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Should Shareholders Rank with Unsecured Creditors in Bankruptcy?

Anita I. Anand*

This article examines the subordination of shareholder claims in bankruptcy. It argues that as a general matter, subordination is justifiable on the basis of contractual arguments. In certain circumstances, however, a carve-out to the subordination rule may be warranted, specifically in the case of misrepresentation in a prospectus. The normative appeal of a carve-out is based on the conception of statutes as standard form contracts. The article raises competing policy considerations that warrant further examination, such as whether a subordination rule will encourage debtors to enter bankruptcy proceedings to avoid shareholder suits or whether a carve-out would give rise to unmeritorious shareholder suits. The article analyzes the process of reform to date, noting that legislative reform implementing subordination occurred without analyzing these policy issues and without consulting those with responsibilities for and interests in protecting investors, such as securities regulators and institutional investors.

Cet article traite du caractère subordonné des réclamations des actionnaires en cas de faillite d'une personne morale. L'auteure soutient que cette règle de subordination est justifiée compte tenu d'arguments contractuels mais qu'elle pourrait être exclue dans certains cas, plus particulièrement en cas de déclarations fausses ou trompeuses dans un prospectus. L'auteure avance qu'une telle exclusion se justifierait bien dans un environnement juridique où les lois sont perçues comme constitutives des relations contractuelles. Elle propose que des analyses plus approfondies de ces questions soient faites, notamment pour évaluer si la règle ? ou son exclusion ? est susceptible de provoquer un recours accru aux dispositions des lois sur la faillite ou des recours frivoles de la part d'actionnaires. Elle souhaite que le processus de réforme tienne éventuellement compte de ces analyses et soit fait en consultation de ceux qui sont responsables de la protection des investisseurs, des autorités en valeurs mobilières et des investisseurs institutionnels.

* Associate Professor and Associate Dean (JD Program), Faculty of Law, University of Toronto. Thanks to Ben Alarie, Robert Aziz, Edward Iacobucci, Andrew Kent, John Knowlton and Mariana Prado for very helpful comments and to Michael Bond and Jon Laxer for thorough research assistance. Special thanks to Tony Duggan for his insights and helpful discussions. This article was conceived as an attempt to flesh out competing claims between unsecured creditors and shareholders in the bankruptcy context which are lucidly raised in Janis Sarra, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings" (2007) 16 Int. Insolv. Rev. 181.
1. INTRODUCTION

I purchase shares in a corporation, and the prospectus under which those shares were issued contains a misrepresentation. The corporation files for bankruptcy. Should I have a claim on the corporation's assets that ranks with the claims of unsecured creditors? Or should my claim be subordinated to those of unsecured creditors? If my claim has been litigated and the corporation has satisfied the judgment, I would not be required to pay back these funds to the corporation.¹ However, what if I have a claim that is in the process of being litigated (i.e., a provable claim in bankruptcy)? Should this claim be subordinated?

The subordination of shareholders' claims in bankruptcy has been settled law in the United States since the enactment of section 510(b) of the Bankruptcy Code in 1978. In Canada, under amendments in Statute c. 36 to the Bankruptcy and Insolvency Act (BIA) and the Companies Creditors Arrangement Act (CCAA), shareholders' claims are similarly subordinated.² However, the Canadian law reforms were undertaken without input from important stakeholders, including securities regulators and institutional investors. This outcome raises two issues: first, the underinclusive process of reform itself and, second, whether, as a substantive issue, subordination of shareholders' claims should be as pervasive and strict as the new law dictates.

Generally speaking, subordination is a reasonable policy response to protecting the claims of unsecured creditors in bankruptcy. Unsecured creditors have chosen a contractual relationship with the corporation in which their risk is limited, whereas shareholders have chosen an arrangement in which they participate in the successes but also suffer in the

¹ Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 70(1) [BIA].
² Ibid., s. 140.1; Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 22.1 [CCAA]. These provisions were inserted by Bill C-12, An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005, 2nd Sess., 39th Parl., 2007, ss. 49, 71 [Statute c. 36]. Section 49 reads, "A creditor is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied." The definition of "equity claim" in Statute c. 36 is as follows:

- a claim that is in respect of an equity interest, including a claim for, among others, (a) a dividend or similar payment, (b) a return of capital, (c) a redemption or retraction obligation, (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).
failures of the firm. Furthermore, subordination ensures robust credit markets where unsecured debt is more readily available to the corporation.

However, it may be that, in certain limited circumstances, a carve-out to the general rule about subordination is necessary, especially where shareholders have purchased their securities on the basis of a misrepresentation or omission in the prospectus. In these limited cases, we must ask whether, in bankruptcy, shareholders should rank with unsecured creditors rather than after them in priority. We must examine the separate contractual relationships that the corporation has with shareholders and unsecured creditors and seek to give effect to the terms of those contracts.

The idea that creditors and shareholders have chosen different bargains with the corporation is a freedom of contract approach that has been the underlying rationale for the subordination rule. However, if we view statutory law as a standard form contract between shareholders and the corporation, then the statutory right to claim damages when there is a misrepresentation in a prospectus forms part of this contract. Subordinating the claims of shareholders who purchase shares on the basis of a misrepresentation in the prospectus to those of unsecured creditors thus contravenes the terms of shareholders’ ultimate contract with the corporation.

