges and powers to which the holders of the debentures, in respect of which

principal or interest or both has been so paid, were entitled by virtue of such debentures, prior to payment by the province under its guarantee, and shall with respect to the debentures in respect of which principal or interest or both has been so paid be in the same position as a holder of debentures upon which the district has made default.

19 To give effect, in the present proceeding, to the equities as between the province as surety and the plaintiff as the primary creditor, by answering the question submitted in consonance with the principle stated, does not amount to a setting aside, directly or indirectly, or the impeaching of the judgment obtained by the surety, as contended on behalf of the defendants, respondents. The point involved in the question is not whether the judgment was properly obtained but whether the judgment creditor, a surety for the whole debt, is entitled, as against the plaintiff, to share in what is realized under the plaintiff's executions and garnishee summonses.

20 Nor does the giving effect, in the present proceedings, to the equities, as between the surety and the principal creditor, nullify, "virtually" or at all, the provision of *The Execution Creditors Act* as also contended on behalf of the defendants.

21 Reliance is placed upon the decision of the Ontario Court of Appeal in *Bowerman v. Phillips* (1888) 15 O.A.R. 679. In that case the contest was between two execution creditors one of whom alleged that the judgment of the other had been improperly obtained. The attacking creditor took proceedings, under a provision similar to sec. 21 of our Act, to contest the claim of a creditor who had not obtained judgment but who was proceeding to obtain a certificate which would be equivalent to an execution.

22 The County Court Judge set aside the judgment complained of holding that it was not a *bona-fide* judgment and had been improperly obtained.

23 On appeal Patterson, J.A. held that the order appealed from had been made upon a contestation which was not authorized by the Ontario *Creditors Relief Act*.

24 Osler, J.A. treated the appeal as arising out of a contestation under the Act. Hagarty, C.J.O. and Burton, J.A. simply concurred.

25 All that Patterson, J.A. held, in the passage relied upon, was that:

> Whatever power the statute gives to a creditor to contest a claim advanced by another, it does not extend the power to the impeaching of a judgment by a summary proceeding.

26 Osler, J.A. was careful to point out that: "There is no reason to suppose that he [the County Court Judge appealed from] would have held that the plaintiff was not entitled to be ranked in the sheriff's distribution scheme for any other reason" than that, in his opinion, the plaintiff's judgment was not a *bona-fide* one and had been improperly obtained.

27 In my opinion the defendants can derive no assistance from the decision in *Bowerman v. Phillips, supra*.

28 The present appeal does not arise out of a summary proceeding under *The Execution Creditors Act*. In passing I may say

that I am inclined to agree that the Act makes no provision for one execution creditor contesting the claim of another execution creditor in a summary proceeding before a District Court Judge. Secs. 18 to 26 seem to be limited to the contestation of a claim asserted by a creditor who has not obtained judgment but whose debt is overdue, or by a creditor who has allowed an execution against lands to remain unsatisfied for nine months, and who applies for a certificate which may entitle him to share in the sheriff's distribution. Sec. 31 deals with the contestation of the sheriff's scheme of distribution which he is required to make when the money realized is insufficient to pay all claims in full.

29 The present appeal arises upon admitted facts set out in a special case agreed upon by all parties in the issue directed, with the consent of all parties, by Mr. Justice Macdonald, in the action in which one of the plaintiff's judgments was obtained.

30 The stating of the special case is a commendable means of avoiding multiplicity of proceedings and provides the Court with a convenient method of exercising the powers given to it, by *The Judicature Act*, R.S.A., 1942, ch. 129, to prevent multiplicity of actions. I cannot think that parties would have gone to the trouble of stating the facts agreed upon with such care unless it were intended that an answer to the question asked would lead to some result having regard to the ultimate rights of the parties in the light of the equities as between the surety and the principal creditor.

31 If both surety and creditor were allowed to share in the sheriff's distribution, there is, I think, no doubt that the creditor would immediately have the right to take proceedings against the surety to recover the balance due him. Indeed in my opinion, the creditors, having a charge thereon, would have the right to claim the very dividend which the surety has received.

32 In the way the issues have been brought before the Court there is quite as much reason for the Court now preventing the surety ranking inequitably in the sheriff's distribution, as against the creditor, as there is to prevent a surety so ranking in bankruptcy or in a distribution for the benefit of creditors. I find nothing in *The Execution Creditors Act* against the Court's power to do so.

33 I should add that I do not desire to be understood as expressing a definite opinion against the view advanced by counsel for the plaintiff that the special case is to be considered as anticipating and taking the place of a contestation of the scheme of distribution which the sheriff is required to make. The argument, as I understand it, is that it is open to one execution creditor, in contesting under sec. 31 the sheriff's scheme of distribution, to raise and have decided the question now submitted. If this argument is sound there is nothing in the way of the Court answering the question having regard to the equities as between creditor and surety, and, the question having been submitted, any difficulty as to the Crown being the surety disappears.

34 The fact that the surety is the province of Alberta, in my opinion, presents no obstacle to the application of the principle I have stated, and does not prevent the Court from doing justice as between the Crown and the subject.

35 I have stated concisely the argument advanced by counsel for the provincial treasurer to the effect that in the absence of a fiat the Court is powerless to make the declaration involved in an answer to the question submitted by the special case, at all events if answered against the contention of the provincial treasurer. It seems to me a strange thing to say that, while the Court might have the right to answer affirmatively, it cannot answer negatively the question which the Crown, through its proper officer, has joined in submitting for its opinion under Rule 218.[FN1] Under that Rule the question of law could not have been stated without the concurrence of all parties to the issue.

36 The present case is clearly distinguishable from *Lovibond v. G.T.R. Co., supra*, and *Royal Trust Co. v. Atty.-Gen for Alta., supra*. In each of these cases the declarations sought were ancilliary to claims which can only be the subject of a petition of right. In the *Lovibond* case the declaration was asked to rectify the stock register of the railway company with respect to shares the existing title to which was in the Crown, represented by the Minister of Finance for Canada, and in the *Royal Trust* case the declaration was asked in support of a claim that the plaintiff was entitled to recover money in the possession of the province of Alberta which the province claimed as its own.

37 The cases referred to in *Royal Trust Co. v. Atty.-Gen. for Alta., supra*, sufficiently show the distinction between the case at bar and the rule relied upon by the defendants, respondents. I would, however, quote, from one of the cases cited therein, an extract which I think is peculiarly appropriate to the present case.

38 In *Eastern Trust Co. v. Mackenzie, Mann & Co. Ltd.*, [1915] A.C. 750, 84 L.J.P.C. 152, 31 W.L.R. 248, Sir George Farwell, who delivered the judgment of the Judicial Committee of the Privy Council, said at pp. 759-60:

> The non-existence of any right to bring the Crown into Court, such as exists in England by petition of right, and in many of the colonies by the appointment of an officer to sue and be sued on behalf of the Crown, does not give the Crown immunity from all law, or authorize the interference by the Crown with private rights at its own mere will. There is a well-established practice in England in certain cases where no petition of right will lie, under which the Crown can be sued by the Attorney-General, and a declaratory order obtained, as has been recently explained by the Court of Appeal in England in *Dyson v. Atty.-Gen.*, [1911] 1 K.B. 410, 80 L.J.K.B. 531, and in *Burghes v. Atty.-Gen.*, [1912] 1 Ch. 173, 81 L.J. Ch. 105. It is the duty of the Crown and of every branch of the Executive to abide by and obey the law. If there is any difficulty in ascertaining it, the Courts are open to the Crown to sue, and it is the duty of the Executive in cases of doubt to ascertain the law, in order to obey it, not to disregard it. The proper course in the present case would have been either to apply to the Court to determine the question of construction of the contract, and to pay accordingly, or to pay the whole amount over to the receiver and to obtain from the Court an order on the receiver to pay the sums properly payable for labor and supplies, as to the construction of which their Lordships agree with the Supreme Court of Nova Scotia.
>
> The duty of the Crown in such a case is well stated by Lord Abinger in *Deare v. Atty.-Gen.* (1835) 1 Y. & C. 197, at p. 208, 160 E.R. 80. After pointing out that the Crown always appears (in England) by the Attorney-General in a Court of justice, especially in a Court of Equity, where the interest of the Crown is concerned, even perhaps in a bill for discovery, he goes on to say: 'It has been the practice, which I hope never will be discontinued, for the officers of the Crown to throw no difficulty in the way of any proceeding for the purpose of bringing matters before a Court of justice where any real point of difficulty that requires judicial decision has occurred.'

39 The case for the declaration involved in a negative answer to the question now submitted comes within the law as laid down by Farwell, L.J. in *Dyson v. Atty.-Gen., supra*. The estate of the Crown is not directly, bot its interests are only indirectly, affected by such a declaration and as stated by Baron Atkyns in *Pawlett v. Atty.-Gen.* (1667) Hardres 465, 145 E.R. 550, in the passage quoted by Farwell, L.J. in *Dyson v. Atty.-Gen.*, "it would derogate from the King's honour to imagine that what is equity against a common person should not be equity against him."

40 There remains now for consideration the plaintiff's appeal from what has been called the "rider" to the answer to the question stated for the Court's opinion.

41 With great respect I am of the opinion that it was not open to the learned Judge to deal with the question of the right of the plaintiff to the proceeds to be realized from the property seized. This question has not been asked and cannot be answered until the issue out of which the special case arose is determined. The question submitted relates solely to the legal rights of the defendant in the issue, the provincial treasurer. The relative rights of the plaintiff and other debenture holders are not involved in either an affirmative or negative answer. Such relative rights cannot be determined in proceedings to which the other debenture holders are not parties, and without there being before the Court sufficient material to determine them. The other debenture holders are not made parties, either by representation or otherwise, and there was no, or not sufficient, material before the Court to determine such relative rights.

42 Furthermore, there is no machinery provided in *The Execution Creditors Act* for carrying out the direction to divide the proceeds of the property attached as directed by the learned trial Judge. There is no provision in the Act for the sheriff holding such proceeds for an indefinite time to enable persons, who may or may never advance them, to establish their claims.

43 True it is that the statute modifies the maxim *vigilantibus, non dormientibus, jura subveniunt*, but, subject to the provisions as to preferences, it is only those who establish their claims in accordance with the Act, and within the time fixed thereby, who have the right to share in the sheriff's distribution.

44 I would allow the plaintiff's appeal by varying the formal judgment appealed from by striking out from the first operative paragraph thereof all the words after the word "no." I would also dismiss the cross-appeal of the defendants. The plaintiff, appellant, will have its costs of both appeal and cross-appeal to be taxed on the same scale as directed for the trial, namely, double column 5.

> The parties to any cause or matter may at any stage thereof, and the parties to any dispute before any proceedings have been instituted may, by leave of a judge, concur in stating the questions of law arising therein in the form of a special case for the opinion of the court.

FN1 Rule 218 reads:

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[1984] 1 All ER 628

Barclays Bank Ltd and others v TOSG Trust Fund Ltd and others

COURT OF APPEAL, CIVIL DIVISION

OLIVER, KERR AND SLADE LJJ

16, 17, 18, 19, 20, 23, 24, 25 MAY, 12 JULY 1983

Company - Winding up - Proof and ranking of claims - Rule against double proof - Test of whether rule against double proof applies - Application of rule against double proof - Guarantor's right of proof - Company taking out bond against insolvency - Banks paying over money under bonds when company becoming insolvent - Money used to pay creditors in part - Creditors assigning claims to third party - Banks proving for debt under bonds - Third party proving for debt under assignments - Whether both proofs admissible - If only one proof admissible, whether banks or third party having better right of proof.

In 1970 a group of holiday tour operators, which included C Ltd, set up a scheme to alleviate the consequences to holidaymakers and customers of the insolvency of any of their number. The scheme required individual tour operators who were members of the scheme to take out a banker's bond whereby the bank agreed to pay a specified sum to a company (TOSG), formed as part of the scheme, in the event of the operator becoming insolvent and unable to fulfil its obligations to holidaymakers and customers. The purpose of TOSG was to use money paid to it under the bonds to look after and repatriate holidaymakers stranded abroad and to protect customers who had made prepaid bookings from suffering financial loss. Under the terms of the bonds TOSG was entitled to call in the bond moneys from the bank as soon as the operator concerned became insolvent. The bonds contained no restriction on how TOSG expended or disbursed moneys it received but TOSG was required to pay back to the bank any surplus remaining after the claims of customers had been met. In accordance with the scheme C Ltd arranged for a number of banks to enter into bonds on its behalf in return for the payment of commission and the execution of counter-indemnities under which C Ltd agreed to indemnify the banks against any loss which they sustained under the bonds. In 1974 C Ltd could no longer fulfil its obligations to its customers and went into liquidation. The bond moneys were called in from the banks by TOSG which, after rescuing C Ltd's customers who were stranded abroad, then had some £1·43268m to reimburse claims by customers who had paid for holidays which C Ltd was no longer able to provide. Since that amount was unlikely to be

sufficient to meet all such claims TOSG entered into an agreement with the Air Travel Reserve Fund Agency (a statutory body set up to compensate persons who lost holidays as a result of the collapse of tour operators) whereby TOSG would, to the extent the bond moneys made possible, reimburse customers who were owed money in return for such customers assigning to the agency their right to prove in the liquidation of C Ltd for the full amount of their claim and the agency would then satisfy customers' debts which remained unpaid by TOSG. In accordance with that agreement TOSG expended, and received assignments to the agency of claims amounting to, some £1·43268m while the agency satisfied the remaining claims, amounting to some £3·4309m. In the ensuing liquidation of C Ltd the banks proved under the counter-indemnities and the agency proved under the assignments for the £1·43268m paid out by TOSG. The liquidators took the view that the rule against double proof prevented the banks and the agency from both proving for the £1·43268m. The banks sought a declaration that they were entitled to prove for the £1·43268m but the judge held that the agency had the better right of proof, on the assumption that the rule against double proof applied, because the banks had in effect guaranteed C Ltd's liabilities to its customers and were therefore subject to the rule that the proof of a surety could not displace the proof of a creditor unless and until the surety fully discharged all his liabilities to the creditor, and therefore C Ltd's customers (and thus the agency) were entitled to prove as creditors

[1984] 1 All ER 628 at 629

for the whole of their debts in priority to the banks (and without giving credit for moneys received from the banks via TOSG) unless and until the whole of their debts were satisfied and, moreover, considerations of broad equity favoured the agency rather than the banks. The banks appealed, contending, inter alia, that they were entitled by subrogation to assume the rights of customers who had been paid out of the bond moneys.

Held - (1) (Per Oliver and Kerr LJJ) There could not be any subrogation between the banks and TOSG because there was no general principle that if money was lent or supplied by one person to another to enable that other to pay off a debt to a creditor the lender was automatically subrogated to the rights of the creditor, and there was no stipulation that TOSG was required to expend the bond moneys in a manner which entitled the banks to stand in TOSG's shoes (see p 638 *a* to *d f g* and p 649 *f g*, post); *Wylie v Carlyon* [1922] 1 Ch 51 and *Paul v Speirway Ltd (in liq)* [1976] 2 All ER 587 applied; *Brocklesby v Temperance Permanent Building Society* [1895] AC 173 explained.

(2) The effect of the bonds and counter-indemnities given by the banks was (i) that a debt due to the banks, provable in the liquidation of C Ltd, arose as soon as TOSG called in and was paid the bond moneys, and (ii) that, although TOSG was under no contractual obligation to the banks regarding the way in which it spent the bond moneys, nevertheless TOSG was required to refund to the banks any bond moneys which were not expended, thereby reducing pro tanto C Ltd's liability under the counter-indemnities. Furthermore, the effect of the payments by TOSG to customers who were owed money by C Ltd was that the customers' rights to prove in the liquidation of C Ltd were

limited to the balance, if any, of their debts still outstanding after the payments made to them by TOSG, and the effect of the assignments to the agency was that the agency was in no better position to prove in the liquidation than the customers or TOSG would have been. In those circumstances it followed that--

(a) (per Oliver LJ) the rule against double proof in a liquidation did apply. The test of whether the rule against double proof applied was whether the two competing claims were in substance claims for payment of the same debt twice over, and, furthermore, that was to be determined at the time of payment of the dividend, at which point the question to be asked was whether two dividends were being sought in the winding up for a liability which the debtor would discharge by one payment if it were solvent. Applying that test, if C Ltd had become solvent after the calling in of the bond moneys and had used its own money to discharge the debts due to its customers, then because the bond moneys would have remained unused and C Ltd would have been required to return them to the banks it would at the same time have discharged its liability to the banks and would thus have only made one payment in discharging both liabilities. Furthermore (Kerr LJ concurring), when the rule against double proof was applied the banks had the better right of proof over the agency because, by analogy with the position of a surety, the banks' position vis-à-vis the customers of C Ltd (and therefore the agency as the assignee of the customers) was akin to that of a surety who had guaranteed a fluctuating account (ie the amount owed by C Ltd to its customers) up to a specified limit and who, if he paid up to that limit, was entitled to that extent to stand in the shoes of the creditor (ie C Ltd's customers) and to prove in priority to him. Moreover, on broad equitable principles the banks had the better right of proof, since they were out of pocket to the full nominal amount of their claims whereas the customers (and therefore the agency) were out of pocket to less than their full nominal claims by reason of having received the banks' money (see p 636 *a* to *j*, p 637 *e* to *j*, p 640 *f*, p 641 *d j* to p 642 *a*, p 643 *c* to *e h j*, p 644 *f* to *j*, p 648 *d e j*, p 650 *e j*, p 651 *e g h* and p 652 *h j*, post); *Ex p Rushforth* (1805) 10 Ves 409, *Hobson v Bass* (1871) LR 6 Ch App 792, dictum of Mellish LJ in *Re Oriental Commercial Bank, ex p European Bank* (1871) LR 7 Ch App at 102 and *Gray v Seckham* (1872) LR 7 Ch App 680 applied; *Ellis v Emmanuel* [1874-80] All ER 1081 considered; *The Liverpool (No 2)* [1960] 3 All ER 307 distinguished;

(b) (per Slade LJ) having regard to the particular facts and the substance of the relevant liability and applying the principle that there could only be one dividend for what was

[1984] 1 All ER 628 at 630

in substance the same debt even though there may have been two contracts, the rule against double proof in a liquidation did apply, because if TOSG had itself taken assignments from C Ltd's customers and then sought to prove for the £1·43268m it would in substance have been proving for the same debt as the banks. Furthermore (Kerr LJ concurring), applying the rule against double proof, the banks had the better right of proof because the relevant comparison was not between the respective rights of proof of the banks and C Ltd's customers but between the respective rights of

proof of the banks and TOSG, and it could not reasonably be inferred that the parties intended at the time the bonding arrangements were made that TOSG would have the right to expend the bond moneys by purchasing assignments of debts from C Ltd's customers which would take priority over, and destroy, the banks' right to prove for the bond moneys in the liquidation of C Ltd, since such an inference was inconsistent with the nature of the bonding arrangements and produced an inequitable result (see p 649 *j*, p 650 *e f*, p 651 *d*, p 653 *b c e* to *j*, p 654 *d e*, p 655 *d* to *f h* to p 656 *c g h*, post); dictum of Mellish LJ in *Re Oriental Commercial Bank, ex p European Bank* (1871) LR 7 Ch App at 102 applied;

(c) (per Kerr LJ) the rule against double proof did not apply because the common intention of the parties concerned in setting up the bonding scheme was that the banks were to be able to prove to the full extent of the bond moneys paid over while each customer was to be able to prove only for the balance of his debt still outstanding after the bond moneys had been paid out, and therefore there was no basis for the application of the rule. However, if, the rule did apply then the banks had the better right of proof (see p 645 *h j*, p 647 *d* to *f*, p 648 *j* to 649 *b* and p 651 *a*, post).

(3) Accordingly, the banks had the right to prove in the liquidation of C Ltd for the £1·43268m to the exclusion of the agency. The banks' appeal would therefore be allowed (see p 645 *b*, p 650 *g h*, p 651 *a c* and p 656 *h*, post).

Per Oliver LJ. Where money is lent or supplied by one person to another to enable that other to pay off a debt to a creditor the lender has a right to be subrogated to the rights of the creditor only if there is an agreement between the supplier of the money and the payer of the debt that the money is to be used for that purpose or, on equitable principles, if the supplier of the money is deprived of his right of recovery, eg because of the incapacity of the person to whom the money was lent (see p 638 *b c e*, post).

Notes

For the rule against double proofs and its application to sureties, see 3 *Halsbury's Laws* (4th edn) paras 712, 728, and for cases on proofs by sureties against a bankrupt principal debtor, see 4 *Digest* (Reissue) 303-306, *2691-2720*.

Cases referred to in judgments

Birkley v Presgrave (1801) 1 East 220, 102 ER 86.

Brocklesby v Temperance Permanent Building Society [1895] AC 173, HL.

Deering v Bank of Ireland (1886) 12 App Cas 20, HL; *rvsg* sub nom *Re Killen, a bankrupt* (1885) 15 LR Ir 388, CA Ir.