In a number of jurisdictions, including the United States, the United Kingdom and Australia, the law makes concessions in favour of defrauded investors. In the United States, the Sarbanes-Oxley Act’s “fair funds for investors” provision allows restitution to be made to shareholders of bankrupt firms. In the United Kingdom and Australia, although corporate law provides for the subordination of shareholder claims in the shareholder’s capacity as a member of the company, the courts have held that a misrepresentation claim brought by a defrauded investor falls outside the provision. Given these developments, we must ask whether there is a need for harmonization across jurisdictions that

3 Sarbanes-Oxley Act of 2002, Pub.L. No. 107-204, § 308, 116 Stat. 745. It seems that, in the US, the reforms may have been inadvertent and that, in enacting the Sarbanes Oxley Act provisions, the legislators overlooked s. 510(b) of the Bankruptcy Code, 11 U.S.C.A. §510(b) (West 1993); see also text accompanying note 44.

would call for a carve-out to the principle of subordination embodied in Statute c. 36 or whether a broad-based subordination rule is preferable on a normative basis.

While the harmonization of legislative regimes highlights the importance of the subordination issue, the gist of this article relates to a broader point: the reform process that culminated in Statute c. 36 occurred without consulting those with responsibilities for protecting investors and without an analysis of the complex policy arguments at stake. In particular, sophisticated creditors may be able to monitor the debtor better than shareholders generally, thus perhaps supporting a carve-out from the subordination rule. However, unsecured creditors may be either oblivious to or unable to monitor the debtor's financial situation and it may be unfair to allow shareholders to rank equally with them. In addition, a subordination rule with no carve-out may encourage debtors to place themselves in bankruptcy as a means of avoiding shareholder suits but implementing a carve-out to the subordination rule may give rise to unmeritorious shareholder suits. Little if any analysis relating to these competing positions appears to have informed the legislative process underpinning Statute c. 36.

We should note at the outset that private actions for misrepresentation in a prospectus are not launched frequently. Some may claim that the subordination issue discussed here is therefore unimportant, relatively speaking. However, Canada's new liability regime for misrepresentations in continuous disclosure documents contains broad bases on which to launch claims. The new liability regime may lead to an increase in the number of misrepresentation claims since the previous numbers only dealt with primary market liability not secondary market disclosure.

The remainder of this article is structured as follows: Part 2 examines the notion of the corporate contract in the bankruptcy setting and reviews the rationale for a rule under which shareholder claims are subordinated to those of creditors in bankruptcy. This section also suggests that the rationale for subordination, which is based in contract,

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5 The number appears to be eight cases in Canada since 2005, two of which reached settlement. See Arisima Pusponogoro & Laura McIntyre, "An Overview of Securities Enforcement in Canada" (Paper presented to the Harvard Law School seminar on financial regulation in a global economy, May 2008) [unpublished].

6 Securities Act, R.S.O. 1990, c. S.5, ss. 1, 130 (OSA or Securities Act)
should take account of statutory provisions which provide shareholders with the right to claim damages for misrepresentation in a prospectus. Part 3, in turn, considers relevant policy positions, suggesting the complexity of the policy arguments for and against subordination. Part 4 examines options for reform, including heightened disclosure and the possibility of insurance for misrepresentations in a prospectus. Part 5 concludes.

2. DOES SUBORDINATION MAKE SENSE?

The foundational contribution of Jensen and Meckling is that a firm’s behaviour can be analogized to the behaviour of a market.\(^7\) Like a market, the firm is a nexus of contractual activity; it is a meeting ground for a number of contractual relationships.\(^8\) These include relationships between the firm and its shareholders, creditors, suppliers, employees, and members of management. This section examines the corporation’s contractual relationships with shareholders, on the one hand, and creditors, on the other. In so doing, it provides support for the argument that subordination is consistent with the contractual terms that shareholders agree to when they purchase their shares.

(a) Justification for the Subordination Rule

The bargain that shareholders and creditors strike with the corporation has been at the heart of the “absolute priority rule” found in section 510(b) of the United States Bankruptcy Code, which holds that, in all cases, equity holders’ claims for rescission or damages will be subordinated to those of creditors.\(^9\) The rule is strict and courts have been unsympathetic to the fraud that shareholders suffer, even if the fraud is massive in scale.\(^10\)

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\(^8\) Ibid.

\(^9\) Section 510(b) of the US Bankruptcy Code states that claims for rescission or damages arising from a purchase or sale of securities “shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such securities is common stock, such claim has the same priority as common stock. . . .” See 11 U.S.C. 741 §§ 501-511.

\(^10\) Historically, case law has held that this rule is strict; for example, outright fraud will warrant circumvention of the strict rule. See for example Allen v. Geneva Steel Co., 281 F.3d 1173, 39 Bankr.Ct.Dec. 47 (10th Cir., 2002). See also Janis Sarra, supra, n.\(^*\) at 189.
Section 510(b) was explicitly based on an argument advanced by Professors Slain and Kripke, who contend that general creditors are actually in a semi-contractual relationship with shareholders. These creditors assert "... a fixed dollar claim and leave [sic] the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim."\(^\text{11}\) Slain and Kripke highlight the fact that, in contrast to creditors, shareholders bargain for and, in purchasing their shares, accept the risk of corporate failure and declining value.\(^\text{12}\) Shareholders should therefore bear the risk of fraud and bankruptcy, given that they will also be able to share in the upside of the firm in good times.\(^\text{13}\)

What precisely do shareholders agree to when purchasing their shares? Basic terms of the shareholders' contract with the corporation are found in the articles of incorporation, where holders of common shares typically agree to be residual claimants who have the final claim on the corporation's assets—they get what is left over after all other claimants, including unsecured creditors, have been paid. In particular, the articles provide that common shareholders cannot receive dividends until all dividends on the preferred shares have been paid in full and that they cannot receive a return of capital until the preferred shares have been paid in full.\(^\text{14}\) In effect, the share provisions themselves provide a certain level of subordination.\(^\text{15}\) Thus, Slain and Kripke's argument is a persuasive one: subordination is the bargain that shareholders themselves strike as residual owners of the firm, at least with respect to capital and dividends.

One could certainly argue that Statute c. 36 changes little. Apart from the terms of a corporation's articles, in two cases—Blue Range


\(^\text{12}\) Ibid., at 286-287.

\(^\text{13}\) Ibid.

\(^\text{14}\) These provisions are reiterated to some extent in the corporate statute which states that where the corporation only has one class of shares, the holders of those shares will have the right to remaining property on dissolution. See Canada Business Corporations Act, S.C. 1974-75-76, c. 33, s. 24(3) (CBCA).

\(^\text{15}\) Where the firm issues preferred shares, the articles typically also state that dividends are specifically subordinated to debt and other claims in the share provisions contained in the articles. The holders of preferred shares accepted subordination regarding dividends when they bought the shares.
and National Bank— the Alberta Court of Queen’s Bench has introduced a subordination of equity claims rule as a matter of judge-made law. ¹⁶ In these cases, the Court relied on the US law to state firmly that shareholders do not have the same priority as unsecured creditors. Thus, Statute c. 36 not only codifies terms already contained in the share provisions of a company’s articles of incorporation but also reiterates case law on point. It could be contended, in keeping with Slain and Kripke, therefore, that Canadian law is settled on the point of the sub-ordination.

(b) Is a Carve-out Justifiable?

While subordination of shareholders as a general matter is understandable, the above analysis is incomplete, since it does not push the contractual analysis far enough. This section continues with the argument from contract and raises the importance of statutory law as a standard form contract between shareholders and the corporation. That is, the bargain that shareholders reach with the corporation is contained in not only the articles of incorporation but also the applicable statutory provisions in securities legislation. By raising the notion of statutes as standard form contracts, this section also questions whether the Slain/Kripke argument is watertight.

Although the articles of incorporation contain the share provisions that attach to each class of shares, they do not contain all of the terms contained in shareholders’ contracts with the corporation. Rather, the articles are incomplete contracts, given that shareholders of public issuers also have statutory rights and remedies available to them. Indeed, certain provisions in the Securities Act, like those in business corporation statutes, can be conceived as forming a standard form contract between shareholders and the corporation.¹⁷ This idea begins with the premise that parties cannot account for all contingencies in their contract. Statutory law assists by setting forth default rules, rights, and remedies to


aid in the interpretation of the contract and represents "the bargain that
investors and agents would strike if they were able to dicker at no cost."18

What are the statutory terms applicable to the issue of subordination
of shareholders? In addition to their common law rights to claim in tort
for misrepresentation, shareholders have a statutory right of action for
misrepresentation in a prospectus, offering memorandum or takeover
bid circular. The relevant provision with regard to prospectuses reads as
follows:

Where a prospectus, together with any amendment to the prospectus, contains a
misrepresentation, a purchaser who purchases a security offered by the prospectus
during the period of distribution or during distribution to the public has, without
regard to whether the purchaser relied on the misrepresentation, a right of action
for damages. . . .19

Thus, if the prospectus or an amendment to the prospectus contains
a misrepresentation, securities law entitles shareholders to bring an ac-
tion. The right of action exists as against the corporation or selling
shareholder (i.e., secondary market purchaser), underwriter, director of
the corporation and any person who signed the prospectus. Reliance
need not be proven, unlike at common law. Damages, and in certain
cases rescission, may be claimed.20 Statutory liability also exists for
misrepresentations in continuous disclosure documents and oral state-
ments by senior management and directors of the corporation.21 These
statutory remedies are in addition to the shareholder's common law
rights but, given that the legislation removes the need for the shareholder
to prove reliance, it offers better protection.

So, my argument is that shareholders reach their agreement with
the corporation knowing that they have this right of action where reliance
need not be proven (and thus winning is easier). They bargain in the
shadow of securities legislation which can be understood as a standard

Yale L.J. 698 at 702; see also Gillian K. Hadfield, "Incomplete Contracts and Statutes"
19 OSA, supra, n. 6, s. 130. The definition of "misrepresentation" contains reference to an
untrue statement of material fact and an omission to state a material fact. OSA, supra, n. 6,
ss. 1, 130. For provisions relating to offering memoranda and takeover bid circulars, see
OSA, supra, n. 6, ss. 130.1(1) and 131(1).
20 OSA, ibid., s. 130. A right of rescission is available as against the issuer, selling shareholder
or underwriter.
21 OSA, ibid., s. 138.3(1). Again, reliance need not be proven and therefore the liability scheme
goes considerably beyond the common law.
form contract between shareholders and the corporation. However, the statutory right is undermined by the subordination provisions in Statute c. 36 and we must ask whether the subordination of this right of action when the firm is in bankruptcy is, legally speaking, the choice that should be made. We cannot fully understand this issue unless we recognize that creditors also have a contract with the corporation. This may be a more traditional contract than that which exists in the shareholder-corporation relationship. Sophisticated creditors enter into an agreement to extend credit to the corporation on the basis of elaborate lending arrangements. These lenders may take security for their loans, as they know that current statutory law provides them with priority as a result of the security they take. Other providers of credit may not have taken security, and they therefore fall into the pool of unsecured creditors, whose priority is determined by statute, generally speaking.