Dering v Earl of Winchelsea (1787) 1 Cox Eq Cas 318, 29 ER 1184, [1775-1802] All ER Rep 140.

Ellis v Emmanuel (1876) 1 Ex D 157, [1874-80] All ER Rep 1081, CA.

Fenton, Re, ex p Fenton Textile Association Ltd [1931] 1 Ch 85, [1930] All ER Rep 15, CA.

Gray v Seckham (1872) LR 7 Ch App 680, LJJ.

Hobson v Bass (1871) LR 6 Ch App 792, LC.

Hoey, Re, ex p Hoey (1918) 88 LJKB 273, DC.

Liverpool, The, (No 2) [1960] 3 All ER 307, [1963] P 64, [1960] 3 WLR 597, CA; *rsvg* [1960] 1 All ER 465, [1963] P 64, [1960] 2 WLR 541.

Melton, Re, Milk v Towers [1918] 1 Ch 37, [1916-17] All ER Rep 672, CA.

Midland Banking Co v Chambers (1869) LR 4 Ch App 398, LJJ.

Moss, Re, ex p Hallet [1905] 2 KB 307, [1904-7] All ER Rep 713, DC.

Oriental Commercial Bank, Re, ex p European Bank (1871) LR 7 Ch App 99, LJJ.

Paul v Speirway Ltd (in liq) [1976] 2 All ER 587, [1976] Ch 220, [1976] 2 WLR 715.

Rushforth, Ex p (1805) 10 Ves 409, 32 ER 903.

Sass, Re, ex p National Provincial Bank of England [1896] 2 QB 12.

Wylie v Carlyon [1922] 1 Ch 51.

Cases also cited

Daunt, Re, ex p Joint Discount Co (1871) LR 6 Ch App 455, LJJ.

Liggett (B) (*Liverpool*) *Ltd v Barclays Bank Ltd* [1928] 1 KB 48, [1927] All ER Rep 451.

Orakpo v Manson Investments Ltd [1977] 3 All ER 1, [1978] AC 95, HL.

Rees, Re, ex p National Provincial Bank of England (1881) 17 Ch D 98, CA.

Wheeldon v Burrows (1879) 12 Ch D 31, [1874-80] All ER Rep 669, CA.

Appeal

The plaintiffs, Barclays Bank Ltd, Lloyds Bank Ltd, National Westminster Bank Ltd and Wintrust Securities Ltd (the banks), appealed against so much of the judgment of Nourse J given on 27 February 1981 and the order made on 26 June 1981 as dismissed the bank's action against the first defendant, TOSG Trust Fund Ltd (TOSG), the twelfth defendant, Air Travel Reserve Fund Agency (the agency), and the thirteenth defendant, Clarksons Holidays Ltd (Clarksons), in which they sought, inter alia, a declaration against those defendants that the banks were entitled to prove in the liquidation of Clarksons to the exclusion of the agency in respect of all bond moneys expended by TOSG in paying creditors of Clarksons, and declared on the agency's counterclaim that the joint liquidators of Clarksons were entitled and bound to admit in full the proof of debt lodged with them by the agency. The facts are set out in the judgment of Oliver LJ.

Peter Millett QC and J B W McDonnell for the banks.

William Stubbs QC and Leslie Kosmin for TOSG and the agency.

David Oliver for the liquidators of Clarksons.

Cur adv vult

12 July 1983. The following judgments were delivered.

OLIVER LJ.

This is an appeal by the plaintiffs against an order of Nourse J made on 26 June 1981 dismissing their action against the first, twelfth and thirteenth defendants, the respondents to this appeal, and declaring on the twelfth defendant's counterclaim that the joint liquidators of the thirteenth defendant, Clarksons Holidays Ltd, were entitled and bound to admit in full the proof of debt lodged with them by the twelfth defendant.

The appeal raises an interesting and unusual question with regard to the applicability and the manner of application of what is known as the rule against double proof in the liquidation of an insolvent estate. The facts are fully set out in the careful judgment of the judge and need only to be summarised here. The thirteenth defendant, to which I will refer as 'Clarksons', was a wholly-owned subsidiary of Court Line Ltd, which, together with its constituent companies, collapsed during the height of the holiday season of the year 1974. Clarksons was one of Court Line's more prominent tour-operating subsidiaries and was at the material time among the market leaders in the package holiday field. For some years prior to the collapse, anxiety had been expressed among tour operators about the effect on the public image of the industry of the failure of operators to provide holidays for which members of the public had made bookings and paid in advance, and in 1969 a group of the more prominent operators (including Clarksons) formed what was known as the Tour Operators Study Group to consider problems confronting the industry, one of which was the absence at that time of any central organisation which could provide guarantees against failure or cessation of business of tour operators. As a result of that group's deliberations, a company limited by guarantee was formed in 1970 and that is the first defendant, TOSG Trust Fund Ltd, to which I will refer as 'TOSG'. The purpose of this company was to be the recipient of

[1984] 1 All ER 628 at 632

moneys contemplated as becoming payable under bonds or similar provision made by the members in the event of a member becoming unable to fulfil its obligations to its customers and to dispense those moneys in such way as might be most expedient to meet the emergency thus created. The principal object of TOSG in cl 3(A) of its memorandum of association was as follows:

> 'To manage, utilise, employ and expend funds and moneys paid and/or to be paid to the Company under or by virtue of Bonds, Letters of Credit, Policies of Insurance or similar arrangements obtained by members of the Tour Operators Study Group and issued in favour of the Company each being in respect of a Tour Operator Study Group member and/or its tour operator subsidiaries ("the member Group") or otherwise paid to the Company by such members, in generally alleviating the consequences to such member Group's customers of the business failure of the Tour Operators Study Group member or any other member Group Company in respect of whom such funds or moneys are received by the Company and in particular (but without prejudice to the generality of the foregoing) in making arrangements to procure the expeditious return by an appropriate means of transport to their departure point from the United Kingdom or Ireland of persons stranded abroad as a result of such member Group's business failure, in procuring that persons in the course of holidays abroad at the date of such member Group's business failure are enabled to complete their holidays in suitable accommodation and to return to their departure point from the United Kingdom or Ireland by an appropriate means of transport, in making all necessary travel and accommodation arrangements for persons who have

> purchased from such member Group, and paid in full, for holidays abroad which, as at the date of the member Group's business failure, had not been commenced and in making such payments as the Company may in its absolute discretion think fit to persons who had paid deposits to such member Group in respect of future holidays abroad and who (being customers of the member Group) otherwise suffer financial loss by reason of the member Group's business failure.'

The members of the study group then established a bonding scheme under which they mutually agreed to provide bonds in favour of TOSG in a form acceptable to that company and they entered into an agreement with TOSG regulating the manner in which TOSG could call up the bonds. The bonds were renewed annually and their amount was to be reviewed in each year but in fact remained from 1971 onwards at a figure equivalent to 5% of the relevant tour operator's turnover for the previous year, that figure being assumed (erroneously as it turned out) to be adequate to cover any failure on the worst possible basis.

Pursuant to these arrangements Clarksons, in October 1973, arranged for bonds to a total value of £2·43226m to be issued by five banks, the four appellants and Williams & Glyn's Bank Ltd, which was the plaintiff in a separate action heard at the same time as the action in which this appeal arises.

Those bonds were for the following amounts:

Williams & Glyn´s Bank	£873,000
Lloyds Bank	£93,000
Wintrust Securities	£260,000
National Westminster Bank	£500,000
Barclays Bank	£500,000

They were all in the same form, were issued to TOSG and provided that the bank concerned undertook to pay the specified sum but subject to a condition that the bond should be void unless during the period of 12 calendar months commencing on 1 October 1973 any one or more of six specified events should occur. I need not enumerate those in detail. They included the event of TOSG notifying the issuing bank that any company in the Clarkson group could not carry out its obligations, the presentation of a winding-up petition and cessation of payment of debts.

[1984] 1 All ER 628 at 633

I ought, however, to read the final provision of the document, which is in these terms:

> 'And in consideration of the issue of this Bond the Fund hereby covenants with the Obligor that upon payment of the said sum of £ specified above by the Obligor to the Fund the Fund will undertake in writing with the Obligor that the Fund will repay to the Obligor on demand such part of the said sum as shall not be expended or required by the Fund in the performance and execution of its rights, duties, powers and discretions as set out in the Fund's Memorandum and Articles of Association, and that such Memorandum and Articles will not be altered during the currency of this Bond without the prior written consent of the Obligor (which shall not be unreasonably withheld) first obtained.'

At the same time each of the issuing banks obtained from Clarksons a counter-indemnity. The form of each indemnity was that normally used by the bank concerned. They are not identical and their precise terms do not matter, for it is not in issue that they created an obligation on Clarksons, in the event of the bond being called up, to indemnify the bank against any loss which it might sustain as a result of having executed the bond.

In August 1974 it became plain that the Court Line Group in general and Clarksons in particular were in such severe difficulties that operations could not continue, and on 15 August the Civil Aviation Authority withdrew Clarksons' civil aviation licence. At the same time Clarksons notified TOSG that it had ceased to trade and could no longer carry out its obligations to its customers. On the following day TOSG notified the banks in writing of the fulfilment of the pre-condition to the operation of the bond and called up the bond moneys immediately. These sums were paid to TOSG and Clarksons were notified by the paying banks. On the same day, 16 August, Clarksons presented its own petition for compulsory winding up and on 21 August Clarksons passed a special resolution to wind up voluntarily.

There then followed a hastily mounted rescue operation, the purpose of which was to enable those customers of Clarksons who were already abroad on holiday to complete their holidays and return to the United Kingdom, an operation which involved, of course, payment for hotel bills and for arrangements with air carriers. In this connection TOSG expended in round terms a sum of £956,000, as to which no question arises on this appeal. The question with which the court is now concerned related to the banks' share of a balance of some £1·43268m which remained in TOSG's hands and which was ultimately disbursed by TOSG in paying in full, so far as it would go, customers of Clarksons who had paid for holidays but had never had them.

TOSG had, under its memorandum of association, a complete discretion as to the manner in which it set about alleviating the losses of the holidaymakers, and clearly one approach, but by no means the only one, would have been simply to distribute the funds in its hands among all claimants pro rata to their claims, leaving them to prove for any balance unpaid in the liquidation. There were, however, a number of complications and the final determination and settlement of claims in this way might have taken a considerable time. In particular, there were a number of test cases pending, in cases where moneys had been paid to travel agents by customers and were still held by the agents at the time of the collapse, to determine whether the customer was entitled to a refund from the agent or whether the agent was accountable to the liquidator for the moneys held.

In the mean time, there had been a major development in the political scene, for the collapse had caused a major parliamentary stir and the government of the day was under pressure, and indeed was, I think, anxious, to make some permanent provision for safeguarding both the general public in the future and the victims of this particular disaster. Thus in 1975 there was passed the Air Travel

Reserve Fund Act 1975 which brought into being an air travel reserve fund, financed initially by government loan but ultimately by contributions from the industry, for the purpose of compensating persons who had lost their holidays as a result of the collapse of tour operators during 1974 and

[1984] 1 All ER 628 at 634

to provide against similar events in the future. The twelfth defendant (to which I will refer as 'the agency') was established to manage and administer the fund.

It will be convenient here to summarise the relevant provisions of the 1975 Act and the regulations made under it. Section 2(1) states the general application of the fund, which is to be applied in making payments to or for the benefit of customers of air travel organisers in respect of losses or liabilities incurred by them in connection with travel contracts. Subsection (3) restricts the losses and liabilities payable under sub-s (1) to those incurred in consequence of the inability of the air travel organiser to meet his commitments under contracts the time for performance of which fell after 1 April 1974. Subsection (6) deals with the position where there is a bonding scheme such as the present by providing that for the purposes of sub-s (3) a loss or liability shall be treated as having been incurred in consequence of the organiser's inability to meet his contractual commitments if, since the booking was made, the bond has become payable. Subsection (7) is important. That provides that where money is available under such a bond (a) no payment shall be made out of the fund until all the money so available has been paid to or for the benefit of the customers in question or any class or description of those customers, and (b) sub-s (1) shall not apply to any loss or liability so far as it has been reimbursed from such bond moneys. Section 3 empowers the Secretary of State to make rules as to the application of the fund (known as 'benefit rules') and those were in fact made in July 1975.

Rule 3(1) and (2) limits the amount of any payment, in effect, to the amount actually paid by the customer, but r 3(7) provides that, where a customer is eligible for a payment from the fund, the agency shall pay him the total amount permissible under the rules. Rule 3(6) is in the following terms:

> 'Where a customer of an air travel organiser has received any sum in liquidation or bankruptcy proceedings brought against the air travel organiser, being a sum paid in respect of losses or liabilities to which section 2(1) of the Act applies, that sum shall be deducted from any payment out of the Fund which would otherwise have been made to him in accordance with these Rules.'

Finally, r 4 deals with the conditions to be satisfied before payments are made (including, eg, method of submission and establishment of claims) and r 4(4) provides that the agency may, before making a payment, require the customer to assign to the agency any rights which he may have against the air travel organiser, whether in liquidation or bankruptcy or otherwise.

Well before the 1975 Act was passed negotiations had been in train between TOSG and the

Department of Trade with a view to agreeing arrangements under which payments to holidaymakers could be expedited, it having been apparent from the inception that the bond moneys were not going to be sufficient to meet all claims in full and that there would be a substantial balance for which the air travel reserve fund would become responsible when the 1975 Act came into force and the regulations made under it were promulgated. Those negotiations contemplated that, rather than waiting for the complete ascertainment and settlement of all claims, TOSG would settled in full as many undisputed claims as could be discharged out of its available resources, leaving the agency to settle the balance. The original suggestion was that TOSG should take assignments of their claims in the liquidation from those customers whose debts were then paid in full, but it was ultimately considered more convenient that all outstanding claims should be dealt with by the agency so that TOSG could conclude entirely its administration of the bond moneys. Accordingly, it was agreed in principle that as each claim was paid by TOSG the customer concerned should be required to execute an assignment of his rights in favour of the agency. This was intended at first to be subject to the agreement of the banks who had put up the bond moneys, but in fact the only bank which was informed of the proposal was Lloyds, who registered a strong objection. Despite this, however, when the 1975 Act received the royal assent and the agency was formed, an agreement along these lines was entered into between TOSG and the agency and it is this that gave rise to the present proceedings. In the result TOSG settled in full claims of customers to

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the extent of the moneys in its hands, each cheque sent out being conditional on the signature and return by the recipient of an assignment of his claims in the liquidation to the agency. The banks had, at any early stage, proved for the full sum of £2·43226m due to them under Clarksons' counter-indemnity when the bonds were issued and the agency now proved not only for the sums which it had disbursed in paying out claims of customers other than those paid out by TOSG but also in respect of the rights assigned by those customers who had been paid by TOSG.

There is no dispute that the banks are entitled to prove in the liquidation of Clarksons for that part of the sums paid by them under the bonds which is represented by the payments made for repatriating customers (£956,000) but it is the liquidators' contention that the balance of £1·43268m paid out to customers and thus reflected in the agency's proof is subject to the rule against double proof and that one or other of the two sets of proofs must be reduced accordingly.

At the trial before Nourse J it was common ground that the rule against double proof applied to the situation with which the court was confronted and the contest was simply one between the banks on the one hand and TOSG and the agency on the other as to who had the better right, in these circumstances, to prove for the moneys which had in fact been applied in or towards discharging the customers' claims. That is, perhaps, a simplification, because there were other issues of ultra vires and misfeasance which fell to be decided but are not in issue on the present appeal. So far as this court is concerned, there is no dispute either that it was intra vires TOSG to deal with the bond

moneys in the way in which it did deal with them (including the procuring of assignments by customers to the agency) or that the agency was acting intra vires in arranging for and taking those assignments. There has, however, in this court been raised a further issue not argued in the court below, because shortly before the hearing of the appeal began the banks amended their notice of appeal in order to raise the question whether the rule against double proof applied at all. An application to strike that amendment out was refused by this court (although on terms as to costs) because, although the point was a new one, we took the view that, assuming it to be good, it would be inappropriate that this court should be put in the position, because of a concession in the court below, of deciding the appeal on a basis which, on that hypothesis, would be wholly wrong in law. It has thus been argued before us and should logically be dealt with first. It is put by counsel for the banks in two ways. First, he submits that the correct time for ascertaining whether the rule is to apply is at the date of the liquidation. This case is not an orthodox case of principal and surety. It is a case in which there were created as a matter of fact two quite distinct contracts with the debtor which had no necessary connection at all. As soon as the collapse occurred the condition of the bonds was fulfilled and the moneys became payable to TOSG. At that moment Clarksons became subject to a liability under the counter-indemnity which was quite independent of its liability to its customers. True the bond moneys or part of them might, in due course, if TOSG chose, be applied in paying to the customers what was due to them from Clarksons, but they might not. The whole fund might have to be expended, for instance, in a repatriation exercise. Thus, it is argued, the two liabilities were quite independent at the inception, and each creditor, be he bank or customer, can prove for his own debt. The mere fact that some part of the moneys provided by the banks may subsequently have been applied in paying out the customer liabilities cannot make the case one of double proof when it was not originally so. Thus, counsel for the banks submits, the liquidators should entertain proofs both from the banks and from the agency, even though that will, of course, be highly prejudicial to the other unsecured creditors.

His alternative formulation results in the banks alone being able to prove because, it is said, the agency has, so far as its proof rests on the assignments from customers paid out by TOSG, nothing for which it can prove. That is said to be so for one of two reasons. First, it is said that immediately the banks' moneys were paid to the customers, the banks stood, by subrogation, in the shoes of the customers whose debts had been paid so that, the customers' rights having, eo instanti, passed to the banks, there was nothing on which the assignments could operate. The second way of putting it is slightly different but the

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result is the same. It is said that for TOSG to arrange with the customers to keep the customers' debts alive notwithstanding the receipt by them of an equivalent sum of money was, and was known to the agency to be, contrary to an implied term to be deduced from the bonds and the counter-indemnities taken in conjunction.

I can deal with these submissions quite shortly, for, speaking for myself, I am unable to accept any of them. Counsel for the banks first way of putting his case is, in my judgment, based on two fundamentally wrong assumptions. In the first place, I am unable to accept that the proper time for determining whether or not the rule against double proof is to apply is the date of the liquidation. I accept the submission of counsel for TOSG and the agency that the rule ought more properly to be styled the rule against double dividends, for its object is to absolve the liquidator from paying out two dividends on what is essentially the same debt. That is a matter which very frequently, for instance in the case of principal and surety, cannot be determined until a payment to the creditor is made. No doubt it can be predicted at the commencement of the liquidation that a case for the application of the rule may arise or that it can never arise, but it may well be impossible to determine at that stage whether it will in fact.

Second, it is, as I think, a fallacy to argue, and this is really the basis of the argument of counsel for the banks, that, because overlapping liabilities result from separate and independent contracts with the debtor, that, by itself, is determinative of whether the rule can apply. The test is in my judgment a much broader one which transcends a close jurisprudential analysis of the persons by and to whom the duties are owed. It is simply whether the two competing claims are, in *substance*, claims for payment of the same debt twice over. It will be necessary to look more closely at the substance of the transactions which have given rise to the problems in the context of which claimant has the better right, but for the moment I accept the broad general proposition of counsel for TOSG and the agency that the rule against double proof in respect of two liabilities of an insolvent debtor is going to apply wherever the existence of one liability is dependent on and referable only to the liability to the other and where to allow both liabilities to rank independently for dividend would produce injustice to the other unsecured creditors.

The rule has nothing to say on the question of which of two proving creditors has the better right to claim a dividend in respect of his debt. It bears merely on the question whether both are to be admitted for dividend and stems from the fundamental rule of all insolvency administration that, subject to certain statutory priorities, the debtor's available assets are to be applied pari passu in discharge of the debtor's liabilities. One way of testing the matter is to ask, in relation to any liability for which proof has been lodged, whether it arises as a result of a payment made in discharge or partial discharge of another liability for which a proof has also been lodged. If the answer to that is affirmative, then it is clear that a distortion of the pari passu principle would occur if both proofs are admitted in full. A simpler test, perhaps, is to postulate the question: what would the position be as regards the payment of the liabilities in respect of which proofs have been lodged if the debtor were now solvent?

Counsel for the liquidator gives by way of illustration what I find a compelling example. Suppose that the insolvent debtor has two creditors, one for £40,000 and one for £20,000, the liability to the latter being guaranteed by a third party to the extent of £10,000. The surety is called on to pay and

pays, thus giving rise to a liability in the debtor to indemnify him. Now if the debtor were in fact solvent the amount required to be found to satisfy all his liabilities would be £60,000; but, if the surety is admitted to prove for £10,000 alongside the principal creditor's proof for £20,000, the total liabilities in the insolvency will be £70,000. Thus for the purposes of the liquidation the claims of creditors are computed at a figure in excess of the amount required to discharge them, to the prejudice of the remaining creditor for £40,000. The rule is designed to prevent this occurring. This method of testing the position emerges from the judgment of Mellish LJ in *Re Oriental Commercial Bank, ex p European Bank* (1871) LR 7 Ch App 99. There bills of exchange were accepted by the European Bank against an undertaking by the Oriental Bank to provide funds to meet them on maturity. They were then handed to the Oriental Bank as agent for the drawer and indorsed by them and discounted. Both banks became

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insolvent and the Agra Bank, the holder of the bill, in fact recovered the amount of the bills by proving in their respective liquidations. The European Bank then sought to lodge a proof in the insolvency of the Oriental Bank for, in effect, damages for breach of the undertaking by the latter to provide funds to meet the bills. In rejecting that proof Mellish LJ observed (at 102):

> 'It appears to me clearly that it is substantially the same debt: because if all parties had been solvent, whatever sums the *Oriental Commercial Bank* might have paid to the *Agra Bank*, although they would have paid it, no doubt, for the purpose of performing the contract they had entered into by their indorsement, yet, substantially, whatever sums they might have paid to the *Agra Bank* would have gone in reduction of the sum which the *Oriental Commercial Bank* had promised to pay to the *European Bank*. In that case the *Oriental Commercial Bank* could never have been called upon to pay these bills twice over. It would have made no difference that they had entered into two contracts with two separate parties that they would pay the bills ... It is clear that they would have performed both contracts by paying the bills once ... '

The true principle, he observed at the end of his judgment (at 103), is 'that there is only to be one dividend in respect of what is in substance the same debt'.

Similar reasoning is to be found in the dissenting judgment of Porter MR in Ireland in *Re Killen, a bankrupt* (1885) 15 LR Ir 388 (subsequently approved by the House of Lords sub nom *Deering v Bank of Ireland* (1886) 12 App Cas 20), where the cumulative proofs of the claimant in respect of different obligations arising out of the same transaction would have resulted in the amount claimed exceeding the amount of the principal debt.

Now, if, as in my judgment these cases show, the true rule is that there are not to be two dividends in respect of what is in substance the same debt, I can see no logical justification for seeking to fix the position at the commencement of the insolvency. One has, as it seems to me, to look at the position at the point at which the dividend is actually about to be paid and to ask the question then whether two payments are being sought for a liability which, if the company were solvent, could be discharged as regards both claimants by one payment.

Tested in this way, the instant case is, in my judgment, one where the rule against double proof does apply and the concession made in the court below was, in my opinion, properly made. It is, of course, true that, if one goes back to the inception of the liquidation, there were two quite separate liabilities. Clarksons owed the holidaymakers the amount which they had paid for a consideration which had wholly failed. It was also liable to the banks for the loss sustained as a result of the calling up of the bonds, the amount of which would depend on the extent to which the bond moneys would in fact be required to meet the holidaymakers' claims. If and so far as those claims were discharged from other sources, the bond moneys would not be required to meet them and, on the terms of the bonds, would fall to be refunded to the banks, thus reducing pro tanto the liability of Clarksons on the counter-indemnities. Thus if Clarksons became solvent in the course of the liquidation (if, for instance, inability to meet commitments which resulted in the bonds being called up had been due merely to a temporary liquidity crisis) the discharge by Clarksons of the debts due to its customers would, as in the *Oriental Commercial Bank* case, at the same time discharge the liability to the banks, disregarding any interest and expense factors, since the bond moneys would then be refunded to them. Thus if bond moneys are in fact applied towards the discharge or partial discharge of the customers' debts the allowance of proofs of debt both for the amount of bond moneys and for the full amount of the customers' debts necessarily involves the liabilities on which dividends are to be declared being computed at a figure in excess of the amount required to discharge those liabilities.

I turn, therefore, to the alternative submissions of counsel for the banks, the first of which is based on a right of subrogation which it is submitted arises from the fact that the debts due to the holidaymakers paid off by TOSG were in fact paid with moneys derived from the banks. It is said that *Brocklesby v Temperance Permanent Building Society* [1895] AC 173 is authority for the proposition that, where A's money is used to pay B's debt, A is subrogated to the rights of the creditor. For my part, I am unable to deduce any such wide principle from that case, which appears to me to rest on a quite different principle, namely that, where a landowner puts another in possession of his title deeds with authority to raise money on them as his agent, he is not entitled to rely on limitations on the authority of the agent which are not brought to the notice of the lender. Indeed, *Wylie v Carlyon* [1922] 1 Ch 51 is, I think, a clear authority against the wide proposition that a right of subrogation stems from the mere fact that B's debt has been discharged with money in fact derived from A. One has to find, in the contract between the supplier of the money and the payer of the debt, some provision that the money is to be applied for that purpose. I can find nothing of this sort in the contract between the banks and TOSG. No doubt the payment of sums due to the holidaymakers was within TOSG's powers and no doubt this was known to the banks, but that is to say no more than that the banks paid the bond moneys to TOSG for whatever purpose TOSG might see fit to use them within its corporate powers, the only stipulation being that any moneys not so applied should be refunded. It was an out and out payment with, for relevant purposes, no reservations of any sort and was, in my judgment, no different in kind from the payment in *Paul v Speirway Ltd (in liq)* [1976] 2 All ER 587, [1976] Ch 220, save that here there was no obligation on TOSG to repay, other than in relation to moneys not required for its corporate purposes. When one

comes to consider the position as between Clarksons and the banks, the case is, I think, a fortiori. Here there was an express right to indemnity giving a direct right of recovery to the banks. Leaving aside the insurance cases (which form a category of their own) and cases of express or implied contract, a right of subrogation arises on equitable principles where otherwise the payer might be deprived of any right of recovery, for instance where money has been lent to an infant and used to discharge debts incurred for necessaries or where money has been borrowed ultra vires or has been paid in discharge of a person's debts without his authority, and I am far from convinced, all other considerations apart, that the equitable principle applies where the payer has already a full and independent right of recovery against the debtor. But, whether that be so or not, I can see no such right in the present case, where TOSG was given an entirely free hand with the bond moneys. One can, perhaps, best test the matter in this way. Suppose that no counter-indemnity had been sought or given and disregard altogether Clarksons' insolvency. The banks undertake, for what they no doubt regard as an adequate consideration, to provide moneys to a third party in a certain event. If the event occurs and if some part of the moneys are applied in fact in paying debts of Clarksons, by what title could the banks claim, in effect, a recoupment for which they never stipulated as part of the original consideration? I can see none.

The alternative proposition of counsel for the banks is expressed thus. Where A provides money to B at C's request for the purpose, inter alia, of paying C's creditors and on terms that C will indemnify A, and B in fact applies the money for that purpose, B cannot keep the claims of C's creditors alive for his own benefit to the prejudice of A and C. He must either extinguish those claims or allow A to be subrogated to them. This is, however, a proposition which makes a number of assumptions and begs a number of questions; and, in the ultimate analysis, counsel for the banks was compelled to justify it by reference, not to any general principle of law, but to an implied term in the contract between A and B (the banks and TOSG) that B will do nothing to impede A's right of subrogation so far as the money is used to pay off debts. I find insuperable difficulties in this. In the first place, it assumes the right of subrogation, and for the reasons stated above, I can find none. But, second, I find it impossible to see any material from which such a term can be implied. There was no restriction at all on the use which TOSG might make of the bond moneys save those imposed by TOSG's own corporate constitution. It was certainly within TOSG's power, if it wished to, to buy up debts and apply any proceeds for its corporate purposes. Whence, then, is any such term to be implied? The banks' obligation was to pay in the stated events. TOSG's only express obligation was to repay anything not required for its corporate purposes; and there is simply no material

[1984] 1 All ER 628 at 638

from which one can infer, as a matter of business efficacy, an undertaking that the corporate powers would only be used in a certain way or would not be used in a particular way.

In my judgment, therefore, the problem has to be approached, as it was by Nourse J in the court

below, on the footing that, subject to the operation of the rule against double proof, the assignments to the agency were effective and that the question of which of the two claimants has the better right to prove has to be resolved by the application of equitable principles. Nourse J approached this problem in two quite distinct ways. He recognised that the situation with which the liquidators were faced was an unusual one both by reason of the arrangements made between Clarksons and the banks and TOSG, which does not fit precisely within the framework of any of the decided cases, and by reason of the unusual feature that arrangements were made for the express purpose of keeping the claims of creditors alive for the benefit of someone other than the payer after they had in fact received 100p in the pound on the amounts of their respective claims. It was pointed out to him, however, that apart from a few authorities to which I shall have to refer briefly, all the learning on the subject of priority between rival claimants in respect of the same indebtedness is contained in a series of decisions governing the relationship of principal and surety, as, indeed, is not altogether surprising, for that is normally where the contest arises, and he therefore took those cases as governing by analogy the instant case. Quite apart from that, however, he approached the case on the basis of what he referred to as the 'broad equity', arrived at by a consideration of which claimant had the better claim having regard to the intentions of the parties as deducible from their contractual rights and duties and the purpose for which those rights and duties were acquired or assumed. Counsel for the banks attacks the judge's conclusion on both grounds. As to the former, he says that if (which he challenges) it is right to take the cases of principal and surety as analogous at all, the judge drew the wrong conclusion about the category into which, as a matter of analogy, the instant case fell. As to the latter, counsel for the banks says that there was no material on which the judge was entitled to arrive at the conclusion at which he did arrive, namely that the claim of the agency was to be preferred to that of the banks.

The instant case is not, of course, literally a case of suretyship, for that involves a contract between creditor and surety. Here there is, of course, no contract between the banks and the holidaymakers or between TOSG and the holidaymakers. There are, however, obvious similarities. The liability of the banks was only to arise if Clarkson failed to fulfil its obligations to its customers; the funds provided by the banks were applicable in alleviating that failure; and the banks were, ultimately, to have recourse to Clarksons for what they had paid. The principal argument in the court below sought, however, to avoid this analogy and to apply, as a test of who had the prior right to prove, the question 'who is out of pocket?' That, in essence, rested on *The Liverpool (No 2)* [1960] 3 All ER 307, [1963] P 64. There are, in fact, a number of cases in which questions of priority have arisen in double proof situations not arising from the discharge by a surety of his obligations under a guarantee. Apart from *The Liverpool (No 2)*, however, they are all cases where, in addition to the principal debt, it has been sought to prove an additional and subsidiary liability, either to the principal debtor himself or to a third party (whether or not a surety) to maintain the value of the security or to indemnify against the failure to maintain it (see *Re Hoey, ex p Hoey* (1918) 88 LJKB 273, *Re Killen, a bankrupt* (1885) 15 LR Ir 388, *Re Moss, ex p Hallet* [1905] 2 KB 307, [1904-7] All ER Rep 713). They are useful illustrations of the test previously propounded of whether the proof under consideration will have the effect of computing the amount of the liabilities in an

insolvent estate beyond the figure which would be required to extinguish the liabilities if the debtor were solvent, but they are otherwise of little help with the problem raised by this appeal. *The Liverpool (No 2)*, however, stands by itself and is prayed in aid by counsel for the banks as providing a guide in the circumstances of the instant case. There the tanker Liverpool, by negligent navigation, sank the coaster Ousel in the port of Liverpool. Liability was admitted, but the Liverpool obtained a decree limiting its liability under the Merchant Shipping Act 1894 and the question arose what claims could

be admitted to prove against the limitation fund. One of the claims against the Liverpool was a claim in tort by the Mersey Docks and Harbour Board for the cost of raising and moving the Ousel in accordance with their statutory duties. The board also had a statutory remedy for the expenses against the Ousel which they exerted to the limited extent permitted by the Merchant Shipping Acts. The Ousel in its proof against the limitation fund included the amount of the board's limited statutory claim against it (in respect of which it had not, at that time, made any payment) and the question before the court was whether this claim could stand having regard to the board's claim, which made no allowance for anything recoverable from this source. At first instance, Lord Merriman P, applying the analogy of the surety cases, regarded the Ousel as being a surety for part of a debt of ascertained amount and held that the board's claim must be pro tanto reduced (see [1960] 1 All ER 465, [1963] P 64). This was reversed on appeal. Harman LJ found the principal and debtor analogy of little help in a case where there was no principal debtor, but applied it to this extent, that the authorities quite clearly established that a surety who has not paid is not permitted to prove for his contingent debt in competition with the principal creditor (see *Re Fenton, ex p Fenton Textile Association Ltd* [1931] 1 Ch 85, [1930] All ER Rep 15). The salient feature of *The Liverpool (No 2)* was that the Ousel had not in fact paid anything. Harman LJ expressed it thus ([1960] 3 All ER 307 at 314, [1963] P 64 at 86):

> 'In our judgment the answer is that the board has priority because it is actually out of pocket by the whole of its claim, whilst the Ousel is not because she has not yet been obliged to pay.'

This, it is argued, is the closest analogy with the instant case. Here the customers have received 100p in the pound on their debts from TOSG using the bank's money. The agency paid nothing for the assignments to it. Thus, if one is to look for the person who is out of pocket, there can be only one answer. The banks having paid must have the prior right of proof.

This argument is perfectly intelligible, and indeed almost unanswerable if one regards the payment of those customers who were paid to TOSG as an entirely separate transaction isolated from any other arrangement made with the agency, but to my mind it ignores the reality. If one is to look for analogies, it is, I think, essential first to analyse what the total effect of the arrangements was and the reasoning behind them. All the cases stress that in relation to the rule against double proofs it is the substance and not the form that is to be regarded (see eg *Re Melton, Milk v Towers* [1918] 1 Ch

37 at 60, [1916-17] All ER Rep 672 at 683, *Re Oriental Commercial Bank* (1871) LR 7 Ch App 99). When regard is had to what actually happened in the instant case, it is, I think, entirely clear that the transaction by which TOSG paid a certain number of customers in full cannot be treated as a transaction on its own isolated from the payment by the agency of the claims of the remaining unpaid customers. The fact is that, if one looks at the reality of the position and asks, 'Who is out of pocket?', the answer is that both the banks and the agency are out of pocket and in that situation *The Liverpool (No 2)* provides no help, since it provides no guidance as to what would have happened if the Ousel had paid either the whole or a part of its liability and the court declined to express any opinion on whether in exerting its claim against the Ousel the board could be compelled to give credit for any part of the sums received as a result of its claims against the Liverpool.

That the reality is as I have described it seems to me inescapable. Under the Air Travel Reserve Fund Act 1975 and the benefit rules the agency was obliged to pay any balance due to customers after taking into account the bond moneys and anything received by way of dividend in the liquidation, but it could not pay anything at all until the bond moneys were exhausted. A year had already passed during which customers were out of their money and since there were still outstanding claims which were the subject of test actions a further lengthy period would have to elapse before anybody could receive anything unless arrangements could be made to expedite payment to those customers whose claims were beyond dispute. It was in these circumstances that TOSG and the

[1984] 1 All ER 628 at 640

agency came to the very sensible arrangement that the bond moneys should be expended in full in paying out customers so that the pre-condition for the agency's making payments was satisfied. This could have been done in several ways. TOSG could have made pro rata payments to customers, leaving it to them either to prove for the balance and to bring into account any dividends received when the agency came to make payments in pursuance of its statutory obligation or to assign such rights of proof as they had to the agency against payment to them of any balance not paid out of the bond moneys.

In the event, it was an accident of administrative convenience rather than anything else which dictated the manner in which the problem was in fact dealt with. There was no difference in kind between the customers paid by TOSG and those paid by the agency and the reality is that a single class of creditors was receiving payments on account of their debts from both TOSG and the agency, the latter's contribution in the case of those customers paid by TOSG being indirectly provided by the assumption by the agency of the full responsibility for paying the others.

It was against this background that the judge felt it appropriate to apply the analogy of the suretyship cases and, in my judgment, he was right to do so. The assignments were mere machinery and what fell to be regarded was in reality a partial payment by TOSG of the totality of the

obligation owed by Clarksons to all its customers as a single class. The position therefore fell to be tested as between the banks on the one hand, whose money had provided the payments, and the customers as a whole on the other hand, for the assignments could not assign any greater rights than the customers themselves had at the moment when they were paid.

The principles which emerge from the suretyship cases have been helpfully summarised both in the judgment of Nourse J and in the skeleton arguments prepared by counsel for the guidance of this court. The starting position is that a creditor is entitled in an insolvency to prove for the whole sum due to him at the date of the liquidation or receiving order without any obligation to give credit for any sum which he has since received from a third party, unless and until he has received 100p in the pound on his debt. That entitlement, however, may fall to be modified by reason of the rule against double proof where the third party is himself a creditor in the insolvency for the sum which he has paid, as in the case of a surety. Whether it is or not depends on whether the payment entitles the payer to be subrogated, to the extent of his payment, to the creditor's right and it is in relation to this question that a number of clearly established rules are deducible from the surety cases.

The basic rule is that the proof of a surety cannot displace the proof of the principal creditor unless and until the surety has fully discharged all his liabilities to the creditor. A fortiori it cannot do so where no payment has been made and the liability to the surety remains contingent *(Re Fenton* [1931] 1 Ch 85, [1930] All ER Rep 15). So long as any liabilities of the surety are outstanding the creditor remains entitled to prove for the full amount of the debt due to him at the date of commencement of the winding up or the receiving order and the surety's proof is excluded.

It is here that there has grown up a distinction, which depends on the construction of the contract of suretyship and which is not altogether easy to understand, between cases where the surety guarantees part of an ascertained debt and cases where he is held to have guaranteed the whole debt but subject to a limitation of his liability to less amount than the whole. In the former case, the payment of the amount guaranteed entitles the surety to stand, pro tanto, in the creditor's shoes in the insolvency, since he has discharged the whole of his liability to the creditor. In the latter case, so long as any part of the whole debt remains outstanding, the surety, although he has paid up to the limit of his financial liability, is treated as not having discharged his liability to the creditor, presumably on the footing that there nevertheless remains an outstanding obligation on him to see that the whole debt is paid. The distinction may seem over-subtle, but it is clearly established by authority: see the judgment of Blackburn J in *Ellis v Emmanuel* (1876) 1 Ex D 157, [1874-80] All ER Rep 1081, where the authorities are reviewed.

This rule is, however, subject to a qualification. Where the guarantee is of the whole

[1984] 1 All ER 628 at 641

of a fluctuating balance (eg as in the case of a guarantee of the debtor's current account with a bank) with a limit on the liability of the surety, such a guarantee is to be construed as a guarantee of part only of the debt and the surety paying up to the limit of his liability will be entitled to that extent to stand in the creditor's shoes and prove in priority to him (see *Ex p Rushforth* (1805) 10 Ves 409, 32 ER 903, *Gray v Seckham* (1872) LR 7 Ch App 680). The right of the surety in these circumstances to prove in priority to the principal creditor can, however (as it normally is in bank guarantees), be excluded by the express terms of the contract of guarantee. A provision that the guarantee is to be in addition and without prejudice to any other securities held from or on account of the debtor and that it is to be a continuing security notwithstanding any settlement of account is probably sufficient for this purpose (see *Re Sass, ex p National Provincial Bank of England* [1896] 2 QB 12) but at least there must be some express clause in the contract which can fairly be construed as a waiver by the surety of his rights in favour of the principal creditor (contrast *Hobson v Bass* (1871) LR 6 Ch App 792 with *Midland Banking Co v Chambers* (1869) LR 4 Ch App 398). Such a provision will not readily be inferred merely from the form which the transaction takes (see *Gray v Seckham)*.

Those being the principles, how are they to be applied by analogy to the instant case? Nourse J regarded the case as one where the proper analogy was that of a guarantor who guarantees the whole of a debt of fixed amount with a limitation on the amount of his liability, so that even after payment of the whole of the surety's liability the creditor remains entitled to prove for the whole sum. The reasoning behind this conclusion was that the object of TOSG was to alleviate the consequences of Clarksons' business failure. TOSG had a discretion about how this was to be done, but one way of carrying out the object was to recoup any shortfall remaining after the customers had received all available dividends in Clarksons' liquidation. Thus, it was argued, since the obligation of the banks was to be answerable for any balance remaining after all moneys available from other sources had been applied in reduction of the debt, the guarantee was a guarantee of the whole debt, subject only to a limitation on the amount which the banks were to pay. This feature of the relationship appears to have convinced the judge that the case of the guarantor of the whole of a fluctuating balance with a limitation on the amount of liability (as in *Hobson v Bass)* was not to be applied and as I understand his reasoning it was this.

The reason why that case is treated differently from the case of the debt of fixed amount is that it is considered inequitable in the creditor, who is at liberty to increase the balance or not, to increase it at the expense of the surety (see *Ellis v Emmanuel* (1876) 1 Ex D 157 at 163-164, [1874-80] All ER Rep 1081 at 1083). Since, the argument runs, it was contemplated that Clarksons would be entitled to take on liabilities to customers without limitation and since in the event of Clarksons' insolvency TOSG *could* apply the bond moneys in discharging any balance remaining after the disappointed customers had received their dividends in the liquidation, there was in fact nothing inequitable in such indebtedness being increased and accordingly the case is to be treated in the same way as the guarantee of the whole of a debt of ascertained amount.