These unsecured creditors understand that secured creditors rank first and that the priority scheme set out in the BIA will then apply. After payments relating to administrative costs associated with the bankruptcy, this ranking is as follows: employee claims, certain family law entitlements, municipal taxes, landlords’ claims for arrears of rent, employee injury claims, Crown claims, and then all of the claims of unsecured creditors. One can argue, therefore, that creditors rank before shareholders, and that those statutory terms also form a standard form contract that is part of creditors’ agreement with the corporation. In the corporate reorganization context (which has been court-driven) these types of arguments have had the effect of holding shareholder claims at bay in favour of unsecured creditors and other stakeholders.

Thus, both shareholders and creditors rely on specific statutory terms in striking their respective bargains with the corporation and each can legitimately claim that they have particular rights under those statutes. But this scenario indicates difficulties with the contractual analysis when two statutes or legal regimes are applicable; it is not clear which regime should govern. The terms of these contracts, and in particular the statutes that comprise them, may conflict, as they may appear to on

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22 BIA, supra, n. 1, s. 136.
23 Ibid., s. 136(1)(d.1), referring to BIA, ibid., s. 178(1)(b)-(c).
24 Ibid., s. 136.
the issue of subordination of shareholder interests in bankruptcy. How does interpreting the respective contracts work in this instance?

From a positive law perspective, the doctrine of paramountcy may apply. In cases of conflict between valid federal and provincial laws dealing with the same matter, paramountcy dictates that the federal law prevails, and the provincial law is rendered inoperative to the extent that it is inconsistent with the federal law. Over time, however, case law has led to a diluted paramountcy doctrine, which has in turn diminished federal powers to regulate securities markets. To the extent that investor protection is at issue with respect to the Statute c. 36 reforms, securities regulators could claim constitutional jurisdiction to respond, without questioning the legitimacy of the federal law, under the property and civil rights power (i.e., section 92(13)) of the Constitution Act.

On the other hand, one could argue that there is no conflict between securities regulation and bankruptcy law at all. One could read the liability provisions of securities law as applying only to the creation of the substantive claim and not to the priority ranking of that claim vis-à-vis any others. Thus, in the case of insolvency, the BIA can (and does) step in to determine the priority of all claims, including those of equity holders. The two types of statutes thus speak to different stages of the corporation’s existence. This interpretation seems to be the current legislative view, especially considering the lack of consultation on the issue of subordination as discussed in Part 4 below.

However, it is not clear that this is the interpretation that should govern given the investor protection issues at stake. When shareholders invest, they do so in the shadow of the law that provides certain substantive rights. That these rights are subordinated in bankruptcy undermines the very notion of investor protection itself and parsing out shareholders’ rights so that they fall under the purview of different statutes seems artificial. The issue raises the lack of coordination between statutes that relate to corporations and the various stages of corporate life.

3. POLICY BASES FOR CARVE-OUT AND SUBORDINATION

In this section, we set forth the argument from contract discussed above and then push the arguing further by considering policy arguments for and against subordination. We examine broader market issues relating to a carve-out as well as efficiency and fairness considerations. We see that the policy issues are complex and do not clearly point in favour of a subordination rule or not. However, they do at least warrant further examination at the legislative level which is the subject of Part 4 below.

(a) Contractual Basis for a Carve-out

Is it necessary to create an exception to the general position that the claims of shareholders should be subordinated in bankruptcy? The argument thus far has been that given shareholders’ contractual relationship with the corporation, an exception may be warranted in the specific case of a shareholder claiming damages for misrepresentation in a prospectus or other disclosure document. But should we support a carve-out on a policy level?

In keeping with Slain and Kripke, we could certainly argue that common shareholders agree to be residual claimants and to rank after all secured and unsecured creditors. Furthermore, general creditors rely on the “equity cushion” that shareholders provide, and allowing shareholders parity eliminates this cushion.26 On a strict contractual analysis, therefore, misrepresentation does not give rise to a valid exception to the subordination rule, because the explicit terms of the contracts that shareholders and creditors reach with the corporation do not provide for this state of affairs. But we have noted above that certain provisions in the Securities Act may comprise a standard form contract on which shareholders rely in purchasing their securities. Thus, subordinating shareholders’ claims seems to violate their contract with the corporation.

There is precedent for allowing shareholders to recover in these circumstances. Following the earlier House of Lords decision in Soden v. British & Commonwealth Holdings plc, the High Court of Australia in Sons of Gwalia v. Margaretic refused to subordinate the claims of a secondary market purchaser who claimed misrepresentation in the cor-

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poration’s disclosure documents, seeking the difference between the purchase price and the value of the shares after the company entered voluntary administration. As indicated above, the relevant legislation provided for the subordination of claims by a person “in the person’s capacity as a member of the company.” The Court held that rights to recover paid-up capital and dividends differ from claims based on misrepresentation. While the former claims are subordinated under the legislation, the latter should not be and so Margaretic was entitled to rank with the ordinary unsecured creditors.

Thus the Court, in effect, recognized something unique about a shareholder’s claim for misrepresentation, warranting an exception to the otherwise blanket rule regarding the subordination of equity holders. Perhaps it is that the CEO, CFO, underwriter and board of directors explicitly warrant that the facts contained in the prospectus represent full, true and plain disclosure of all material facts. The investor not only purchases on the assurance of this representation but also knows that if the prospectus contains a misrepresentation, she will have a statutory right to sue the company for misrepresentation without having to prove reliance. These are not unreasonable bases on which to make an investment decision.