With respect to the judge and to counsel for TOSG and the agency, from whom the argument originated, I find an element of circularity in this reasoning, which really begs the question of priority by starting from an assumption that it must be decided in favour of the customers. Of course, factually and dependent on the order in which events take place, any surety may find himself paying, up to the amount of this liability, any balance remaining due to the creditor after he has received a dividend on the whole of his debt in the insolvency of the principal debtor. But the mere fact that the creditor may have received a dividend on the whole is not determinative at all of how that dividend falls to be treated when it comes to settling the accounts between the creditor and the surety who, ex hypothesi, has not been able to prove because he has not paid (see, for instance, *Gray v Seckham*, where the creditor had received his dividend before calling up the guarantees, and *Hobson v Bass*, where the sureties had paid but had not themselves proved in the bankruptcy).

It is, of course, true that in the instant case the moneys paid by the banks were paid, not to the creditors in the first instance, but to a third party, TOSG, against whom there

would be no recourse for dividends received by the customers, but by the same token, the moneys having actually been paid by the banks, they would themselves have a right of proof under their counter-indemnity in the insolvency for the full amount paid, subject only to reduction of that amount by reason of the rule against double proof. As a practical matter, of course, the liquidator, who was faced with proofs both by the banks and by the customers, and knowing that some part of the bond moneys was bound to be paid in discharge of the indebtedness to the customers, would be bound to defer paying dividends on either until the question of double proof had been cleared up and it had been determined who had the better right to prove. Thus, to say that the bond moneys could be used by TOSG in discharging what was due to the customers after they had proved and received dividends in the liquidation begs the question of the extent to which their proofs should be allowed. It cannot itself be prayed in aid as solving the question. Nor can I, for my part, follow why the contemplation that Clarksons should be entitled to incur obligations without limit should take the case out of the ordinary rule. If the arrangements made in this case are to be treated, as I think they are, as analogous to a guarantee by the banks of Clarksons' liabilities to its customers, they appear to me clearly to be analogous to a guarantee of a balance which is going to fluctuate from time to time but subject to a limit on the surety's liability, and exactly the same considerations as apply in that case to prevent the surety's right of proof being prejudiced by the debtor's increasing his indebtedness appear to me to apply here. If that is right, then the question is whether there can be spelt out of the arrangement some express or implied term to the effect that, in the event of the debtor's insolvency, the banks would not prove for the amount which they had paid under their bonds until the customers had been paid in full. Certainly there is no express term to that effect and, speaking for myself, I am unable to find in the documents or the circumstances in which the bonds were given any such implied term. So far as the banks were concerned, their contract with Clarksons was that they would put up the bond moneys in consideration of the agreed fee and of a right of counter-indemnity which clearly contemplated a proof of debt for the moneys paid in the

only likely event in which they would become payable. There is simply no room for any such implication here.

So far as TOSG was concerned, the banks simply entered into an obligation to pay over moneys for TOSG's complete disposition in the stated events. In its defence the agency plead an implied term arising under the bonds that TOSG should be entitled to utilise the bond moneys in any transaction authorised by its constitution and that in such event the banks 'would do nothing to hinder any such transaction or to prevent any such transaction from being effectual'. Speaking for myself I find it impossible to see from what material it is sought to make this implication, but in any event, as was pointed out in the course of the argument, such a term does not assist in the present context. It is said that it was within TOSG's powers to procure assignments to the agency of such rights of proof as the customers had but nothing done by the banks in the least interfered with that. To assist the agency it would, I think, be necessary to imply a term that the banks would not, by proving in the liquidation of Clarksons, do anything which might impede in any way the maximum alleviation possible of the customers' losses. By any ordinary test for the implication of contractual terms, this is fanciful.

If, therefore, the analogy of the surety cases is treated as conclusive of the present case, then, in my judgment, the banks are in the position of the surety under the ordinary form of guarantee of a fluctuating account with a limit on the guarantor's liability and no term excluding the equity which ordinarily arises from that relationship. It would follow that as between the banks and the customers, the banks have the prior right of proof and that, that right must prevail against the agency, which cannot be in any better position than its assignors.

There remains, however, the judge's primary ground of decision. He pointed out that a decision of the case did not necessarily rest on which of two categories of suretyship case bore the closer affinity to it. The determinative factor was the application of equitable principles as applied to a true construction of the parties' intentions. He concluded:

> 'But in the end I do not need to rely on the analogy at all. I agree with [counsel

[1984] 1 All ER 628 at 643

> for TOSG and the agency] that the decisive feature of the present case is the trust fund's power to recoup to the customers any shortfall remaining after they had received all available dividends in Clarksons' liquidation. Once you get to that stage it is apparent that it would indeed be most inequitable for the banks to claim, as against the customers, a rateable proportion of any dividends receivable or received by them. This is not a narrow equity but a broad one. And it is a surer basis for decision than any mere analogy.'

It will be observed that in arriving at the broad equity the judge is here relying on precisely the same argument as that which led him to assimilate the banks' position to that of guarantors of the whole

of an ascertained indebtedness. In doing so, it seems that he was much influenced by some figures produced by the chairman of the agency, Sir Kenneth Selby, which were designed to contrast the position as it might have been with the position as it actually was. These figures demonstrated that the total amount due to customers was £4,357,677. On the footing that they all proved and assuming a dividend of 121/2p in the pound they would receive £544,710. If they were then paid by TOSG the bond moneys actually paid out (£1,267,759), the agency's liability in pursuance of its statutory duties would then have been £2,545,208. What the agency actually paid to customers was £3,089,918. Thus, it was argued, by adopting the method of paying out first against assignments, the agency would have spent more than its statutory liability to the extent it was unable to recover the customers' proofs of debt assigned to it, a sum of £158,470, on the footing that the banks are admitted to prove in priority to the customers paid by them. That figure, of course, includes the share of Williams & Glyn's Bank, which is not an appellant.

As an exercise in arithmetic this, of course, is admirable, but the assertion that the actual method of dealing with the claims involves an expenditure in excess of the agency's liability rests on the same assumption as the proposition which I have already ventured to criticise. The agency was under a statutory liability to make good anything not met from dividends or bond moneys, but the assertion that it would have expended less if it had waited until the customers received their dividends assumes that there is no question of double proof and therefore begs the question of what dividends were in fact available. These figures demonstrate the arithmetic. They do not, in my judgment, demonstrate the equity, and I cannot, for my part, share the judge's view that there is anything inequitable in allowing the banks who have paid real money to recover a dividend on the sums which they have paid and in reducing the proofs of the customers, who have received real money in priority to other creditors, by the amounts which they have in fact received. Leaving aside, for the moment, the suretyship analogy, if the amounts of the customers' claims had been equal to or less than the bond moneys, there could be no question whatever that the banks were entitled to prove for what they had paid. What is there then in the fact that the customers' debts exceed the amount of the bond moneys that displaces the banks claims? It is only the rule against double proof and that brings one back to the suretyship analogy. If one discards that as a guide, one is left with competitive claims between a class of creditors (the banks) who are out of pocket to the full nominal amount of their claims and a class of creditors (the customers) who are in fact out of pocket to an extent less than the full nominal amount of their claims because of their receipt of the banks' money. Unless there can be found in the arrangements under which the money was put up some implied term which precludes the payers from exerting the limited right of recoupment which they were careful to reserve against the debtor when those arrangements were made, I can see no equity which dictates that the customers' claims should be preferred. It is said that it is illogical that the banks should enter into bonds which they knew were designed to alleviate losses to holidaymakers whilst at the same time reserving the right to 'claw back' from the holidaymakers what they might otherwise have got in the liquidation. This I find an emotive description of what seems to me a perfectly commonsense business arrangement and it really comes back to seeking to imply an intention on the part of the banks not simply that the bond money should be used to alleviate the

losses of customers in such way as TOSG might think fit but that such losses should be alleviated to the maximum extent possible by

[1984] 1 All ER 628 at 644

eliminating the rights which the banks had reserved against the debtor. I find no material for any such implication and I cannot think that it would have occurred for one moment to any bystander, officious or otherwise, who was present when the arrangements were made.

I find myself, therefore, unable to reach the same conclusion as the judge. In my judgment both the suretyship analogy and the broad equity of the position favour the banks' claim as against that of the agency, and I would allow the appeal.

KERR LJ.

For convenience I will refer to the parties as 'Clarksons', 'the banks', 'TOSG', 'the holidaymakers', 'the agency' and 'the liquidators'. The issue on this appeal concerns the right to prove in Clarksons' liquidation for part of the 'bond moneys' provided by the four appellant banks to TOSG. The competing claimants for payment of a dividend by the liquidators on the amount of the bond moneys are the four banks and the agency. However, this is to some extent an over-simplification: each of the banks with which this appeal is concerned seeks to prove for the fixed amount of the bond which it has provided, viz Barclays for £500,000, Lloyds for £93,000, National Westminster for £500,000 and Wintrust for £260,000, and the agency is disputing each of these claims to proof. For convenience it may be simpler to treat the total bond moneys as one composite sum. But in analysing the position one must also constantly bear in mind that each of the banks is a separate claimant in respect of the amount of its bond, even though their claims must stand or fall together. Further, although it is convenient to refer to the bond moneys compendiously, the competing claims are in fact confined to the sums paid by TOSG to holidaymakers directly, to the exclusion of the repatriation costs as to which the banks' right to proof is not in dispute.

There are only three possible solutions. (1) The banks are entitled to prove to the exclusion of the agency. (2) The agency is entitled to prove to the exclusion of the banks. (3) The banks and the agency can both prove.

Either of the first two solutions would follow from the application of the so-called rule against double proof, though, in my view, they also fall to be considered independently from this rule. The third solution can only be correct if this rule has no application to the unusual situation in this case.

Before Nourse J the case proceeded on the basis that the rule against double proof was on all sides assumed to apply. He therefore had to choose between the first two solutions, but on this appeal we have to consider all three. To my mind this provides a better approach to seeking the solution which most closely accords with justice and the presumed intention of the parties concerned. The rule against double proof is highly technical in some facets of its application, but ultimately it is based on what the court regards as justice between all the creditors. Exceptionally it may fall to be applied in unforeseeable situations such as *The Liverpool (No 2)* [1960] 3 All ER 307, [1963] P 64, where the priority between competing claims has to be determined without reference to the parties' presumed intentions before the occurrence of the insolvency. Generally, however, it applies in cases in which there is something in the nature of a debtor-creditor-surety situation which precedes the insolvency. In such cases, the solutions at which the courts have arrived, as illustrated by the decisions to which Oliver LJ has referred, have taken account, expressly or tacitly, of what the parties concerned are to be regarded as having intended. It is on this basis that they have generally decided whether or not the rule applies and, if so, with what consequences as regards priorities. I think that this is particularly important in the present case, since its unusual feature is that Clarksons, in conjunction with the banks and TOSG, set up the bonding arrangements with the express intention that they should take effect in the event of Clarksons' possible insolvency for the benefit of a particular class of creditors. I therefore feel that the safest course is to begin by examining the presumed intentions of the various parties at the time when the bonding arrangements were made.

The parties' intentions

The background can be summarised as follows. In order to strengthen their position

[1984] 1 All ER 628 at 645

as reliable tour operators in the eyes of members of the public who might book holidays with them, Clarksons, together with other major tour operators, wanted to set up a fund whose existence would be publicised and which would be immediately available to these customers in the event of Clarksons becoming insolvent, at least to the extent that they might run into cash-flow difficulties and become unable to meet their commitments to them, as had notoriously happened in a number of other cases. They therefore combined to set up TOSG as a vehicle for the receipt and application of a fund to be available for this purpose outside their possible liquidation. The main objectives of this fund appear from cl 3(A) of TOSG's memorandum of association. These were to 'alleviate' the consequences of any insolvency to the holidaymakers in two main respects, (i) to enable them to complete their holidays and to bring them home more or less as they had planned, and (ii) to refund to them any prepaid deposits, or prepayments made in full, so that these moneys would be available to them for making alternative holiday arrangements. The total amount of the bond moneys to be provided by Clarksons for these purposes was computed on the basis of 5% of their annual turnover, because it was hoped that, by and large, this could be sufficient to cover what might turn out to be Clarksons' maximum exposure in this respect. However, there was no requirement that Clarksons were to take any account of the total amount of the bond moneys in accepting bookings from their

customers; and there was also no suggestion that the banks had any knowledge or concern about the relationship between the amounts which, individually and collectively, they agreed to guarantee by issuing the bonds and the amounts which might at any time be required to meet Clarksons' commitments within the objectives of cl 3(A).

There is also no indication, I think, that in issuing the bonds, the banks acted otherwise than individually to the extent of the various amounts which they undertook to pay to TOSG in the event of Clarksons' insolvency. However, this is of no importance, since, apart from whatever commission which may have been agreed with Clarksons for issuing the bonds, each bank required a counter-indemnity for the bond moneys from Clarksons in the usual way. Each such counter-indemnity was to take effect if and when the bonds were called by TOSG. It was common ground that TOSG, as well as the agency, when it came into existence later on, were well aware of the counter-indemnities.

Against this background, one can then ask oneself the first material question concerning the intention of the parties which set up the bonding arrangements: 'In the event of the bonds being called up, due to Clarksons' insolvency, was it envisaged that the banks would be entitled to prove for the amounts of their respective bonds in Clarksons' liquidation?' To this there can only be one answer: 'Yes, obviously, by reason of the counter-indemnities.' The common intention in this regard can be expressed by each bank saying, in effect, with the assent of Clarksons and TOSG: 'In the event of the bonds being called, we will immediately provide cash to TOSG to the extent of our bond. This will be applied by TOSG for the benefit of Clarksons' customers in accordance with TOSG's memorandum of association, and in particular cl 3(A). Any balance which is not needed for these purposes will be refunded to us. To the extent that there is no refund, we will be left with a claim in Clarksons' liquidation under our counter-indemnity.'

Since this was clearly the common intention of the parties concerned in setting up the bonding arrangements, I am bound to say that, right from the outset, I find it difficult to accept that any answer to the complex problems of this case can be correct in so far as it precludes the banks from proving in Clarksons' liquidation to the full extent of their counter-indemnities. Whatever may be the effect of the mysteries of the rule against double proof, to which I turn later, it would be strange indeed if it led to any other result.

I realise, however, that this approach is too simple and that, in ascertaining the parties' intentions, one must go on and pose a further, more complex, question to the parties who set up the bonding scheme, on the following lines: 'But, suppose that the bond moneys, or their residue after paying for the repatriation of stranded holidaymakers, are paid to customers of Clarksons who have paid deposits or prepaid for their holidays in full, but the bond moneys are found to be insufficient to reimburse them in full, what would then be the rights of the holidaymakers?' I think that the instant

answer would be: 'Well, of course, they can claim in the liquidation of Clarksons for the balance.' This,

I think, is the right answer from every commonsense point of view, and it ought to be the right answer in law. However, suppose that the questioner then explained the rule against double proof and repeated the question, somewhat on the following lines: 'But, you see, the position is this. The bond moneys have been provided by the banks, at Clarksons' request and expense, to be applied by TOSG, at any rate as to the relevant part, in order to meet the debts owed by Clarksons to the holidaymakers, who will be one class of Clarksons' creditors in the event of Clarksons' insolvency. In a sense, therefore, the banks are in a position of sureties for the holidaymakers. In general, however, to simplify a legal rule called "the rule against double proof", a creditor can claim against the debtor the full amount of his debt, without having to give credit for anything received from a surety until he has had his debt repaid in full; and, in cases where the rule applies, the creditor can generally claim the full amount of his debt against the insolvent debtor to the exclusion of the surety. Alternatively, if there are competing claims by two creditors for what is in substance the same debt, then one must have priority over the other, because it would not be fair to the general body of creditors of the insolvent debtor that two dividends should be paid for what is in substance the same debt. What then?'

The intelligible part of the answer, no doubt after a good deal of head scratching, would in my view have been somewhat as follows: 'Well, I still think the same. I don't see how the banks can in any event be precluded from claiming on their counter-indemnities. They agreed to pay over the bond moneys for the benefit of the holidaymakers in the event of Clarksons becoming insolvent, but only on the basis that they would then be entitled to claim in Clarksons' liquidation under the counter-indemnities. I don't see how they can lose this right. I can see that Clarksons' liquidators should not pay a dividend on the bond moneys both to the banks and the holidaymakers. But the banks have paid out the bond moneys, and the holidaymakers will have received them, all as had been intended. The holidaymakers will find that they are fortunate to get these sums. And, after all, indirectly the bond moneys will have been made available to the holidaymakers by Clarksons themselves. Why, then, having received them with one hand, should the holidaymakers still be able to claim them from Clarksons' liquidators with the other? So, as I say, the banks should be entitled to a dividend on the bond moneys, and the holidaymakers to a dividend on the balance of their debt after giving credit for what they will have received out of the bond moneys. In so far as I understand your rule against double proof, I don't think that it was ever intended to apply here. But, if it does, then the banks must have the better claim.'

Those, I think, would have been the answers of the persons concerned in setting up the bonding arrangements to the problems raised by this case before the advent of the agency and the complications created by the assignments, to which I come later. I shall also have to deal with the

inevitably much more sophisticated answers to these problems in the contrary sense given in the judgment of Nourse J and elaborated in the able argument of counsel for TOSG and the agency on this appeal. Meanwhile, however, in considering the presumed intentions of the various parties before Clarksons' insolvency, one should perhaps also bear in mind two other classes of persons in so far as they dealt with Clarksons in the knowledge of the bonding arrangements: the general body of Clarksons' creditors at any time, and in particular the holidaymakers themselves, who may well have made bookings with Clarksons partly in reliance on these arrangements. But, in my view, their answers would have been precisely to the same effect. The reason is that, from the point of view of justice and common sense, I do not see how they could have been different.

The original effect of the bonding arrangements

After giving answers on the foregoing lines, the holidaymakers would no doubt have added: 'Of course, if the law allows us more, then we would like to have it.' In my view, however, these answers were in accordance with the legal position at the stage when the bonds were established. None of the counsel who appeared on this appeal were able to refer us to any case in which an analogous position had been considered. But sometimes, in new situations, the court has to find a just solution which stems simply from the nature of the transaction, the relationship between the parties and their presumed

[1984] 1 All ER 628 at 647

common intention. For instance, the rules concerning rights and obligations of contribution in general average were originally based simply on 'common principles of justice' (see *Birkley v Presgrave* (1801) 1 East 220 at 227, 229, 102 ER 86 at 88, 89), and these rules were then applied by analogy in laying down the principles of contribution between co-sureties (see *Dering v Earl of Winchelsea* (1787) 1 Cox Eq Cas 318 at 322, [1775-1802] All ER Rep 140 at 143). In my view, the same approach applies here.

However, Nourse J reached a diametrically opposite conclusion, though under the constraint of the applicability of the rule against double proof, since the case before him proceeded on this basis. Having dealt with the analogy of the banks' position as sureties, to which I come later, he said:

> 'But in the end I do not need to rely on the analogy at all. I agree with [counsel for TOSG and the agency] that the decisive feature of the present case is TOSG's power to recoup to the customers any shortfall remaining after they had received all available dividends in Clarksons' liquidation. Once you get to that stage it is apparent that it would indeed be most inequitable for the banks to claim, as against the customers, a rateable proportion of any dividends receivable or received by them. That is not a narrow equity, but a broad one. And it is a surer basis for decision than any mere analogy.'

With the greatest respect, I find myself wholly in disagreement with this for a number of reasons. First, and quite generally, I think that every principle of 'broad equity' points in the directly opposite

direction, for the reasons already mentioned. Second, I think that this definition of the 'decisive feature' begs the question. What is meant by 'all available dividends'? Are they the dividends payable after the banks have also proved for the bond moneys? Or is the assumption that the banks will have been excluded from proof? The test appears to me to be circular, since the question is whether or not the banks are entitled to prove. In this connection it must be borne in mind that the banks' prima facie right of proof will have arisen as soon as the bonds were called, so that, even if all the holidaymakers had then also proved at once for their full debts, the liquidators would have been faced with both claims to prove in full, as they are now. I therefore cannot see how this formulation can provide any answer to the problem. Third, I think that its premise in no way corresponds to the realities of what had been intended, and indeed happened. The whole purpose of the bonds was to provide a fund which, on Clarksons' insolvency, would be immediately available to TOSG for the benefit of the holidaymakers. It was never envisaged that the fund would be distributed only after the holidaymakers had proved in the liquidation and it was known what dividends the holidaymakers would receive. I appreciate, of course, that there could in theory have been an immediate partial distribution, with a reserve being held back until after completion of the liquidation. But this possibility seems to be too artificial to provide any sound basis, at any rate for the purpose of raising any 'broad equity'. The common intention, as well as the objects of TOSG, surely envisaged that every penny of the bond moneys should (apart from administrative expenses) be applied, as quickly as possible, to whatever extent was necessary to alleviate the plight of Clarksons' customers. The possibility of a reserve could only have arisen if there had been a surplus. I can see that, on that assumption, the test posed by Nourse J could have arisen, though subject to the reservations which I have already expressed about it, in deciding whether or not to return the surplus to the banks under the terms of the bonds. But where, as in the present case, the fund in fact proves to be insufficient to meet all the needs of the holidaymakers, it seems to me that this test provides no realistic basis in any event for arriving at a just solution of the problem.

It follows that in my view, leaving aside for the moment the advent of the agency and the effect of the assignments, the correct solution, on the basis of the parties' intentions and 'common principles of justice', is that the banks were to be entitled to prove for the full amount of the bonds, and that each holidaymaker was to be entitled to prove for the balance of his debt after giving credit for whatever he or she may have received out of the bond moneys. I formulate my conclusion at this stage in this way, because, but for

[1984] 1 All ER 628 at 648

the advent of the agency, the available bond moneys would no doubt have been distributed pari passu between the relevant holidaymakers, as had indeed been TOSG's original intention; but this assumption does not affect what I would respectfully regard as the correct solution in principle. Accordingly, when the bonding scheme was set up, it was intended to operate in a way in which there would be no basis for the application of the rule against double proof.

The effect of the subsequent events

However, I must then turn to what in fact happened when the balance of the bond moneys was distributed by TOSG after the repatriation costs had been met. The facts have already been stated by Oliver LJ, and I need not repeat them. The agreement between TOSG and the agency was, if I may respectfully say so, an extremely sensible one, since it enabled the balance of the bond moneys, together with the new funds available to the agency, to be used to compensate all the relevant holidaymakers in full as quickly and conveniently as possible. However, what was the legal effect, if any, of TOSG paying one category of holidaymakers in full, until the bond moneys became exhausted, but subject in each case to taking an assignment in favour of the agency of these holidaymakers' debts, or of their right to prove in Clarksons' liquidation? This category consisted of those who had made prepayments to Clarksons direct, whereas it was thought that those who had made payments to travel agents would have to await the outcome of a test case. Subsequently they, together with those who had not been paid by TOSG out of the bond moneys, had their prepayments reimbursed by the agency in full. During the argument before us it was found convenient in this connection to refer to the holidaymakers paid by TOSG as 'the Browns' and to those paid by the agency as 'the Smiths', and to refer to the general body of both categories as 'the Brown-Smiths'. I will use the same terminology. The issue therefore turns on whether the banks are entitled to prove in Clarksons' liquidation to the extent of the sums paid to 'the Browns' to the exclusion of the agency, or vice versa, or whether the banks and the agency can both claim a dividend on these sums. It is of course not in dispute that the agency can prove in any event in respect of the payments which it made to 'the Smiths'.

I must begin by dealing shortly with two submissions put forward by counsel for the banks. The first was that the banks had a right to be subrogated to 'the Browns' as soon as 'the Browns' were paid out of the moneys provided by the banks, and that the assignments could not destroy this right of subrogation. In the same way as Oliver LJ I cannot accept this submission. Given the existence of the express counter-indemnities, of which both TOSG and the agency were aware at all times, and the unrestricted powers of TOSG, I cannot see any scope for any parallel implication of a right of subrogation to the same effect as the counter-indemnities.

Second, counsel for the banks submitted that, by requiring the assignments in favour of the agency, TOSG was in breach of some term to be implied as between TOSG and the banks, or possibily, as I understood him, in breach of trust to the banks, and that the banks could rely on these breaches against the agency, since it was in the position of an equitable assignee with notice. Again, I think that these submissions go too far. If one regards the agency as representing all 'the Smiths', I can see, as submitted by counsel for TOSG and the agency, that under the terms of the bonds, which incorporated the wide objects of TOSG, TOSG was entitled to do anything which might be of benefit to 'the Smiths'. Even on this assumption, however, there remains the question whether the assignments had the effect of excluding the banks' right of proof under the counter-indemnities or whether the banks and the agency can both prove. In my view the assignments have no effect on the conclusions which I have already expressed, for a number of alternative reasons which all lead to

this result.

The first point in this connection is that I cannot accept any of the arguments of counsel for the banks, which in the end he did not strongly maintain, to the effect that the banks and the agency can both prove and receive a dividend in respect of the payments made by TOSG to 'the Browns'. This would be unfair to the general body of Clarksons' creditors and inconsistent with the principle of the rule against double proof, whether or not this rule is strictly applicable in the circumstances of this case.

[1984] 1 All ER 628 at 649

Second, as it seems to me, since 'the Browns' were paid by TOSG in full, out of the bond moneys which had been specifically arranged to be provided by Clarksons for their benefit in the event of Clarksons' insolvency, 'the Browns' had no right of proof thereafter, and nothing which they could effectively assign to the agency. There were then no debts owed by Clarksons to 'the Browns' which remained to be assigned. Council for TOSG and the agency countered this by submitting that 'the Browns' cannot for this purpose be considered in isolation, but that, having regard to the reasons which underlay the agreement between TOSG and the agency, the division between 'Browns' and 'Smiths' should be ignored, and that the position should be tested by reference to 'the Brown-Smiths' as a whole, as though TOSG had made a partial payment towards the debts of all the relevant holidaymakers pari passu and had then taken assignments from all of them in favour of the agency. I was at first greatly attracted by this argument, but on reflection it seems to me again that it displaces reality in favour of theoretical possibilities, though on this occasion in a different context. Why should the legal effects of the assignments not be judged by reference to what actually happened? Admittedly, the agreement between TOSG and the agency could have been framed differently, and less conveniently, by each party paying all 'the Brown-Smiths' pari passu, and all of them could then have effected assignments in favour of the agency in consideration of the payments made to all of them by TOSG. But, since this did not in fact happen, why should the effect of the assignments fall to be determined on this hypothetical basis?

Third, however, let it be assumed that this is wrong, and that each transaction between TOSG and one of 'the Browns' is to be regarded as valid and effective in the sense that it constituted a purchase of each debt by TOSG in consideration of its assignment to the agency, and not a payment which extinguished the debt. What is the position then?

The first answer in my view is that the assignments would still have no substantial effect, because they would not entitle the agency to prove in Clarksons' liquidation in competition with the banks. For the reasons stated in the judgment of Slade LJ, which I have seen and with which I respectfully agree, the agency cannot, as TOSG's assignee, be in any better position than TOSG itself. However, it cannot possibly have been in the contemplation of any of the parties, when the bonding scheme was set up, that TOSG might be entitled to buy up the debts of the holidaymakers in order to seek to

acquire claims in the liquidation which would rank in priority over the claims of the banks under the counter-indemnities. Any such suggestion as to the rights of TOSG would transgress the common intention of the parties to the bonding scheme to an even greater extent than in relation to the rights of the holidaymakers themselves, with which I have dealt at the beginning of this judgment.

Nevertheless, I can see the force of the argument, though to my mind only a technical one, that the correct analysis resulting from the assignments on these assumptions is that they have the effect of bringing the rule against double proof into operation between the agency and the banks. On that basis, however, it seems to me to be clear, for the reasons explained in the judgment of Oliver LJ, that the effect of the rule in the circumstances of this case is that the banks can prove to the exclusion of the agency. Here again I respectfully differ from Nourse J. He said:

> 'In all the circumstances, if the suretyship analogy is to be applied and carried through, the case is clearly one where there was a guarantee of the whole debt, subject to a limitation on the liability of the surety in the amount of the bond moneys.'

In my view, however, there was clearly no guarantee of the whole debt by the banks, either collectively or, as is more relevant, individually. If the language of the authorities concerning the rule against double proof is to be used at all, then each bank guaranteed, to use the word loosely and I think inaccurately, an indeterminate part of an unknown fluctuating balance up to the limit of its bond. With the greatest respect to Nourse J, I cannot begin to see how the terms of the bonds, albeit that they incorporated all the terms of TOSG's memorandum of association, can be regarded as having guaranteed the whole of any debt or debts whatever. I have already set out earlier in this judgment what appears to me to be a clear formulation of the position of the banks in this regard.

[1984] 1 All ER 628 at 650

Accordingly, even if the rule against double proof is applicable, it follows from the analysis of the authorities in the judgment of Oliver LJ that the banks can prove to the exclusion of the agency.

For all these reasons I would allow this appeal.

SLADE LJ.

I agree that this appeal should be allowed. Oliver LJ has stated the facts and I will not repeat them, save to the extent necessary to explain my own conclusions.

I think that the task of Nourse J was made more difficult by the fact that no argument was addressed to him in support of the contention that the rule against double proof has no application in the

present case and that there is accordingly no reason why both the four plaintiff banks and Air Travel Reserve Fund Agency (the agency) should not prove in respect of the relevant debts. In this court we have had the assistance of submissions by counsel for the banks (albeit in the alternative) in support of this contention, and submissions from counsel for TOSG and the agency and counsel for the liquidators of Clarksons in opposition to it. In the end, for reasons which I will state, I have been convinced that the contention is unsustainable. Nevertheless, a substantial part of the argument in this court has centred round it and I have found it helpful in finally identifying what I regard as the important signposts in this jungle of obscure legal territory.

I have had the advantage of reading in draft the judgments of Oliver and Kerr LJJ. Since I agree with their conclusions that the rule against double proof does apply and that the claim of the banks takes priority to that of the agency, I hope that it will not appear discourteous if I deal less specifically than they have done with the able and multifarious arguments which all counsel have addressed to us. I propose to do little more than explain the route which leads me to these conclusions.

As soon as the banks paid the bond moneys to TOSG on 16 August 1974, they became immediately entitled to prove in the liquidation of Clarksons in respect of the full amounts so paid, by virtue of the counter-indemnities given them by Clarksons. Under the express provisions of the bonds, they had a right to demand repayment by TOSG of such part of the bond moneys as should not be expended by TOSG in the performance and execution of its rights, duties, powers and discretions as set out in TOSG's memorandum and articles of association. This right, however, was more theoretical than substantial, since Clarksons was hopelessly insolvent and there was no real prospect of TOSG failing to expend the whole of the bond moneys in this manner.

The banks, in my judgment, had a contractual right (arising by necessary implication from the terms of the bonds) to prevent TOSG from expending the bond moneys otherwise than in the performance and execution of its rights, duties, powers and discretions as set out in TOSG's constitution. Subject to this limitation, however, the choice was that of TOSG as to how it should spend the bond moneys and the banks could not, as a matter of contract, complain about such expenditure, even though it would inevitably prejudice pro tanto the banks' theoretical rights of subsequently obtaining recoupment by TOSG of unexpended bond moneys.

TOSG, having received the bond moneys, in accordance with the powers given it by its memorandum, expended some £956,000 in repatriating customers of Clarksons. The banks make no complaint about this expenditure. Though it diminished the banks' theoretical rights of recoupment against TOSG, TOSG were plainly entitled to effect it and it did not prejudice the banks' right of proof in the liquidation.

The dispute in the present case has arisen because of the arrangements made by TOSG and the agency in July 1975 for dealing with the residue of the bond moneys held by TOSG, in respect of the bonds provided by Clarksons. These arrangements have been set out more fully by Oliver LJ in his judgment, so I need only refer to their contents quite briefly.

The agreement of 23 July 1975 (the assignment agreement) made between the agency and TOSG provided, inter alia, that TOSG would pay out 'non-T.C. claims' (non test-case claims) in full as soon as reasonably practical, until the bond moneys (less a retention fund) were exhausted or until all non-TC claims had been paid in full, and that, when paying any claim, TOSG would obtain an assignment in favour of the agency from the

[1984] 1 All ER 628 at 651

payee of his right to prove in the liquidation of Clarksons for the full amount of his claim.

This provision was duly implemented in the manner contemplated by the assignment agreement. TOSG drew cheques amounting to about £1·43268m in favour of customers presenting non-TC claims, which were expressed as not to be honoured unless the assignment form on the back had been signed by the payee; and this form effected an assignment to the agency of all the customer's rights to prove in the liquidation of Clarksons in respect of overseas holidays, which proofs he had lodged with the joint liquidators.

It would have been possible for the agency and TOSG so to arrange matters so that, when TOSG paid over cheques in respect of the claims in question, it did so on the terms that the customers released all their claims in the liquidation, so that such claims were extinguished. However, the arrangements actually made were, instead, clearly intended to have the effect of operating as assignments of the relevant choses in action, consisting of the customers' rights to prove in the liquidation, and thus to keep the claims alive.

In the court below, it was submitted by the banks, inter alia, that the assignment agreement was ultra vires TOSG, in so far as it provided for the claims in the liquidation of customers who were paid by TOSG to be assigned to the agency. Nourse J, in my opinion, correctly rejected this submission and it has not been pursued in this court. At one stage in the argument before us, counsel for the banks sought to argue that TOSG, in arranging for the claims of customers who were paid by it to be assigned to the agency, was in breach of an implied term of the contract entered into between TOSG and the banks when the bonding arrangements were concluded. In my opinion, however, this contention is not well founded. I think that, as a matter of contract, the banks could not complain if TOSG used the bond moneys in any manner authorised by TOSG's constitution.

However, merely because TOSG was acting neither ultra vires nor in breach of contract in arranging these assignments, it does not follow that the assignments had the legal effect of substantially impairing the banks' rights of proof in the liquidation. For that is the effect of the claim of the agency. It boldly asserts not only that, by virtue of the assignments, it has become entitled to prove in the place of the relevant holidaymakers for the £1·43268m but that the banks' previously existing rights of proof have in effect pro tanto been wholly extinguished, because the rule against double proof applies and the agency's proof takes priority to that of the banks.

In considering this claim of the agency, I would begin by making these observations. The agency is itself a body set up by statute under the Air Travel Reserve Fund Act 1975, with the broad intention of mitigating the losses suffered by holidaymakers on account of the inability of air travel organisers to meet their financial commitments. Furthermore, it has unquestionably done much to assist those disappointed customers of Clarksons who were not repatriated or paid by TOSG. Nevertheless, these points and the identity of the agency as assignee of the relevant rights of proof are, in my opinion, immaterial for present purposes.

On their true legal analysis, in my opinion, the effect of the relevant transactions was that: (a) TOSG purchased for £1·43268 m the rights of proof of the respective holidaymakers in question (whom I will call 'the assigning holidaymakers'); (b) TOSG directed that the respective purchases should be completed by assignments, not to itself but to the agency.

In these circumstances, and I regard this as a point of crucial importance, the agency, in my opinion, stands in the position in which TOSG would now find itself if it had taken the assignments in favour of itself. Though it is common ground that rights of proof are in principle assignable as choses in action, TOSG manifestly could not have conferred on the agency better rights of proof in respect of the debts of the assigning holidaymakers than it could have obtained for itself. The fact that the assignee happens to be the agency is immaterial.

At this point I find my approach to this case rather different from that of the judge. In the course of his judgment, after saying that the rule against double proof prevented both the banks and the agency from together proving, he said:

[1984] 1 All ER 628 at 652

> '[Counsel for the banks] accepts that the agency, as the assignee of the customers' rights to prove in the liquidation is in the same position vis-à-vis the banks as the customers themselves would have been. Accordingly, the only question which I have to decide is whether, at the material time, the banks or the customers had the better right of proof. The reduction of the question to that simple form does not mean that the answer is simple.'

As will appear from what I have already said, I look at the matter rather differently. Though I agree that the rights of proof of TOSG, through which the agency claims, could not have been *better* than those of the assigning holidaymakers through which TOSG would have claimed, I do not think it should be assumed that the rights of TOSG to prove in competition with the banks would necessarily have been as good as those of the assigning holidaymakers. For reasons which will appear, I think it was only the expenditure of moneys by TOSG in purchasing the relevant rights of proof in such manner as to keep the relevant debts of the holidaymakers alive which caused a double proof situation to crystallise. If such purchase had never taken place and the assigning holidaymakers had been left to prove in respect of their own debts, I think it possible that no question of double proof would have arisen as between them and the banks. Accordingly, in my judgment, the relevant inquiry is: what would have been the position of TOSG vis-à-vis the banks in relation to proof if the assignments had been taken by TOSG in favour of itself? Two questions thus fall to be answered. (1) On the footing that the relevant rights of proof had been assigned to TOSG itself, would the rule against double proof have applied so as to prevent TOSG and the banks from proving in competition with one another? (2) If the answer to question (1) is Yes, would TOSG or the banks have had the better right of proof?

As to question (1) above, the true principle of the rule against double proof, stated by Mellish LJ in *Re Oriental Commercial Bank, ex p European Bank* (1871) LR 7 Ch App 99 at 103, is that--

> 'there is only to be one dividend in respect of what is in substance the same debt, although there may be two separate contracts.'

Earlier in the same passage of his judgment, Mellish LJ had likewise made it plain that the rule is directed against payment of more than one dividend in respect of the same debt, rather than against presentation of more than one proof. In many cases, such as the present, where more than one proof has been presented, one may find what was sometimes described in argument as a 'potential double proof situation', which can only be finally resolved at a later stage, having regard to the facts subsisting at the time when a dividend is about to be paid (for example, having full regard to the arrangements made pursuant to the assignment agreement in the present case). The purpose of the rule is, of course, to ensure pari passu distribution of the assets comprised in the estate of an insolvent in pro rata discharge of his liabilities. The payment of more than one dividend in respect of what is in substance the same debt would give the relevant proving creditors a share of the available assets larger than the share properly attributable to the debt in question.

Difficulty may well arise in determining whether, in any given case, two proofs are in respect of what is in substance the same debt. Though various broad tests have been canvassed by both Bar and Bench in argument in this case, I have, for my own part, found none of them wholly satisfactory. The question can, I think, only be determined by reference to the particular facts of the case before the court, bearing in mind that it is the substance of the relevant liability, rather than the

form, on which attention must be concentrated.

On the facts of the present case, I have come to the clear conclusion that, if TOSG had itself taken assignments of the rights of proof of the assigning holidaymakers and had then sought to prove in respect of the debts of those holidaymakers, it would have been proving for what were in substance the same debts as an equivalent part (£1·43268m) in respect of which the banks were proving. The matter may be tested this way. TOSG would unquestionably have been claiming in respect of the debts owed by Clarksons to

[1984] 1 All ER 628 at 653

the assigning holidaymakers. Though in form the banks' claims arise under the counter-indemnities given them by Clarksons in respect of the bond moneys, in substance they are attributable to the debts owed by Clarksons to the assigning holidaymakers, because: (i) it was only the actual expenditure of bond moneys by TOSG which pro tanto finally crystallised the liability of Clarksons to indemnify the banks, because it finally destroyed any possibility of the banks obtaining recoupment from TOSG; (ii) the particular expenditure of bond moneys by TOSG which finally crystallises the liability of Clarksons to indemnify the banks in respect of the £1·43268m was expenditure in the purchase of these very same debts owed by Clarksons to the assigning holidaymakers.

In short, in the contingency now under discussion, the joint liquidators would find themselves faced with two competing proofs, namely one at the suit of TOSG in respect of the debts of the assigning holidaymakers and one at the suit of the banks which arose as a result of TOSG purchasing those very same debts. Subject to the rule against double proof, the substantial effect of the purchase of the debts by TOSG was, I think, to increase the provable liabilities of Clarksons by £1·43268m because, until that event, it was always possible that the banks would, in due course, recoup this amount from TOSG, and accordingly would not be entitled to receive any dividend in respect of it in the liquidation of Clarksons.

In these circumstances, regarding the matter as one of substance, I find it impossible to say that if TOSG had itself taken assignments of the rights of proof of the assigning holidaymakers and had then sought to prove for the £1·43268m, its proof and the banks' proofs for the equivalent amounts would not have been in respect of the same debts. It would not, in my view, have been open to TOSG and the assigning holidaymakers, even with the consent of the banks (which was never obtained), to prejudice the general body of creditors by effecting transactions of this kind.

If this be correct, it can make no difference in the context of the rule against double proof that TOSG in fact directed the assignments to be made in favour of the agency. The rule must still apply for the protection of the general body of creditors, whichever of the banks and the agency is entitled

to invoke it, so as to exclude the other.

I now revert to question (2) above. On the hypothesis that TOSG had taken assignments of the relevant debts in favour of itself, who would have been entitled to the better rights of proof as between itself and the banks? The judge considered that the substance of the relationship between Clarksons, its customers, TOSG and the banks was that the banks were sureties for Clarksons' indebtedness to one class of its creditors, namely its holidaymaker customers. He recognised that the interposition of TOSG between the banks and the customers gave rise to a distinction, but thought that it was not one which affected the substance of the relationship. As he put it: 'TSOG was merely a trustee or, if you prefer it, in the broad sense an agent, for the customers.' On the footing that the banks were to be treated as sureties for Clarksons' indebtedness to its customers, he then proceeded to draw certain analogies with the suretyship cases.

As I have already mentioned, the judge regarded the crucial question for decision as being whether at the material time the banks or the holidaymakers had the better right of proof. On this assumption and on the footing that in substance the banks were sureties for Clarksons' indebtedness to the assigning holidaymakers, I recognise that some assistance might fall to be derived from the suretyship cases, by way of analogy.