As stated earlier, the premise of this argument is the implied contract between the shareholder and the company. That is, when shareholders purchase their shares, they have a statutory right to such damages, and, indeed, on a “deemed reliance” basis. There is no indication in the statute itself that the availability of the right shifts – that it is available in good times (i.e., solvency) and will be subordinated in bad (i.e., insolvency). If we think of statutes as standard form contracts, then it would seem that insolvency issues should not undermine the rights contained therein. Indeed, as a matter of risk allocation, it could be argued that shareholders agree to be subordinated on the basis of what was represented to them in the prospectus or disclosure document. They also invest on the basis that they will have a right (and corresponding

27 Sons of Gwalia v. Margaretic, supra, n. 4.
28 Corporations Act 2001 (Cth), s. 563A.
29 OSA, supra, n. 6, s. 58(2) certificate of CEO, CFO, any two directors, “The foregoing constitutes full, true and plain disclosure of all material facts relating to the securities” offered by this prospectus....
30 Ibid., s. 130.
remedy potentially available) as against the company in case of misrepresentation. Whether they diversify or not, this is part of the risk profile that they accept in purchasing their shares. It is not clear that this pre-existing statutory right should be deferred in insolvency.

By the same token, however, we may not want unsecured creditors to have to assume this risk, and this is the fundamental conflict between stakeholders that we are addressing here. In particular, the argument is that a carve-out should apply only in the case of misrepresentation and not to shareholder claims at large. This is the basis of the carve-out and we are dealing only with a small subset of shareholders who may have claims against the corporation.

(b) Broader Policy Considerations

The argument sketched above says little about countervailing policy reasons for a carve-out. One possible counter-argument is that allowing shareholder claims to rank equally with unsecured creditors might chill the willingness of lenders to extend credit to corporations that need to borrow in order to operate the business. Why would I want to lend money to a firm if I thought that, in the event of bankruptcy, shareholders would no longer be treated as equity claimants but would have a creditor-type claim that ranks equally with mine?

Regardless of what the law says, creditors will simply price the risk into the transaction. Thus, it is not obvious why higher priority matters to lenders since they adjust by charging a higher price to lend without it. Furthermore, it can persuasively be argued that creditors are more sophisticated risk takers and in a better position to protect themselves against risks, either by taking security, if they choose, or by monitoring their borrowers.31 Creditors typically protect themselves through covenants in their credit agreements. These covenants restrict the actions of the firm in certain circumstances or trigger acceleration. They also address operational matters and the financial condition of the firm.32


pecially in the case of private loans, banks and other institutions can negotiate amendments and take specific action in the event of breach – conduct that is not as feasible when dealing with holders of debt securities, etc.

On the other hand if shareholders' interests are subordinated, investors may be reluctant to invest since they know that, in bankruptcy, their claims will be deferred to unsecured creditors' claims. Alternatively, they may seek to diversify their portfolios so that the risk of bankruptcy or insolvency in any one instance is not as great. Indeed, diversification can act as a type of insurance against loss, as discussed below. In short, the effect of a subordination rule on shareholders is unclear; it is difficult to predict with certainty the effects that Statute c. 36 will have on the behaviour of public investors.

The economic viability of the firm may depend on a certain class of unsecured creditors (e.g., suppliers, contractors, trade creditors) who are crucial to the establishment and functioning of the business. Allowing shareholders to rank with these creditors in bankruptcy in the specific case of misrepresentation would likely not deter them from taking on their respective contracts with the corporation. It might, in fact, make unsecured creditors more judicious about their choice of debtor. This heightened level of scrutiny by parties on the other end of contracts with the corporation is a good thing; it may function as a disciplining device and force the firm to adhere to standards of "good behaviour."

But these creditors, particularly if they are unsophisticated, may be oblivious to, or unsuspecting of, the risks of bankruptcy (trade creditors for example do not have incentives to investigate). They may be judicious, but the firm's downturn may come suddenly, accompanied by pre-bankruptcy transactions, preferences and the like. Thus, we must also ask whether a carve-out to the subordination rule is fair to unsecured creditors and especially those who do not monitor the corporation's behaviour or those who have no other means of survival. We turn now to overall efficiency and fairness concerns.

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(c) **Efficiency and Fairness Concerns**

Broadly speaking, two important considerations come into play in this analysis: efficiency and fairness. As the discussion below suggests, these two concepts raise questions about whether the reforms in *Statute c. 36* were warranted, particularly without further analysis of the consequences of a subordination rule.

From a societal perspective, there are risk-bearing costs involved with a carve-out in place as with shareholders will bear investigation, transaction and litigation costs. It may not be cost-effective to establish a legal regime which in effect gives such shareholder suits legitimacy, especially when the likelihood that they will recover is affected by the claims of secured creditors and even certain unsecured creditors who have statutory priority. But we must remember that a carve-out would not be available to all shareholders, only the small set of shareholders who have purchased securities on the basis of a misrepresentation (and therefore have a claim under the *Securities Act*).

A carve-out may give rise to increased transaction costs for creditors also. Claims for misrepresentation may be asserted by shareholders, or class action lawyers, in unmeritorious instances. Reorganization proceedings typically do not lend themselves to lengthy cases and firms may thus attempt to structure around potential claims by settling or by foregoing the reorganization altogether. In addition to unmeritorious lawsuits that might crop up, we may need to consider the consequences of a subordination rule with no carve-out in place. In particular, companies facing insolvency or bankruptcy may choose to put themselves into a reorganization process under the *BIA* or *CCAA* in order to avoid shareholder lawsuits.