Nevertheless, for reasons which I have tried to explain, I think that for the purpose of determining priorities in the liquidation, attention must be focused not so much on the relationship between the banks and the holidaymakers as on that between the banks and TOSG. Indeed, I do not think that the banks can be treated as having had any relationship at all with the holidaymakers. When the bonding arrangements were originally made, the banks did, of course, know and contemplate that, if Clarksons' business failed, and the bond moneys became payable to TOSG, TOSG would use them, so far as necessary, to alleviate the consequences to Clarksons' customers of such failure. If, however, at the time when the bonding arrangements had been made, it had been suggested to the banks that, in the event of the liquidation of Clarksons, the banks' rights in the liquidation would have fallen to be determined on the footing that they were sureties for Clarksons'

[1984] 1 All ER 628 at 654

liabilities to its holidaymakers, I think they would have replied, and would have been justified in replying, that their relationship was solely with TOSG and Clarksons. The banks would have appreciated that, if Clarksons went into liquidation and they became obliged to pay the bond moneys to TOSG, TOSG would be entitled to spend them for the benefit of Clarksons' holidaymakers in accordance with its constitution and that they would not be entitled to complain if it did. Nevertheless, the holidaymakers would have had no rights against the banks and would have owed them no duties. The banks themselves would have had no rights against the holidaymakers and owed them no duties. In the event of the banks becoming obliged to pay the bond moneys to TOSG, their relevant rights would have been simply: (a) a right to prevent TOSG from spending the

moneys otherwise than in accordance with its constitution; (b) a right to recover from TOSG any of the moneys not expended by it; (c) a right to prove in the liquidation of Clarksons in respect of the debts which arose in the banks' favour under the counter-indemnities, immediately the bond moneys were paid to TOSG, giving credit for any moneys which might thereafter be recouped to them by TOSG. This brief analysis, to my mind, illustrates how far removed from the relationship of creditor, surety and debtor was the relationship of TOSG, the banks and Clarksons at the time when the bonding arrangements were concluded. The suretyship analogy can only give firm guidance in determining the order of priorities of the banks and TOSG (through whom the agency claims) in the liquidation of Clarksons if one identifies TOSG with the holidaymakers and this, in my opinion, is not a justifiable process.

Nevertheless, the many suretyship cases to which we have been referred do, in my opinion, show that, where both principal creditor and surety are seeking to prove in a bankruptcy in respect of what is in substance the same debt, so that a double proof situation arises, the court will seek to determine the priorities of the two supposed rights of proof by reference to the expressed or presumed intentions of the parties, as manifested in the contract by which the surety undertook his liability. In particular, it will not allow a creditor, who is at liberty to increase the balance due from the debtor, to rely on any such increase in such a manner as to prejudice the surety's rights of proof in the bankruptcy of the debtor, where to do so would be inequitable having regard to the expressed or presumed intentions of the parties as so manifested (see, for example, *Ellis v Emmanuel* (1876) 1 Ex D 157 at 163-164, [1874-80] All ER Rep 1081 at 1083 per Blackburn J). To this limited extent, I think that the suretyship cases do afford some guidance by analogy in the present case for the purpose of determining the respective priorities of the rights of proof of the banks and TOSG (through whom the agency claims) in respect of the £1·43268m.

I, therefore, revert to a consideration of the expressed and presumed intentions of the banks and TOSG as at the date when the bonding arrangements were concluded. I do not think it is disputed that TOSG, when it entered into these arrangements, was well aware of the counter-indemnities which had been or were to be given by Clarksons to the banks in respect of any moneys that might become payable by the banks to TOSG. These counter-indemnities were, I think, part of the essential background of the bonding arrangements. Since the events on which the moneys were expressed to become payable under the bonds all presupposed that Clarksons would already be in, or on the verge of, an insolvent liquidation, TOSG must have well known that the banks intended to prove in the liquidation of Clarksons in respect of any such moneys. The present contention of the agency seems to me, on analysis, by necessary implication to involve the proposition that TOSG would have been at liberty (a) to expend the entirety of the bond moneys in purchasing debts of disappointed holidaymakers, (b) then to inform the banks that not a penny was repayable to them by TOSG under the bonds, because all the bond moneys had been properly spent, and (c) then to assert that the banks had no rights to prove for anything whatever in the liquidation, since they would be proving in respect of the same debts as TOSG, and TOSG had the prior right of proof.

I would accept propositions (a) and (b) but find myself quite unable to accept proposition (c). I accept that the purchase by TOSG of debts of disappointed holidaymakers would not actually have involved any breach by TOSG of any express or implied

[1984] 1 All ER 628 at 655

contractual term of the arrangements. Nevertheless, the parties to the bonding arrangements cannot, in my opinion, reasonably be supposed to have contemplated, at the date when they were concluded, that TOSG would have the right to expend bond moneys in such manner as to elevate itself into the position of a proving creditor in Clarksons' liquidation, while at the same time finally destroying the subsisting rights of the banks both (i) to obtain any recoupment from TOSG in respect of the bond moneys, and (ii) to prove in the liquidation. Such an inference would, in my opinion, have been inconsistent with the nature of the bonding arrangements and would have produced a thoroughly inequitable result.

Accordingly, I conclude that the double proof rule applies in respect of the £1·43268m and that, if TOSG had taken an assignment of the assigning holidaymakers' debts in favour of itself, the banks would have had a better right of proof in respect of this sum. As I have already explained, I think that the agency can be in no better position than TOSG itself would have been. The banks, in my judgment, therefore have the better right of proof.

Nourse J, in reaching the contrary conclusion, relied in part on possible analogies with the reported cases concerned with principal and surety. I have already referred to this point. However, he attached greater importance on the fact that the power of TOSG 'to alleviate the consequences and so forth of Clarksons' business failure clearly enabled TOSG to recoup to the customers any shortfall remaining *after* they had received all available dividends in Clarkson's liquidation'. He concluded that in the end he did not need to rely on the analogy with the cases relating to principal and surety at all. He said:

> 'I agree with [counsel for TOSG and the agency] that the decisive feature of the present case is TOSG's power to recoup to the customers any shortfall remaining after they had received all available dividends in Clarksons' liquidation. Once you get to that stage it is apparent that it would indeed be most inequitable for the banks to claim, as against the customers, a rateable proportion of any dividends receivable or received by them. That is not a narrow equity, but a broad one. And it is a surer basis for decision than any mere analogy.'

With great respect to the judge, I am not able to agree with this reasoning for two reasons. First, the amount of the dividends available to Clarksons' customers in its liquidation must partially depend on the resolution of the very questions which are in issue in the present litigation. I find it difficult to see how in practice TOSG could possibly have awaited the completion of the liquidation of Clarksons before taking such steps as it was entitled and bound to take under its constitution for the relief of Clarksons' holidaymakers. Second, as I have already indicated, I think that, when broader questions of equity fall to be considered, the relevant comparison is not between the respective

rights of proof of the banks and of the holidaymakers, but between the respective rights of proof of the banks and TOSG. When the latter comparison is made, for the reasons which I hope will have already appeared, I am of the clear opinion that any broader considerations of equity favour the banks in preference to TOSG and likewise in preference to the agency, which claims through TOSG.

For all these reasons. I would concur in allowing this appeal.

Appeal allowed. Leave to appeal to House of Lords granted on condition that if and to the extent that the liquidators are incurred with costs in the House of Lords the agency will pay the liquidators on an indemnity basis.

Solicitors: Wilde Sapte (for the banks); Norton Rose Botterell & Roche (for TOSG and the agency); Stephenson Harwood (for the liquidators of Clarksons).

Mary Rose Plummer Barrister.

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[2011] UKSC 48

***939 In re Kaupthing Singer & Friedlander Ltd (in administration) (No 2) v**

Supreme Court

Lord Hope of Craighead, Lord Walker of Gestingthorpe, Baroness Hale of Richmond, Lord Clarke of Stone-cum-Ebony, and Lord Collins of Mapesbury

2011 July 13, 14; Oct 19

Insolvency—Administration order—Distribution of assets—Bank's subsidiary issuing floating rate notes under trust deed—Bank guaranteeing payment—Proceeds advanced to bank by way of unsecured loan—Bank and subsidiary going into administration—Trustee giving notice of default and notes becoming due and payable—Bank's administrators obtaining permission to make distributions to creditors—Equitable rule preventing person sharing in fund while own debts to fund unpaid—Whether applying until bank's right as surety to indemnity satisfied in full—Whether excluded by rule against double proof— Insolvency Act 1986, Sch B1, para 65 (c 45) (as inserted by Enterprise Act 2002, s 248, Sch 16 (c 40))— Insolvency Rules 1986 (SI 1986/1925) (as substituted by Insolvency (Amendment) Rules 2003 Sch 1, para 9 (SI 2003/1730),), r 2.95

F plc was a wholly-owned subsidiary of a bank, whose sole function was to raise funds for use by the bank and other group companies. In 2005, F plc issued £250m floating rate notes, repayable in 2010, under a trust deed made between F plc, the bank and the trustee. The bank guaranteed payment of the principal and interest on the notes and the net proceeds of the notes were advanced to the bank by way of an unsecured loan. In 2008 the bank and F plc went into administration. The trustee gave notice that an event of default had occurred in respect of the notes, with the effect that the notes became immediately due and payable, and the obligations of F plc, as principal debtor, and the bank, as guarantor, came into immediate effect. The trustee submitted to the administrators of F plc and the bank proofs of debt for principal and interest in respect of the loan notes in the sum of approximately £248.1m. F plc then submitted a proof in respect of its loan to the bank in the sum of approximately £242.6m. The bank's administrators obtained permission to make a distribution pursuant to paragraph 65 of Schedule B1 to the Insolvency Act 1986 , as amended 1 , and gave notice under rule 2.95 of the Insolvency Rules 1986 , as amended 2 , of their intention to make distributions, including to ordinary unsecured creditors. The bank's administrators applied for directions from the court as to whether, notwithstanding the rule against double proof, the distributions had to be administered so as to give effect to the rule in Cherry v Boultbee (1839) 4 My & Cr 442 that a person could not share in a fund in relation to which he was also a debtor without first contributing to the whole by paying his debt. The judge, holding himself bound by an earlier decision of the Court of Appeal, directed that the bank's ***940** administrators could rely on that rule, in respect of the proof of debt submitted by F plc, unless and until the bank's right to indemnity, as a surety, had been satisfied in full; but he granted the trustee a certificate under section 12(1) of the Administration of Justice Act 1969 for appeal direct to the Supreme Court.

On the trustee's appeal—

Held , allowing the appeal, that the effect of the long-standing rule against double proof was that so long as a creditor had not been paid in full a surety could not compete with the creditor either directly, by proving against the principal debtor for an indemnity, or indirectly, by setting off his right to an indemnity against any separate debt owed by the

surety to the principal debtor; that that rule took priority to the equitable rule in Cherry v Boultbee ; and that, accordingly, the trustee had to be paid in full before there could be any proof against F plc as the principal debtor by the bank as guarantor (post, paras 12, 53–54, 55).

Secretary of State for Trade and Industry v Frid [2004] 2 AC 506, HL(E) applied .

Cherry v Boultbee (1839) 4 My & Cr 442 , In re Binns [1896] 2 Ch 584 , In re Melton [1918] 1 Ch 37, CA , In re Fenton; Ex p Fenton Textile Association Ltd [1931] 1 Ch 85 , Luxmoore J and CA and In re Fenton; Ex p Fenton Textile Association Ltd (No 2) [1932] 1 Ch 178 considered .

In re SSSL Realisations (2002) Ltd [2006] Ch 610, CA disapproved .

Decision of Sir Andrew Morritt C [2009] EWHC 3377 (Ch); [2010] WTLR 235 reversed.

The following cases are referred to in the judgments:

- Abrahams, In re [1908] 2 Ch 69
- Akerman, In re [1891] 3 Ch 212
- Auriferous Properties Ltd, In re [1898] 1 Ch 691
- Auriferous Properties Ltd, In re (No 2) [1898] 2 Ch 428
- Barclays Bank Ltd v TOSG Trust Fund Ltd [1984] AC 626; [1984] 2 WLR 49; [1984] 1 All ER 628, CA
- Binns, In re [1896] 2 Ch 584
- Cherry v Boultbee (1838) 2 Keen 319; (1839) 4 My & Cr 442
- Fenton, In re; Ex p Fenton Textile Association Ltd [1931] 1 Ch 85, Luxmoore J and CA
- Fenton, In re; Ex p Fenton Textile Association Ltd (No 2) [1932] 1 Ch 178
- Glen Express Ltd, In re [2000] BPIR 456
- Jeffs v Wood (1723) 2 P Wms 128
- Melton, In re [1918] 1 Ch 37, CA
- Midland Banking Co v Chambers (1869) LR 4 Ch App 398
- Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd (Revenue and Customs Comrs intervening) [2011] UKSC 38; [2011] 3 WLR 521; [2011] Bus LR 1266, SC(E)
- Oriental Commercial Bank, In re; Ex p European Bank (1871) LR 7 Ch App 99
- Overend Gurney & Co, In re; Grissell's case (1866) LR 1 Ch App 528
- Peruvian Railway Construction Co Ltd, In re [1915] 2 Ch 144; [1915] 2 Ch 442, CA
- Polly Peck International plc, In re [1996] 2 All ER 433
- Rhodesia Goldfields Ltd, In re [1910] 1 Ch 239
- SSSL Realisations (2002) Ltd, In re [2004] EWHC 1760 (Ch); [2005] 1 BCLC 1; [2006] EWCA Civ 7; [2006] Ch 610; [2006] 2 WLR 1369, CA
- Secretary of State for Trade and Industry v Frid [2004] UKHL 24; [2004] 2 AC 506; [2004] 2 WLR 1279; [2004] 2 All ER 1042, HL(E)
- Stein v Blake [1996] AC 243; [1995] 2 WLR 710; [1995] 2 All ER 961, HL(E)
- West Coast Gold Fields Ltd, In re; Rowe's Trustee's Claim [1905] 1 Ch 597; [1906] 1 Ch 1, CA

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- Willes v Greenhill (1860) 29 Beav 376

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The following additional cases were cited in argument:

- Anson v Anson [1953] 1 QB 636; [1953] 1 WLR 573; [1953] 1 All ER 867
- Cattles plc v Welcome Financial Services Ltd [2010] EWCA Civ 599; [2010] 2 Lloyd's Rep 514; [2010] 2 BCLC 712, CA
- Davies Chemists Ltd, In re [1993] BCLC 544
- Davies v Humphreys (1840) 6 M & W 153
- Debtor (No 627 of 1936), In re A [1937] Ch 156; [1937] 1 All ER 1
- Ellis v Emmanuel (1876) 1 Ex D 157, CA
- Ewart v Latta (1865) 4 Macq 983
- Flightlease Holdings (Guernsey) Ltd v Flightlease (Ireland) Ltd 2009–10 GLR 38
- Hodgson, In re (1878) 9 Ch D 673
- Kenway Investments (Australia) Pty Ltd v Teamda Developments Pty Ltd [2007] NSWSC 48
- Leeds and Hanley Theatres of Varieties Ltd, In re [1904] 2 Ch 45
- Lennard, In re [1934] Ch 235
- Liberty Mutual Insurance Co (UK) Ltd v HSBC Bank plc [2002] EWCA Civ 691, CA
- MS Fashions Ltd v Bank of Credit and Commerce International SA [1993] Ch 425; [1993] 3 WLR 220; [1993] 3 All ER 769; [1993] BCLC 1200, Hoffmann J and CA
- Mac-Jordan Construction Ltd v Brookmount Erostin Ltd [1992] BCLC 350, CA
- National Live Stock Insurance Co Ltd, In re [1917] 1 Ch 628
- Sass, In re; Ex p National Provincial Bank of England Ltd [1896] 2 QB 12
- Thomas v Nottingham Incorporated Football Club Ltd [1972] Ch 596; [1972] 2 WLR 1025; [1972] 1 All ER 1176

APPEAL from Sir Andrew Morritt C

Margaret Mills, Alan Bloom, Thomas Burton and Patrick Brazzill, the joint administrators of Kaupthing Singer & Friedlander Ltd (in administration) (“KSF”), applied for directions pursuant to rule 2.95 of the Insolvency Rules 1986 , as amended, in respect of distributions to be made under paragraph 65 of Schedule B1 to the Insolvency Act 1986 , as amended. On 18 December 2009 Sir Andrew Morritt C declared and directed that (1) clause 7.7 of the trust deed dated 9 February 2005 between Singer & Friedlander Funding plc (“Funding”), KSF and HSBC Trustee (CI) Ltd as trustee did not prevent the administrators of KSF from relying on the rule in Cherry v Boultbee (1839) 4 My & Cr 442 in respect of the proof of debt submitted by Funding to the administrators of KSF; and (2) the administrators of KSF could rely on the rule in Cherry v Boultbee in respect of the proof of debt submitted by Funding to the administrators of KSF unless and until KSF's right of indemnity, including any part of that right which was contingent, had been satisfied in full.

The trustee appealed, with permission granted on 7 April 2010 by the Supreme Court (Lord Hope of Craighead DPSC, Lord Walker of Gestingthorpe and Lord Clarke of Stone-cum-Ebony JJSC) and

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pursuant to a certificate granted by Sir Andrew Morritt C under section 12 of the Administration of Justice Act 1969 that a sufficient case had been made out for appeal direct to the Supreme Court. The issues for the Supreme Court, as set out in the parties' statement of agreed facts and issues, were as follows. (1) In circumstances where the trustee was already proving against Funding for the entirety of the outstanding principal and interest due in respect of the notes, whether KSF and/or its administrators were prevented from relying on the rule in Cherry v Boultbee in respect of KSF's contingent right to a counter-indemnity from Funding by reason of the rule against double proof. ***942** (2) Alternatively, whether KSF and/or its administrators were in any event prevented from relying on the rule in Cherry v Boultbee in respect of Funding's proof of debt by reason of the terms of clause 7.7 of the trust deed. (3) If KSF and/or its administrators were not so prevented: (i) whether the mode of application of the rule in Cherry v Boultbee in a guarantee situation involving insolvent companies permitted KSF and/or its administrators to rely on Cherry v Boultbee on the basis of the maximum theoretical right to a counter-indemnity as against Funding; (ii) if not, whether the correct mode of application of the rule in Cherry v Boultbee limited KSF and/or its administrators' ability to rely on the rule in Cherry v Boultbee to those amounts actually paid, alternatively paid and likely to be paid, by KSF as guarantor of Funding's obligations, or some other amount (and if so, what amount); (iii) whether, by reason of clause 7.7 of the trust deed, any part of the assets which would have been paid to Funding by way of dividend but for the application of the rule in Cherry v Boultbee were held on trust for the trustee.

The facts are stated in the judgment of Lord Walker of Gestingthorpe JSC.

Gabriel Moss QC and *Richard Fisher* (instructed by *Allen & Overy LLP*) for the trustee.

Robin Dicker QC and *Tom Smith* (instructed by *Freshfields Bruckhaus Deringer LLP*) for the administrators of KSF.

The court took time for consideration.

19 October 2011. The following judgments were handed down.

LORD WALKER OF GESTINGTHORPE JSC (with whom BARONESS HALE OF RICHMOND, LORD CLARKE OF STONE-CUM-EBONY JJSC and LORD COLLINS OF MAPESBURY

agree.)

1 This appeal is concerned with the long-standing principle of insolvency law known as the rule against double proof. It originated in the law of individual bankruptcy but has since the Companies Act 1862 (25 & 26 Vict c 89) applied to the winding up of companies. It now extends to distributions made by administrators under paragraph 65 of Schedule B1 to the Insolvency Act 1986 , as substituted by section 248 of and Schedule 16 to the Enterprise Act 2002 . Like the anti-deprivation rule recently considered by the Supreme Court in Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd (Revenue and Customs Comrs intervening) [2011] 3 WLR 521 , the rule against double proof is implicit in the Insolvency Act 1986 . In the words of Neuberger J in In re Glen Express Ltd [2000] BPIR 456 , 460, it “remains good law. It is an overarching principle which still applies to insolvency, and nothing in Stein v Blake [1996] AC 243 calls it into question”.

The facts

2 The appeal is concerned with distributions made and to be made by the administrators of Kaupthing Singer & Friedlander Ltd (“KSF”), a bank which went into administration during the financial crisis in October 2008. The disputed issues as to the rule against double proof arise, as is generally the case, in the context of suretyship. KSF has a wholly-owned subsidiary ***943** named Singer & Friedlander Funding plc (“Funding”), which is also in administration. Funding's sole function was to raise

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funds for use by KSF and other group companies. In 2005 Funding issued £250m floating rate notes repayable in 2010. They were constituted under a trust deed dated 9 February 2005 made between Funding, KSF (then named Singer & Friedlander Ltd) and HSBC Trustee (CI) Ltd ("the trustee"). By clause 7 of the trust deed KSF guaranteed payment of principal and interest on the notes and performance of Funding's other obligations under the trust deed. The correct construction of clause 7 (and in particular the non-competition provisions in clause 7.7) is one of the issues in the appeal.