Fairness concerns also are relevant. We may have no doubt that unsecured creditors should have a claim to the corporation’s assets in bankruptcy once secured creditors have been paid. But we may also feel that aggrieved shareholders should not be last in line. By allowing a carve-out in limited circumstances, we are not denying unsecured creditors the right to the corporation’s assets in bankruptcy, only stating that their priority does not supersede the priority of shareholders who are victims of misrepresentation. Bringing these shareholders into the circle depletes the total available assets for the unsecured creditors. However, in egregious circumstances, it may be necessary to protect shareholders
as they themselves are victims of misrepresentation that affects them in a direct way, given that they purchased their shares on the basis of misstatements made directly to them.

Thus, a number of policy arguments augur in favour and against a carve-out. Contractually speaking, shareholders have purchased securities on the basis of terms contained in the articles and in statute. It seems unfair to deny shareholders a right to rank beside unsecured creditors when the prospectus pursuant to which they purchased shares contained a misrepresentation. Furthermore, a subordination rule may actually encourage debtors to avoid such suits by entering bankruptcy proceedings. Counter-arguments relate to efficiency concerns, including increased transaction costs for both shareholders and creditors and the possible increase of unmeritorious cases. In response to these counter-arguments, one could contend that shareholders can diversify and thereby protect themselves against loss. Similarly, some creditors can limit their risk by contract and can also monitor the debtor.

In summary, there is no clear answer at the policy level to the question of whose interests (i.e., unsecured creditors or shareholders) should trump – persuasive arguments can be made on both sides. The fact that there are strong competing policy arguments, however, raises the question of the reform process that led to the changes in Statute c. 36 and in particular the apparent lack of analysis of these issues either on a conceptual or an empirical level prior to the implementation of the legislation. We turn now to examine the reform process in more detail.

4. REFORM

Thus far, we have examined the contractual basis for a carve-out as well as policy arguments that weigh for and against a carve-out. This section examines the flawed law reform process that led to Statute c. 36 and, in particular, the absence of consultations with relevant stakeholder groups on the issue of subordination. I argue that the subordination rule in Statute c. 36 not only warrants further research (as argued above) but also possible reforms in the securities law area. Reforms that are considered below include increased disclosure obligations for corporations and investor education.
(a) Process of Reform

The reform of Canadian bankruptcy laws over the past decade has seen the arrival and departure of federal governments from differing political parties.\textsuperscript{33} Reform is generally a mammoth exercise, and Statute c. 36 has been no exception. However, what is evident about the reform process is that key stakeholders on the regulatory side (\textit{i.e.}, securities commissions) and the buy-side (\textit{i.e.}, institutional investors) were not included in the consultation process on the issue of subordination of equity shareholders. Indeed, in writing this article, I met with a number of securities commissions and representatives of institutional investors who confirmed that they had not been involved. This is a conspicuous omission, especially given the impact that a new subordination rule will have on the investing public.

The Senate Banking, Trade and Commerce Committee did hear from academics and members of the practicing bar, and it appears to have been heavily influenced by testimony from Andrew Kent. Mr. Kent, a senior bankruptcy and insolvency lawyer in Canada, represented the Insolvency Institute of Canada and the Canadian Institute of Insolvency Related Professionals and presented a report on their behalf.\textsuperscript{34} The first prong of Mr. Kent’s testimony related to the need for harmonization with the United States and his belief that Canadian laws disadvantage insolvent Canadian companies since there is no mechanism to deal with shareholder claims in bankruptcy. As a result they are induced to file for bankruptcy in the United States.\textsuperscript{35} The second prong favours subordi-

\textsuperscript{33} Bill C-55 was introduced on June 3, 2005. It was passed by the House of Commons on November 21, 2005 and received Royal Assent on November 25, 2005. It was never proclaimed into law. Bill C-62 was introduced on June 13, 2007 and proceeded to the Senate by June 14, 2007. The Bill died when parliament was prorogued. It was reintroduced as Bill C-12 on October 30, 2007, and passed by the house on December 13, 2007. Royal Assent was granted December 14, 2007.


\textsuperscript{35} See \textit{Proceedings of the Standing Senate Committee on Banking, Trade and Commerce}, 37th Parl. 2d Sess., No. 19 at 19:10 (May 8, 2003):

The problem in a modern corporation is that you may be faced with such things as shareholders claims by people who say that they have been lied to through the public markets. In the United States, these claims are dealt with expressly in the US \textit{Code of Bankruptcy}. Our laws have no reference to them... If such a claim is filed in Canada, there is no facility in place to deal with it. They have no choice but to file in the US
nation because "shareholders should not be given a veto over the process . . ." The Report appears to have swayed the Committee, which ultimately supported a broad subordination rule consistent with section 510(b) of the United States Bankruptcy Code.

As noted above, a handful of Canadian cases have dealt with this issue, and some courts have been reluctant to embrace a blanket subordination rule. Further, the United States, the United Kingdom and Australia have all moved away from a blanket subordination rule. The United Kingdom and Australian developments have been discussed above. The Fair Funds for Investors provision in the Sarbanes-Oxley Act allows the Securities and Exchange Commission (SEC), when pursuing a civil action with monetary penalties attached, to have a portion of those monies set aside for defrauded shareholders. If the company is bankrupt, this provision seems to circumvent section 510(b) of the Bankruptcy Code, since it allows for payments out of the estate to defrauded shareholders, as in the case of WorldCom.

where there is a vehicle to deal with these claims in a sensible, fair and reasonable way. In Canada, we have no mechanism. Thus, you end up with situations where it becomes difficult to reorganize a Canadian enterprise under Canadian law because our laws do not generally deal with shareholder claims.