3 The net proceeds of the notes (approximately £249.5m) were advanced by Funding to KSF by way of unsecured loan. When KSF went into administration on 8 October 2008 it owed Funding approximately £242.6m. When Funding went into administration on 15 October 2008 the amount of principal prospectively due on the notes was (following the buyback and cancellation of some of the notes during 2008) approximately £240.3m. On 23 March 2009 the trustee gave notice that an event of default had occurred in respect of the notes. The effect of this was that the notes became immediately due and payable, and the obligations of Funding (as principal debtor) and KSF (as guarantor) came into immediate effect.

4 On 28 April 2009 the trustee submitted to Funding's administrators, and also to KSF's administrators, proofs of debt for principal and interest in respect of the loan notes in the sum of approximately £248.1m in each case. Those proofs have been admitted. On 8 May 2009 Funding submitted a proof in respect of its loan to KSF in the sum of approximately £242.6m. KSF's administrators have indicated that, subject to the issues raised in this appeal, they intend to admit Funding's proof.

5 On 20 May 2009 KSF's administrators gave notice of their intention to make distributions in the administration, including distributions to ordinary unsecured creditors. This notice was given under rule 2.95 of the Insolvency Rules 1986 (SI 1986/1925), as amended by paragraph 9 of Schedule 1 to the Insolvency Amendment Rules 2003 (SI 2003/1730), and with the permission of the court granted by an order of Henderson J made on 24 April 2009. KSF has numerous creditors who have already received dividends amounting to 58p in the pound (or in the case of Funding, had provision made for payment, subject to this appeal). By contrast Funding has only one creditor other than the trustee, that is HM Revenue and Customs, which has proved for the relatively trivial sum of £2,654.10. Funding has no assets other than its loan to KSF. It has an issued capital, fully paid up, of only £12,500. The administrators of Funding have not given notice of an intention to make distributions in their administration. Mr Dicker QC, for the administrators of KSF, drew attention to this fact but did not take any point on it.

The proceedings

6 This is a leapfrog appeal to the Supreme Court under section 12 of the Administration of Justice Act 1969 . The administrators of KSF applied to the Chancery Division for directions. The matter came before Sir Andrew Morritt C. At the hearing the trustee recognised that the Chancellor was bound by the decision of the ***944** Court of Appeal in In re SSSL Realisations (2002) Ltd [2006] Ch 610 , in which the Court of Appeal had in comparable circumstances applied the equitable principle known as the rule in Cherry v Boultbee (1839) 4 My & Cr 442 . The only issue argued before the Chancellor was whether clause 7.7 of the trust deed excluded that rule. But the trustee made clear its intention to argue in the Supreme Court, if granted permission to appeal, that In re SSSL was wrongly decided. Funding's administrators were joined in the proceedings but were not represented.

7 The Chancellor's order dated 18 December 2009 declared that the rule in Cherry v Boultbee was not excluded and directed that the administrators of KSF might rely on it unless and until KSF's right to indemnity (as a surety) had been satisfied in full. He granted a certificate under section 12 of the 1969 Act that there was a point of law of general

public importance on which he was bound by a fully considered judgment of the Court of Appeal. The Supreme Court gave the trustee permission to appeal. Both sets of administrators are respondents to the appeal but, again, Funding's administrators have not been represented.

The rule against double proof

8 The expression "the rule in Cherry v Boultbee " suggests a technical rule of some complexity. Any such impression would be misleading. It is basically a simple technique of netting-off reciprocal monetary obligations, even where there is no room for legal set-off, developed and used by masters in the Court of Chancery in giving directions for the administration of the estates of deceased persons. Complication arises only in a situation of insolvency, where the equitable rule produces a different outcome from that produced by statutory set-off (see para 43 below).

9 This appeal ultimately turns on what function, if any, the equitable rule has to perform in the operation of the rule against double proof as it applies in suretyship situations. The appellant trustee, on behalf of the noteholders, submits that it would be irrational and unfair to apply it in circumstances in which there is clear House of Lords authority (Secretary of State for Trade and Industry v Frid [2004] 2 AC 506) that statutory set-off does not apply. The active respondents, the administrators of KSF, submit that its application is required by two decisions of the Court of Appeal, In re Melton [1918] 1 Ch 37 and In re SSSL [2006] Ch 610 , and that they were rightly decided. The starting point in understanding and resolving this issue must be, not Cherry v Boultbee , but the rule against double proof as it applies to suretyship.

10 One of the earliest judicial expositions of that rule was by Mellish LJ in In re Oriental Commercial Bank (1871) LR 7 Ch App 99 , 103–104:

"But the principle itself—that an insolvent estate, whether wound up in Chancery or in Bankruptcy, ought not to pay two dividends in respect of the same debt—appears to me to be a perfectly sound principle. If it were not so, a creditor could always manage, by getting his debtor to enter into several distinct contracts with different people for the same debt, to obtain higher dividends than the other creditors, and perhaps get his debt paid in full. I apprehend that is what the law does not allow; the true principle is, that there is only to be one dividend in respect of what is in substance the same debt, although there may be two separate contracts."***945**

11 The function of the rule is not to prevent a double proof of the same debt against two separate estates (that is what insolvency practitioners call "double dip"). The rule prevents a double proof of what is in substance the same debt being made against the same estate, leading to the payment of a double dividend out of one estate. It is for that reason sometimes called the rule against double dividend. In the simplest case of suretyship (where the surety has neither given nor been provided with security, and has an unlimited liability) there is a triangle of rights and liabilities between the principal debtor (PD), the surety (S) and the creditor (C). PD has the primary obligation to C and a secondary obligation to indemnify S if and so far as S discharges PD's liability, but if PD is insolvent S may not enforce that right in competition with C. S has an obligation to C to answer for PD's liability, and the secondary right of obtaining an indemnity from PD. C can (after due notice) proceed against either or both of PD and S. If both PD and S are in insolvent liquidation, C can prove against each for 100p in the pound but may not recover more than 100p in the pound in all.

12 The primary purpose of the rule has been described as the protection of other creditors of PD against unfair treatment by an arrangement under which there are multiple creditors in respect of the same debt: Swinfen Eady LJ in In re Melton [1918] 1 Ch 37 , 48 citing Mellish LJ in In re Oriental Commercial Bank LR 7 Ch App 99 , 103. There is a full discussion of the purpose and scope of the rule

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in the judgment of Oliver LJ in Barclays Bank Ltd v TOSG Trust Fund Ltd [1984] AC 626 , 636–644. The much-quoted example given by Mellish LJ may seem surprising, since in a suretyship situation there are on the face of it two debtors and one creditor. But the surety is also potentially a creditor of the principal debtor, because of his right to an indemnity. The effect of the rule is that so long as C has not been paid in full, S may not compete with C either directly by proving against PD for an indemnity, or indirectly by setting off his right to an indemnity against any separate debt owed by S to PD. The position was summarised by Lord Hoffmann, with whom the rest of the appellate committee agreed, in Secretary of State for Trade and Industry v Frid [2004] 2 AC 506 , para 13, commenting on In re Fenton; Ex p Fenton Textile Association Ltd (“ In re Fenton (No 1)”) [1931] 1 Ch 85 :

“ In re Fenton; Ex p Fenton Textile Association Ltd [1931] 1 Ch 85 was another case of a surety under a pre-insolvency guarantee, but this time he had not actually paid. Nor could he pay, because he was bankrupt and his assets had vested in his trustee. The creditor was still owed the money and entitled to prove in the liquidation. The Court of Appeal held, first, that one could not have more than one proof in respect of the same debt (‘the rule against double proof’); otherwise, if there had been, say, four guarantors, there could have been five people receiving dividends on the same debt. Secondly, the Court of Appeal said that until the creditor had been paid, he had the superior right of proof and a proof by a surety was excluded. Thirdly, the court said that a debt which could not be proved could not be relied upon for set-off. There is no longer doubt about any of these propositions. But the judgments of Lawrence and Romer LJJ make it clear (that of Lord Hanworth MR is a little obscure) that if the guarantor had paid off the debt after the insolvency date, he would have been entitled to set it off against a debt which he owed to the company.” ***946**

The rule in Cherry v Boultbee

13 After that brief introduction to double proof (it will be necessary to return to it in more detail) it is appropriate to go back in time to the origins and development of the equitable rule. The rule was described as follows by Kekewich J in In re Akerman [1891] 3 Ch 212 , 219:

“A person who owes an estate money, that is to say, who is bound to increase the general mass of the estate by a contribution of his own, cannot claim an aliquot share given to him out of that mass without first making the contribution which completes it. Nothing is in truth retained by the representative of the estate; nothing is in strict language set off; but the contributor is paid by holding in his own hand a part of the mass, which, if the mass were completed, he would receive back. That is expanding what the Lord Chancellor calls in Cherry v Boultbee ‘a right to pay out of the fund in hand,’ rather than a set-off …” In re Akerman was not an insolvency case. The issue was whether in the division of the testator's residuary estate three of the testator's seven children had to bring into account statute-barred debts due to the estate. It was held that they were bound to bring them into account.

14 The early cases on the rule were mostly concerned with testamentary gifts in favour of relatives who were debtors of the testator (or testatrix). Some of them became bankrupt. Three points should be noted. First, it was only later, and by analogy, that the rule was extended to cases not concerned with the administration of deceased persons' estates. Second, the beneficiary's bankruptcy sometimes occurred before, and sometimes after, the death on which the testamentary disposition took effect, and the sequence of events may make a difference. Third, very few of the early cases involved suretyship.

15 The earliest case that calls for mention is Jeffs v Wood (1723) 2 P Wms 128 . Jeffs senior made a will appointing his son Jeffs junior as his executor and leaving a legacy of £500 to his nephew Wood, who was indebted to the testator in a smaller sum. Wood was made bankrupt after the testator's death,

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[2011] UKSC 48 [2011] 3 W.L.R. 939 (2011) 161 N.L.J. 1485 [2011] N.P.C. 105 Times, November 14, 2011 Official Transcript [2011] UKSC 48 [2011] 3 W.L.R. 939 (2011) 161 N.L.J. 1485 [2011] N.P.C. 105 Times, November 14, 2011 Official Transcript
(Cite as: [2011] 3 W.L.R. 939)

but before the legacy had been paid. Sir Joseph Jekyll MR directed the executor to pay Wood the balance of the legacy after retention by the executor of the full amount of Wood's debt to the testator.

16 If Jeffs v Wood is (as some authorities have suggested) the first clear application of the equitable rule, then Cherry v Boultbee 4 My & Cr 442 , which has given its name to the rule, is an illustration of how it operates differently where the beneficiary became bankrupt before the will took effect. The facts are more fully stated in the first instance report (1838) 2 Keen 319 . Thomas Boultbee owed £1,878 to his sister Catherine, who left him legacies totalling £2,500. He became bankrupt in 1821. She died in 1823, and Thomas's assignee in bankruptcy claimed the legacy from Catherine's executors. Lord Cottenham LC held that the executor could deduct from the legacies (which had in any event abated) only so much of the debt as would have been paid as a dividend in Thomas's bankruptcy (in which Catherine had not proved).

17 The reasoning behind the different outcome in the later case appears at p 447: "the bankruptcy of the debtor having taken place in the lifetime of the testatrix, her executors never were entitled to receive from the assignee more than the dividends upon the debt." The underlying principle appears ***947** even more clearly in later cases. In Willes v Greenhill (1860) 29 Beav 376 the testator had in 1830 backed a bill for his son Henry. It was dishonoured, and after the testator's death in 1832 his executors met the liability. Henry had a one-sixth interest, subject to his mother's life interest, in the residuary trust fund. Henry mortgaged this interest and the mortgage was transferred to Willes. The issue of priority in the distribution of Henry's share arose on the widow's death in 1849. Sir John Romilly MR held that the executors' right to make an adjustment to indemnify themselves took priority to the rights of the mortgagee. It was not a bankruptcy case, but it brings out the proprietary character of the rights of those who participate (whether as creditors, legatees or shareholders) in the distribution of a fund held or administered by fiduciaries. The inception of the administration (or bankruptcy, or liquidation) crystallises the position, and persons who were previously unsecured creditors obtain proprietary interests of a sort (though they may ultimately prove worthless because others take priority).

18 The rule was applied in the compulsory liquidation of a company in In re Rhodesia Goldfields Ltd [1910] 1 Ch 239 . Partridge, a director of the company who held some of its debenture stock, was facing a serious misfeasance claim which had not yet been resolved. Set-off was therefore not available. But Swinfen Eady J said, at p 247, that "it would be a strange travesty of equity to hold that in distributing the fund Partridge was entitled to be paid at once all that was due to him out of the company's money, and subsequently to find, after it had been established that he owed money to the fund, that the amount could not be recovered from him." Payment of what was due to Partridge and his assignees was therefore deferred until the claim against him was resolved.

19 The rule was applied again by Sargant J in In re Peruvian Railway Construction Co Ltd [1915] 2 Ch 144 (upheld by the Court of Appeal in brief judgments [1915] 2 Ch 442). William Alt died insolvent in 1908. His estate included shares in the company, which went into voluntary liquidation in 1914. Alt was indebted to the company in the sum of £2,633 (as certified by the master in the administration of the insolvent estate). It was held that in the distribution of the company's surplus assets the liquidator could retain out of the fund, on account of Alt's debt, only the amount of the dividend on the debt. Sargant J distinguished other cited authorities, at p 153, as having "an entire absence of the special feature present in Cherry v Boultbee and in the case before me, namely, the insolvency of the original debtor before the right of retainer or quasi set-off had first arisen".

20 Sargant J's judgment contains a full review of the authorities. These included In re Auriferous

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Properties Ltd (No 2) [1898] 2 Ch 428 and In re West Coast Gold Fields Ltd; Rowe's Trustee's Claim [1905] 1 Ch 597 . These cases concerned claims made in liquidations by creditors who were also holders of shares which were not fully paid up. In each case it was held, following the seminal decision of Lord Chelmsford LC and the Lord Justices in In re Overend Gurney & Co; Grissell's case (1866) LR 1 Ch App 528 , that the claimant could recover nothing as a creditor until all his liability as a contributory had been discharged. Buckley J said in In re West Coast Gold Fields Ltd [1905] 1 Ch 597 , 602 (where the shareholder was bankrupt but the company solvent and in voluntary liquidation): ***948**

"The right view is that the person liable as contributory must discharge himself in that character before he can set up that, as a creditor, he is entitled to receive anything, and a fortiori, as it seems to me, before he can set up that, as a contributory, he is entitled to receive anything." That decision was upheld by the Court of Appeal in a brief judgment of the court [1906] 1 Ch 1 . The payment-up of the shares in full was a condition precedent to any participation in the distribution of surplus assets. In this appeal the trustee's case is that payment-off in full of the trustee as creditor is a condition precedent to the admission of any proof against Funding by KSF as surety.

In re Melton, In re Fenton (No 1) and In re Fenton (No 2)

21 In re Melton [1918] 1 Ch 37 and the two cases of In re Fenton (No 1) [1931] 1 Ch 85 and In re Fenton (No 2) [1932] 1 Ch 178 are discussed at length in the judgment of Chadwick LJ in In re SSSL [2006] Ch 610 , paras 69–91, and In re Melton was the principal authority relied on in the Court of Appeal's reasoning in In re SSSL . It is therefore necessary to look at these cases, and especially In re Melton , in some detail.

22 The facts of In re Melton were quite complicated and it is important to note the sequence of events. Richard Melton was married, with one son Arthur, and three daughters. In 1901 Richard and another surety gave a joint and several guarantee in respect of Arthur's bank overdraft, limited to £500. Richard died in 1907. By his will he settled his real estate on his wife for life and then on trust for sale for his four children in equal shares. His personal estate was very small. In 1910 Arthur mortgaged his one-quarter interest in expectancy to the bank. In 1911 Arthur absconded and later in that year he was adjudicated bankrupt. He then owed the bank £1,057. The bank valued its security at £158 and proved for the balance. It received a dividend of £494 in Arthur's bankruptcy.

23 By then both sureties were dead and the bank called on their respective executors to pay £500, with interest from the date of demand. The other set of executors paid £250 and their share of the interest. Richard's executors had no funds available and had to go to court for power to raise money on the settled real estate. They obtained authority, raised £420, and paid £313 to the bank, representing £250 together with interest. In 1916 the widow died and the trust for sale arose. The land was sold for about £1,600 net of the mortgage and costs. Three-quarters of the fund was distributable to the daughters. Arthur's mortgaged quarter share had been sold by the bank and purchased by Frances, the deserted wife of the absconding Arthur. The question was whether Frances, as assignee of Arthur's original interest, must bring into account the £313 paid by the executors to the bank. Astbury J held that she must. Frances appealed. The daughters opposed her appeal. The executors were neutral, and neither Arthur's trustee in bankruptcy nor the bank was a party.

24 In the Court of Appeal all three members of the court (Swinfen Eady, Warrington and Scrutton LJJ) delivered full judgments. All of them attached great weight to the sequence of events. The testator had before his death incurred a potential liability as surety to the bank, with a concomitant potential right to indemnity if the surety was called on to

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pay, and the bank was (by one means or another) paid off in full. The law report does not state ***949** in terms that the bank was paid off in full, but both the statement of facts, and the judgments, seem to proceed on the basis that the bank had no further claim against either the surety or the estate of the principal debtor. The testator's potential liability was a liability which affected the administration of his estate prior to Arthur's bankruptcy, and it matured into an immediate liability when the bank called on the executors to pay, and £313 was eventually paid. Similarly the potential right to an indemnity was a contingent asset of the estate prior to Arthur's bankruptcy, and it matured into an immediate claim when the £313 was paid, apparently in full and final satisfaction of the bank's claims against anyone.

25 The proprietary character of the rights (or “equities”) arising from this sequence of events was reflected (though expressed in rather different terms) in all three judgments in the Court of Appeal in In re Melton [1918] 1 Ch 37 . Swinfen Eady LJ stated, at p 52 (speaking of In re Binns [1896] 2 Ch 584 , a comparable case where there were two sons made bankrupt after the death of their father, the surety):

“The fallacy is that at the date of the bankruptcy what was claimed was not part of the debtor's estate. An equity that the testator's estate should be indemnified in respect of his liability under the guarantee arose at his death; and when the sons became bankrupt there was already an equity subject to which the trustees in bankruptcy took the sons' interests; and the trustees in bankruptcy took nothing more than the debtors had, and the debtors' interests under the will were subject to this equity.” In this passage the word “equity” is used three times. It is not fully explained but it emphasises that an unsecured right of indemnity had, on the testator's death, acquired some sort of proprietary character.

26 Similarly Warrington LJ stated, at p 57:

“What the trustees are here claiming never was distributable amongst the creditors of the bankrupt at all. I think, therefore, in the present case, on the simple ground that the right of the trustees to retain is in respect of something which at the date of the bankruptcy did not form part of the estate distributable amongst the creditors of the bankrupt, the trustees are still entitled to the right they then had. If it were necessary for the purposes of this decision—I do not think it is—I should, as at present advised, be prepared to say that the trustees in respect of their claim are in the position of secured creditors; for their right, as expressed by the Lord Chancellor in Cherry v Boultbee , seems to me to have all the characteristics of a depository lien.”

27 Scrutton LJ reached the same conclusion, though he saw it in less definitely proprietary terms, at p 60:

“Speaking for myself, I am not prepared to say that this right of the executor is a mortgage, charge or lien. I do not wish finally to decide that, because the question may directly arise in other cases, but, as at present advised, I do not see how that can be called a lien. Equally, however, I see nothing in section 7(1) of the Bankruptcy Act 1914 , to prevent the exercise of this right; it is not the use of a remedy against the property or person of the debtor, which the creditor is forbidden to make use of, unless he is a secured creditor. It appears to me to be simply a right to see ***950** that the person who claims a share of the testator's estate claims only the proper share …” So the appeal was dismissed.

28 In In re Melton [1918] 1 Ch 37 all three members of the court considered that In re Binns [1896] 2 Ch 584 had been wrongly decided, and was based on a fallacy which had already been exposed in Midland Banking Co v Chambers (1869) LR 4 Ch App 398 . This point played an important part in the reasoning of Swinfen Eady LJ [1918] 1 Ch 37 , 51–52, and Warrington LJ, at pp 56–57. Midland Banking Co v Chambers and In re Binns were both cases concerned with insolvency and suretyship, but with the further element of security being

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provided—in the earlier case by PD to S, and in the later case by S to C.

29 In the earlier case (LR 4 Ch App 398) Thorpe gave the bank a guarantee, limited to £300, of Mercer's overdraft. The guarantee was given in 1865. In 1866 Mercer made an assignment to trustees for his creditors, which was equivalent to bankruptcy. At some time before then Mercer granted Thorpe a mortgage to indemnify him. Mercer's overdraft stood at £410. The trustees sold the mortgaged property and paid Thorpe £300, which he paid to the bank. The issue between the bank and the trustees was whether the bank could prove for £410 or only £110. It was not argued that the security was a fraudulent preference. Malins V-C held that the bank could prove for the full sum, and the trustees appealed.

30 The Lord Justices dismissed the appeal. The trustees argued that the £300 had been paid out of PD's estate, but that was dismissed as a fallacy because S had the benefit of a valid security granted prior to the bankruptcy. Giffard LJ said, at p 402, that the £300 "was paid out of something which, having before the execution of the creditors' deed been dedicated to the purpose of indemnifying the surety, was not, at the time of the execution of that deed, part of the debtor's estate." There was also a question of construction of the guarantee which both courts resolved in favour of the bank.

31 In In re Binns [1896] 2 Ch 584 the security was the other way round. In 1894 William Binns deposited £2,400 in his own name with the bank where two of his sons, who traded as J & F Binns, had an overdraft. William signed a letter in these terms: "I hereby declare that my deposit of £2,400 is lodged with you as a continuing security for any amount that may from time to time be owing to you by J & F Binns." In 1895 William died leaving each son a legacy and a one-sixth share of his residuary estate. The overdraft then stood at £8,858. A few months later the sons were made bankrupt. The bank proved for the whole overdraft debt but was unlikely to receive more than about £3,300 by way of dividend. It had not yet appropriated the £2,400 deposit but it was accepted that it would do so.

32 The issue was between the sons' trustees in bankruptcy, who contended that the sons' beneficial interests under the will were assets available for their creditors, and the trustees of the father's will, who contended that they could retain the sons' beneficial interests in order to indemnify the father's estate against the £2,400 which he had deposited. The trustees in bankruptcy were represented by Mr Swinfen Eady QC, who argued that the trustees of the will had no right to prove in the bankruptcy, because the bank had proved for the whole overdraft debt and it was "gone" ***951** (in the sense, it seems, of being incapable of proof again, because of the rule against double proof).

33 This argument was accepted by North J. He said, at p 588 (but using PD, S and C):

"But the difficulty in [S's] way is this—that there is no debt in respect of which [S] can at present claim to retain anything as against [PD]. The claim against [PD] is made by [C]; and [S] cannot as against [C] set up an adverse claim of any kind. No doubt when [C] have been paid in full the position of matters would be different …" North J went on to explain that, on the facts, there was no real prospect of the bank ever being paid in full. Warrington LJ criticised North J in In re Melton [1918] 1 Ch 37 , 57 but he was mistaken in his premise, at p 56, that the facts of In re Binns were "undoubtedly, for all substantial purposes, identical" with those of In re Melton . In In re Melton the bank had been paid in full; in In re Binns the bank had not been paid in full, and was never going to be paid in full. Moreover in In re Melton there was no question of anything in the testator's estate going to the bankrupt son's trustee: his interest had been mortgaged and then sold and Frances (the deserted wife) was a purchaser for value (but only of an equitable interest, and with notice of the equity of indemnification). In In re Binns , by contrast, the sons' interests under their father's will were available to their trustees in bankruptcy, and the diversion of those

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interests to other members of the family would have meant that S was in competition with C while C's claims had not been fully satisfied.

34 There is also the question why Swinfen Eady LJ, having won In re Binns as leading counsel about 20 years before, said in his judgment in In re Melton [1918] 1 Ch 37 that it was fallacious and wrongly decided. The relevant passage is at pp 51–52 and it is not at all easy to follow. Swinfen Eady LJ said twice that North J fell into the same fallacy as was exposed by Giffard LJ in Midland Banking Co v Chambers LR 4 Ch App 398 , but the facts and the issues in that case were quite different. In the later case S had provided security to C; in the earlier case PD had provided security to S, and the security had been dealt with in an unusual way (by a mortgagor's sale, not a mortgagee's) which left room for argument about where the £300 should be treated as coming from. The reasoning in In re Melton does not satisfy me that In re Binns was wrongly decided. That does not however cast any doubt on the correctness of the decision in In re Melton , the facts of which were quite unusual.

35 I come next to the two In re Fenton cases: In re Fenton (No 1) [1931] 1 Ch 85 and In re Fenton (No 2) [1932] 1 Ch 178 . Fenton had a large holding of shares in a company (referred to as the association) which owned woollen mills. He was also heavily indebted to the association. In 1921 he made an arrangement with his creditors and the association submitted a proof for over £550,000, subsequently reduced to about £423,000. Fenton had entered into four limited guarantees of bank loans in respect of which the association was the principal debtor. The total liabilities under these guarantees amounted to £166,795, which his trustee sought to set off against the debt proved by the association. The association itself went into compulsory liquidation in 1923. The banks were unsecured creditors of the association and only one of them proved in the liquidation, because there ***952** was going to be nothing left for unsecured creditors (this was established in the Court of Appeal; at first instance the judge was told that none of the banks had proved). The banks proved against Fenton for the total sum of £166,795.

36 Luxmoore J at first instance, In re Fenton (No 1) [1931] 1 Ch 85, permitted the set-off in full. The Court of Appeal unanimously allowed an appeal by the association's liquidator. The judgment of Lord Hanworth MR is a little obscure (as Lord Hoffmann put it in Secretary of State for Trade and Industry v Frid [2004] 2 AC 506 , para 13). Much of it was concerned with a discussion of the need for mutuality in set-off; but in the final passage (at [1931] 1 Ch 85 , 109–110) he referred to In re Oriental Commercial Bank LR 7 Ch App 99 , 103 and relied on the rule against double proof. So did Lawrence LJ at [1931] 1 Ch 85 , 114, addressing the situation where both principal debtor and surety are bankrupt:

"The reason why, in my opinion, such a claim … cannot be set off is because so long as the estate of the principal debtor remains liable to the principal creditor the surety will not be permitted to prove against the estate of the principal debtor, as such a proof would be a double proof for the same debt, and would therefore be inadmissible as being contrary to the established rule in bankruptcy." Romer LJ agreed. He said, at pp 119–120:

"In the present case, if Fenton, not having paid the banks anything under his guarantee, were entitled to prove in the winding-up of the association, or if, having paid them less than the amount due to them, he were to prove for the amount so paid, and the banks were also to prove in the winding-up of the association for the full sum due to them, as they would be entitled to do, the estate of the association would be subjected to more than one proof in respect of the same debt, and this is not permissible."

37 A further issue in the liquidation of the association came before Luxmoore J a year later: In re Fenton (No 2) [1932] 1 Ch 178 . Fenton's trustee in bankruptcy had declared a dividend of one shilling (5p) in the pound and the question was whether the

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trustee could withhold the association's dividend because of Fenton's liability on his guarantees to the banks, and his potential right to an indemnity. The judge held (rather surprisingly, in view of the passage from Romer LJ's judgment quoted above) that this point had not been decided by the Court of Appeal. The argument for Fenton's trustee was that so long as the association was indebted, either immediately or contingently, to Fenton's estate, the association should receive no dividend, despite the fact that it had proved for a separate liability of £423,000. Luxmoore J rejected this for essentially the same reason as the Court of Appeal had rejected set-off in the earlier proceedings, at pp 187–188:

"But the position is further complicated by the fact that the banks have already proved or are entitled to prove against the assets of the association in respect of the whole of the sum guaranteed, and consequently if the trustee of the deeds of arrangement should retain out of the dividend payable to the association a sum equal to the dividend on ***953** the total amount due to the banks under the guarantee, there would in effect be an allowance against the association of two dividends in respect of what is for all practical purposes the same debt, and so the rule against double proof would be infringed." In other words S (Fenton's estate) would be competing with C (the banks, which had not been, and never were going to be, paid in full) in claiming (whether directly or by set-off or retention) against PD (the association). The Court of Appeal in In re SSSL [2006] Ch 610 held that Fenton (No 2) was wrongly decided.

In re SSSL: introduction

38 Both the facts and the issues in In re SSSL were complicated. Remarkably, the point now at issue was not raised at all at first instance, and so the Supreme Court has not been referred, except in passing, to the judgment of Lloyd J [2005] 1 BCLC 1 . The numerous issues that Lloyd J did have to resolve turned largely on the correct construction and legal effect of a subordination (or non-competition) clause in a deed of indemnity entered into by six companies in the group headed by Save Group plc ("Group") in favour of AIG Europe (UK) Ltd ("AIG"). The group traded as petrol retailers and AIG provided a bond for payment of excise duty to HMRC, so enabling liability for duty to be deferred. The deed of indemnity related to the bond and the companies that gave the indemnity included Group and its subsidiary, then called Save Service Stations Ltd, later renamed SSSL Realisations (2002) Ltd ("Stations"). Stations owned most of the fixed assets of the petrol retailing business. There were substantial inter-company debts. Group had a treasury function and Stations owed large sums to Group both for loans and for petrol products bought by Group and sold on to Stations.

39 In 2001 Group and all its subsidiaries went into administration. Later Group went into compulsory liquidation and Stations into creditors' voluntary liquidation. In early 2004 both sets of liquidators made separate applications to the court for directions. Issues were agreed and heard by Lloyd J in June 2004. On 27 July 2004 he held that Group was not entitled to prove for the debt due to it from Stations. That is a very brief summary of the practical result of a long judgment which covered numerous issues, not including the rule in Cherry v Boultbee .

40 The rule was raised in a respondent's notice served by Stations in response to Group's notice of appeal. The point was raised contingently, against the event that the Court of Appeal were to hold that Group's liquidators could disclaim its contract with AIG. In the event the Court of Appeal upheld Lloyd J on the disclaimer point, and every other point, and dealt with Cherry v Boultbee only because the issue had been fully argued, and Chadwick LJ, at para 68, thought it sensible to address it. When the present case came before the Chancellor it was not disputed that In re SSSL should be treated as a binding precedent. In In re SSSL Chadwick LJ gave the only judgment in the Court of Appeal [2006] Ch 610 , with which Jonathan Parker LJ and Etherton J agreed. In his judgment he introduced the rule in Cherry v Boultbee in paras 11–17, 20–25 and 31,

but his main reasoning about the rule is in paras 68–117. ***954**

41 Before coming to those paragraphs I would note parenthetically that in In re SSSL the Court of Appeal had detailed evidence as to the assets and liabilities of the various group companies, and Chadwick LJ was at pains to explain the financial implications of the issues. That was no doubt appropriate in a case in which the court was being asked to grant an injunction. In this appeal, by contrast, the Supreme Court has no relevant documentary evidence (the only exhibit to the sixth witness statement of Mr Brazzill, one of the administrators of KSF, included in our papers is the offering circular published by Funding, which is now ancient history), and Mr Moss QC, for the trustee, was not eager to go into the figures. I make no complaint about that, as the court has to decide the point as a matter of principle. Mr Moss did tell us that the trustee will recover about 84% of its claim if it loses the appeal completely, and 100% if it wins either on Cherry v Boultbee or on the point of construction which the Chancellor decided against the trustee. Apart from that we know that Funding has no assets other than the debt owed to it by KSF, and no significant creditors other than the trustee; and that KSF has numerous creditors and has so far paid (or reserved) dividends totalling 58p in the pound.

42 Above all it is essential to bear in mind, in order to avoid confusion, that although this appeal raises the same legal issue as was raised in In re SSSL the factual context is different. In In re SSSL PD was the parent company, Group, and S was (among other subsidiaries) Stations; and (apart from any question of indemnification of S) S owed PD about £70m. In the present appeal PD is the subsidiary, Funding; S is the parent company, KSF; and (apart from any question of indemnification) S owes PD about £242m.

43 In his judgment Chadwick LJ was also at pains to explain the operation of the rule in Cherry v Boultbee in mathematical notation which, if I may respectfully say so, tends to suggest that the rule is a branch of rocket science. The disparity between the results of the examples in para 13 of his judgment is simply the difference between netting-off at 100p in the pound and netting-off at the appropriate dividend rate. In the example set-off means that the debtor beneficiary gets £1,818, that is 100p in the pound worth of set-off, and 90.9p in the pound for the balance of £2,000 due from the bankrupt's estate. The equitable rule means that he gets £1,750, that is 91.7p in the pound for the whole £3,000 due to him, with £1,000 treated as already in his hands. Where the equitable rule applies the rate of dividend is marginally higher for everyone, because the differential (in the example, £91 out of the set-off of £1,000) is made available for distribution across the board. The lower the expected rate of dividend, the greater will be the disparity between the two computations.

In re SSSL: the Court of Appeal's reasoning

44 The scheme of paras 68–117 of Chadwick LJ's judgment is as follows.

- (1) Para 68 sets out the financial implications of the point.
- (2) Paras 69–78 contain a full discussion of In re Melton [1918] 1 Ch 37 , concluding with the extraction of three principles stated in para 79.
- (3) Paras 80–82 identify three questions left unanswered by In re Melton .

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- (4) Paras 83–92 discuss the two cases of In re Fenton , concluding that In re Fenton (No 2) [1932] 1 Ch 178 was wrongly decided.
- (5) Paras 93–97 discuss the purpose of the rule against double proof (which has been briefly introduced in

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paras 14–15).

- (6) Paras 98–117 discuss and answer the three questions left unanswered by In re Melton , the first being whether the equitable rule applies in a situation where statutory set-off is (as noted by Lord Hoffmann in Secretary of State for Trade and Industry v Frid [2004] 2 AC 506 , para 13) excluded by the rule against double proof.

45 The first principle that Chadwick LJ extracted from In re Melton [1918] 1 Ch 37 is the equitable rule itself, which he set out as a mathematical formula. The second principle is that the rule extends to cases where the fund has a right to be indemnified by the claimant against a liability which the fund may be required to meet in the future. That proposition seems to be too widely stated. In the passage quoted from the judgment of Warrington LJ in In re Melton , at p 55, “that time” refers to the death of Richard Melton in 1907. His settled estate did not become distributable until his widow's death in 1916, and by then there was an immediate right to an indemnity for the £313 paid by the estate. The judgment of Warrington J in In re Abrahams [1908] 2 Ch 69 , 73, states the correct rule:

“the debt due to the testator is one which is not immediately payable, whereas the right of the debtor to receive the residuary share is an immediate right. I think, therefore, that the debtor is entitled to receive that share …” Chadwick LJ also relied on Warrington LJ's comments on In re Binns [1896] 2 Ch 584 . But (as already noted) the facts of In re Binns were not identical, or even similar, to those of In re Melton .

46 The third principle, set out in para 79(3), is also too widely stated, as Chadwick LJ himself recognised in the following paragraph. After referring to section 323 of the Insolvency Act 1986 and rule 4.90 of the Insolvency Rules 1986 he observed:

“But the question remains whether the [equitable] rule is applicable in a case where—by reason of the rule against double proof—there is no set-off between X's claim against the fund, on the one hand, and the fund's right to be indemnified by X on the other hand.”

47 That is the heart of the matter, but having posed that question the judgment embarks on a lengthy discussion of the two In re Fenton cases, concluding that In re Fenton (No 2) was wrongly decided because it was inconsistent with the judgments in In re Melton . I respectfully disagree. In In re Fenton (No 2) [1932] 1 Ch 178 Luxmoore J was faithfully following the reasoning of the Court of Appeal in In re Fenton (No 1) [1931] 1 Ch 85 . The banks (C) were never going to recover in full either from the association (PD) or from Fenton (S), and Fenton's trustee could not seek to recover from the association in competition with the banks, either by direct proof or by set-off, merely because he had paid a dividend of 5p in the pound.

48 The equitable rule is a technique of netting-off similar to statutory set-off. It is true that in a situation of double insolvency (that is where both PD and S are bankrupt or in insolvent liquidation) the equitable rule may produce a different result from set-off if PD's insolvency occurred before that ***956** of S (that is the difference between Jeffs v Wood 2 P Wms 128 and In re Rhodesia Goldfields Ltd [1910] 1 Ch 239 , on the one hand, and Cherry v Boultbee 4 My & Cr 442 and In re Peruvian Railway Construction Co Ltd [1915] 2 Ch 144; [1915] 2 Ch 442 , on the other hand). But in this appeal that is of little importance as there is a larger and more basic question to be asked first. If the policy of the law underlying the rule against double proof is powerful enough to oust statutory set-off, is there any good reason why it should not have the same effect on the equitable rule?

49 Chadwick LJ considered that there are good reasons, and [2006] Ch 610 , para 92, that the contrary view involved three misunderstandings: of the principle underlying the equitable rule, of the reasoning in In re Melton [1918] 1 Ch 37 , and of the

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object of the rule against double proof. I have to say that I find much of his reasoning difficult to follow. The distinction drawn in [2006] Ch 610 , para 94 between swelling assets and limiting claims seems to be, in this context, a distinction without a difference: netting-off matches assets against claims, and the rule against double proof is (as has often been said) a matter of substance, not form.

50 Para 96 of the judgment suggests that in a double insolvency the equitable rule and the rule against double proof can and should both apply, and that this would strike a fair balance between the competing interests of creditors. In my view this approach would lead to many doubts and difficulties, and whether the end result would strike a fair balance would depend very much on the facts of the particular case (that point is made forcefully in a case note by Look Chan Ho, “Understanding Debt Subordination and the Rule in Cherry v Boultbee : In re SSSL Realisations” [2006] JIBLR 266 , 271–272; see also a learned article from an Australian viewpoint, Dean, Luckett and Houghton, “Notional Calculations in Liquidations Revisited: the case of ASC Class Order Cross Guarantees” (1993) Company and Securities Law Journal 204). The facts of this case would be regarded as unusual in normal commercial dealings (though they may be more usual in the world of investment banking) in that Funding, a subsidiary with a relatively tiny paid-up capital, borrowed almost £250m, and as it has no other significant creditors the trustee will, if it wins this appeal, make a full recovery on behalf of the noteholders. In that respect the case has some similarity to In re Polly Peck International plc [1996] 2 All ER 433 , in which it was argued, unsuccessfully, that the special purpose vehicle incorporated in the Cayman Islands should be regarded as a single economic unit with the holding company, so as to eliminate “double dip” as well as double dividend.

51 Para 98 of the judgment ([2006] Ch 610) refers to the line of authority dealing with the special case of shareholders liable for calls on shares which are not fully paid up. Some of these cases are mentioned in para 20 above. Chadwick LJ sets out a fuller citation of the cases but I have to say, with respect, that he seems to have missed their point.

52 The situation in this line of authority is that a shareholder is a creditor of an insolvent company, but his shares are not fully paid up, so that he is liable as a contributory. Suppose he has 10,000 £1 shares, 10p paid, and is owed £15,000, but the dividend prospectively payable is only 30p in the pound. If the liquidator calls on him for £9,000 to make his shares fully paid up, he has no right of set-off, and to that extent he is disadvantaged (that is In re Auriferous Properties Ltd [1898] 1 Ch 691). If he seeks to ***957** prove in the liquidation, the liquidator can rely on the equitable rule as it applies in a case of this sort—that is, that he can receive *nothing* until he has paid *everything* that he owes as a contributory. That is In re Auriferous Properties Ltd (No 2) [1898] 2 Ch 428 . The rule is also very clearly stated by Buckley J in In re West Coast Gold Fields Ltd [1905] 1 Ch 597, 602 (affirmed [1906] 1 Ch 1 , and cited in para 20 above). Payment of the call is a condition precedent to the shareholder's participation in any distribution, and again the shareholder is to that extent disadvantaged.

53 So the equitable rule may be said to fill the gap left by disapplication of set-off, but it does not work in opposition to set-off. It produces a similar netting-off effect except where some cogent principle of law requires one claim to be given strict priority to another. The principle that a company's contributories must stand in the queue behind its creditors is one such principle. The rule against double proof is another. I would accept Mr Moss's submission that it would be technical, artificial and wrong to treat the rule against double proof as trumping set-off (as it undoubtedly does) but as not trumping the equitable rule.

Conclusion

54 I would therefore allow this appeal on that

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ground, and set aside the Chancellor's direction. Once the trustee has received 100p in the pound the rule against double proof will cease to apply, and any assets then remaining in the hands of Funding's administrators will be administered without further regard to it. It is not necessary to address the issue of the correct construction of clause 7.7 of the trust deed, and it seems better not to comment on an issue which Sir Andrew Morritt C approached (as he was bound to) on legal premises now shown to be mistaken.

LORD HOPE OF CRAIGHEAD DPSC

55 I would allow this appeal. For the reasons given by Lord Walker of Gestingthorpe JSC with which I am in full agreement, I too would hold that the equitable rule in Cherry v Boultbee 4 My & Cr 442 is excluded by the rule against double proof. So the trustee must be paid in full before there can be any proof against Funding as the principal debtor by KSF as guarantor.

Appeal allowed . Jill Sutherland, Barrister ***958**

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1. Insolvency Act 1986, Sch B1, para 65 , as inserted: “(1) The administrator of a company may make a distribution to a creditor of the company … (3) A payment may not be made by way of distribution under this paragraph to a creditor of the company who is neither secured nor preferential unless the court gives permission.”

2. Insolvency Rules 1986, r 2.95(1) , as substituted: “Where an administrator is proposing to make a distribution to creditors he shall give 28 days' notice of that fact.”

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