Ibid., at 19:15, 19:16.

Blue Range Resources, supra, n. 16; and National Bank of Canada, supra, n. 16.

In the Matter of the Companies' Creditors Arrangement Act and in the Matter of a Plan of Compromise or Arrangement of AT&T Canada Inc., Re (2003), 2003 CarswellOnt 5046 (Ont. S.C.J. [Commercial List]) at para. 9, Farley J.: "I am of the view that the question of whether there is a doctrine of subordination of equity claims (particularly on a bright line basis) is recognizes as 'involving difficult complex policy issues and broad social ramifications.'" Farley J. would not definitively state that Canada has a blanket subordination rule.

Sarbanes-Oxley Act, supra, n. 3, § 308 states:

If in any judicial or administrative action brought by the Commission under the securities laws . . . the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

Given the position that other jurisdictions have taken on the issue, we need to ask why Canada has moved in the other direction and, in particular, why it has done so without consulting stakeholders who may view such a policy as undermining the interests they are charged with protecting. While Statute c. 36 may appear to be consistent with past case law, key stakeholders have indicated that the lack of consultation undermines the reform process and raises concerns about the legitimacy of the new law on the issue of subordination.

(b) Reform Proposals

The argument thus far has been that while contractual analysis suggests that shareholders' interests should not be deferred to creditors, the policy arguments require further consideration before a subordination rule is adopted. However, given that a subordination rule is in place under Statute c. 36, the question is whether securities regulators should adopt a particular policy response.

Policy alternatives may be one of two types: preventive or remedial. Preventive measures are common in securities law; indeed, securities regulation itself is premised on the idea that disclosure of information allows investors to assess the risks of their potential investment, keeps issuers honest and creates more efficient markets. Alternatively, we could consider a remedial alternative, as was implemented in the United States with the passage of the Fair Funds provision. Such an alternative would compensate aggrieved investors for the loss occasioned by misrepresentation or omission. The remedial option is complicated because in bankruptcy, the debtor's resources are by definition scarce and there are likely not enough assets for all who claim (hence the bankruptcy). This option would also pit the securities law regime against the bankruptcy regime (as is the case in the United States), which poses the issue of potentially conflicting legislation raised in section 2 above. On the other hand, as discussed below, preventive measures can be implemented which would avoid this conflict. What are some other possibilities for reform?

Allow issuers to insure against misrepresentation. At the heart of the issue is compensation that investors should receive in case of misinformation in the company's disclosure. It goes without saying that diversification is a way to limit loss and is indeed a means of self-
insurance against such losses. A decision to purchase shares involves an acknowledgement of risk. But the risk can be limited not only by diversification but also by the principle of limited liability itself (which holds that the shareholder's loss is limited to the value of her investment).

A more explicit option in terms of protecting investors would be for firms themselves to purchase insurance for shareholders. Firms would purchase such insurance if the benefits of doing so outweighed the costs. While benefits include creating incentives for investors to purchase securities, costs relate to the purchase price of the insurance, which would likely be determined by the likelihood of a misrepresentation. The firm would likely need to be the purchaser of this insurance, given that the transaction costs of individual investors' purchasing their own insurance would be prohibitive. Easterbrook and Fischel suggest that creditors or insurance firms could be the sellers of this insurance.

Yet an insurance market has not emerged and we should contemplate the reasons for this. Is it because shareholders can diversify, and therefore there is no need to for them to insure? Is it because of the rule of limited liability, under which creditors generally hold more of the risk of business failure, as Slain and Kripke point out? Both of these explanations are plausible and, regardless of the reasons, it would seem that insurance – given that a market has not emerged – is not a viable policy response. Regardless, we have argued above that the diversification option is not a sufficient justification for a subordination rule, since there are fairness concerns for shareholders at stake.

Increase disclosure regarding risks. As previously mentioned, securities regulation is built on the concept of disclosure of information, which has at its foundation two key ideas. First, if shareholders are informed, they can assess the risks of the investment and make rational decisions about whether it is one that they wish to pursue. These investors may conduct research into the company’s disclosure documents to dis-

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41 Tom Baker, "Insurance against Misinformation in the Securities Market" (Commissioned by the Task Force to Modernize Securities Legislation in Canada, 5 June 2006) at 363.
42 Easterbrook & Fischel, "Limited Liability and the Corporation," supra, n. 17 at 101.
43 Ibid., stating that "each shareholder would have to negotiate with the insurer. The insurer would have to monitor the wealth of the insured and all other shareholders to assess the riskiness of its own position."
44 The point about creditors acting as a type of insurance cushion is made by Slain and Kripke as well as by Easterbrook and Fischel. Slain & Kripke, supra, n. 11 at 286; Easterbrook & Fischel, ibid., at 103-104.
cern whether investing in the company’s securities is worth their while. Second, given that capital markets are not perfectly efficient (i.e., they are at best semi-strong form efficient), disclosure of information is important, since price does not perfectly reflect all available public and non-public information about the issuer and the security.

Increasing the disclosure obligations of corporations to inform investors of the risks of investing is consistent with the first of these two ideas. For example, public corporations could indicate to potential investors that the statutory right of action for misrepresentation in the prospectus is subordinated to the rights of unsecured creditors in bankruptcy. This would to some extent accord with current law requiring that issuers make disclosure about risks in the prospectus. Unless such disclosure is required, information asymmetries remain between corporations, who know that claims for misrepresentation in a prospectus are virtually meaningless in the case of bankruptcy, and investors, who do not.

Issuers may have little incentive to make this disclosure, since it is a deterrent to investment (they may ask, “Why would investors buy our stock if they know that their remedial rights are subordinated in bankruptcy?”). On the other hand, Statute c. 36 does not privilege one issuer over any other; the right of shareholders to claim for misrepresentation is deferred in bankruptcy regardless of the individual corporation. Though the issuer has no incentive to make the disclosure, it may favour subordination as a route out of massive shareholder lawsuits and into a structured process for dividing the assets of the bankrupt firm.

Short of heightened disclosure for issuers is reform that involves investor education with respect to the subordination issue. At the very least, investors should be informed that the right to claim rescission or damages for misrepresentation is subordinated to the claims of unsecured creditors in bankruptcy. However, investor education initiatives reach a limited number of people (i.e., those who seek to learn) and may not, in fact, decrease information asymmetries. Thus, they can supplement other initiatives aimed at investor protection but, in and of themselves, are insufficient to accomplish this task.

**Enact a Fair Funds provision for Canada.** While heightened disclosure and investor education are preventive measures that affect the ex ante bargain, adding new remedies to the legislation affects share-
holders’ rights *ex post.* This is exactly the route taken in the United States with the adoption of the Fair Funds provision, discussed briefly above. Under this provision only the SEC can initiate a proceeding. If the SEC commences a civil enforcement suit, it can file a motion requesting that the court add to any civil penalties it may create a disgorgement fund to be paid out to injured investors. The SEC has demonstrated a willingness to use this provision.45

Section 510(b) of the United States *Bankruptcy Code* was inadvertently reformed with the passage of the Fair Funds provision. Investors can actually receive funds via this route without any reference to creditors’ rights at all.46 The question that arises in the Canadian context is whether, in the wake of *Statute c. 36*, the provincial securities laws should be amended by the incorporation of a fair funds provision.47

A fair funds provision is not a substitute for the rights that shareholders lose in *Statute c. 36*. After all, those rights consist of a private right of action against an issuer, whereas a fair funds provision is essentially a public right of action. The public right provides no assurance to investors that they will be able to exercise remedial options, since they have no control over the initiation of the process or its subsequent evolution.48 In any case, the Fair Funds provision appears to have been enacted without consideration of section 510(b). And, as argued above, *Statute c. 36* already conflicts with securities law remedies. It is not in anyone’s interest (creditors’, investors’, or regulators’) to implement conflicting legislative provisions, given the transaction costs involved in trying to determine which statute applies in any given situation and


46 Christenson, *ibid.* As Christenson argues:

> [e]ssentially, section 308(a) of Sarbanes-Oxley bypasses the rule set forth in section 510(b) of the Bankruptcy Code that a defrauded shareholder may not recover damages from a bankrupt debtor simply by filing a securities fraud claim against the debtor. Section 308(a) has this effect because it enables stockholders to recover indirectly from the bankrupt debtor’s estate via civil penalties obtained by the SEC from the bankrupt debtor in an enforcement action.

47 Notably, some provincial securities acts already have within their statutory scheme the ability for the Commission to order disgorgement. *OSA, supra,* n. 6, s. 127(1)10.

the difficulties of establishing efficiency-producing network effects. Thus, Fair Funds is not the way to go in Canada.

In any case, some may argue that Canadian securities laws already contain a public disgorgement right. The Securities Act (Ontario), for example, provides that if a market participant has not complied with Ontario securities law and has thereby acted contrary to the public interest, the Commission can order the person to disgorge to the Commission any amounts obtained as a result of the non-compliance. Yet payment out would depend on the Commission’s pursuing a public interest action under the administrative power of the Act for misrepresentation in a prospectus. While there is precedent for the Commission’s pursuing this type of claim, the obvious limitations associated with the public right of action as opposed to the private right persist.

Furthermore, the application of the Fair Funds provision has posed problems for the SEC in terms of the collection and distribution of funds. It has proven difficult to prepare a plan, give notice and an opportunity to comment on the plan, complete the claims process and distribute the monies, all in accordance with the Fair Funds process. And, in the U.S. the penalty and disgorgement numbers are significantly larger – there is much to be lost in the procedural quagmire.

5. CONCLUSION

The discussion raises a general question about the role of securities regulators in reform processes outside of their strict legislative domain. The mandate of securities regulators is broad and therefore it can be argued that many legislative initiatives – even those outside of the Securities Act per se – affect the investing public and require regulatory attention. On the other hand, securities regulators could interpret their mandate more narrowly, pointing to their specific obligations under the Securities Act rather than the broad mandate.

Regardless of the policy stance adopted by securities commissions on this issue, this article points to the need for input from all stakeholders on whether, as a matter of substantive law, a subordination rule or a

49 OSA, supra. n. 6, s. 127(1)10.
51 See Christenson, supra. n. 40.
carve-out should exist. A number of key policy issues require further examination: will a subordination rule deter investment by shareholders? What are the transaction costs for both shareholders and creditors associated with subordination on the one hand and a carve-out on the other? Would shareholders and their counsel use a legislated carve-out to launch unmeritorious claims? Will corporations utilize a subordination rule to escape legitimate shareholder suits?

The main point, though, is that the bankruptcy and insolvency law reform process occurred without a full discussion on the issue of subordination in which those charged with investor protection participated. Amending the law without consulting either regulators or institutional investors seems misguided, given that those who stand to suffer under the new law are the individuals whom regulators are statutorily bound to protect. At the very least, the issue of subordination of shareholders in bankruptcy should be reopened and discussed in a more inclusive manner.