

ONTARIO
SUPERIOR COURT OF JUSTICE
(IN BANKRUPTCY AND INSOLVENCY)

IN THE MATTER OF THE BANKRUPTCY OF I. WAXMAN & SONS LIMITED,
a corporation incorporated under the laws of the Province of Ontario,
carrying on business in the City of Hamilton, in the Province of Ontario

FACTUM OF THE TRUSTEE IN BANKRUPTCY
(Motion returnable December 14, 2007)

December 6, 2007

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PART I – OVERVIEW

1. Deloitte & Touche Inc., in its capacity as trustee in bankruptcy (the “Trustee”) in the estate of I. Waxman & Sons Limited (“IWS”), brings this motion for advice and directions with respect to the treatment of the claim of Morris Waxman (“Morris”) (the “Morris Claim”) against the estate of IWS.
2. Morris is a judgment creditor of IWS.¹
3. For reasons delivered June 27, 2002, and subsequently supplemented (the “Judgment”), Justice Sanderson of the Superior Court of Justice awarded Morris approximately \$46.6 million dollars in damages against IWS and other parties. The Judgment is on a number of different causes of action, and includes claims arising from Morris’ capacity as a former shareholder of IWS.
4. IWS was adjudged bankrupt on September 4, 2007. Morris has submitted a proof of claim for the Judgment. Various unsecured creditors oppose the allowance of the Morris Claim. They suggest that the Morris Claim is rooted in the equity of IWS and should therefore be subordinated to the claims of general creditors. If this position is accepted, the general

¹ *Waxman v. Waxman*, [2002] O.J. 2528 (Sup. Ct.); varied slightly, [2004] O.J. No. 1765 (C.A.); leave to appeal refused, [2004] S.C.C.A. No. 291, Brief of Authorities, Tab 21.

creditors will likely receive full payment of their claims. Morris could receive as little as 8% of his claim.²

5. The Trustee has reviewed the law it understands to be applicable to this question. Morris and certain general creditors have been provided with the Trustee's analysis. The Trustee considers the following principles to be relevant to the treatment of the Morris Claim:

- (a) equity investors rank below general creditors in bankruptcy. This sequence has been adopted for policy reasons arising from the varying levels of risk and control accepted in the different positions;
- (b) the characterization of a claim as debt or equity is a question of fact depending on the substance of the transaction in question;
- (c) litigation claims by equity-holders based upon allegations of misrepresentation have been characterized as equity by the Alberta Court of Queen's Bench;
- (d) there is no "bright line" or absolute priority rule on the subordination of shareholder claims; and
- (e) claims for declared dividends are provable in bankruptcy. This implies that claims that originate in equity may eventually lose that status.

6. Based upon these factors, and subject to the direction of this Court, the Trustee has concluded that the Morris Claim should be allowed. In the circumstances of this case, the Morris Claim is most analogous to a claim for a declared dividend: the elements of shareholder speculation and control have been replaced by a fixed debt.

7. Finally, as part of its review, the Trustee has also considered the doctrine of equitable subordination. The Trustee has concluded that regardless of its status in law, the doctrine was not engaged by the Morris Claim. A key element of the doctrine is misconduct. This element does not appear to be present on the facts of the Morris Claim.

² The distribution percentage is subject to future variation, depending upon the amount of claims against the estate that are ultimately allowed.

PART II – THE FACTS

A. CHRONOLOGY OF I. WAXMAN & SONS LTD.

8. IWS was a privately owned, successful scrap metal, garbage and recycling business operating in Hamilton, Ontario and established by Isaac Waxman in 1911.³

9. In 1956, IWS was incorporated under the *Ontario Business Corporations Act* (“*OBCA*”).⁴ In 1972, Isaac Waxman’s two sons, Chester Waxman (“Chester”) and Morris, became equal owners of IWS with each essentially owning 50% of the IWS shares.⁵

10. Chester and Morris were both involved in the day-to-day operations of IWS. Chester was responsible for maintaining the financial and legal affairs of IWS. Morris was responsible for the trucking operations and supervision of yard employees.⁶ Chester deferred to Morris’ mechanical and technical expertise, and Morris deferred to Chester’s financial and legal expertise.

11. IWS prospered. Chester and Morris brought their sons into the business. In 1979 IWS gave bonuses totalling \$250,000. In 1981-82 IWS bonuses totalled \$6.6 million.

12. On December 22, 1983, Morris, signed an agreement wherein he agreed to sell his shares, which totalled a fifty percent interest in IWS, to Chester for \$3 million. Part of the agreement included Morris gifting his 1983 dividend back to Chester and loaning IWS \$500,000 repayable on October 8, 1984.⁷ Morris also signed a fifty year lease (the “Lease”) regarding real property that was jointly owned by Chester and Morris through companies they had individually incorporated. The Lease authorized assignment without Morris’ approval or consent and contained no rent adjustment clause.⁸

³ *Waxman v. Waxman*, [2004] O.J. No. 1765 at para. 1 (C.A.) (“Appeal Decision”), Brief of Authorities, Tab 24.

⁴ R.S.O. 1990, c. B.16. See Appeal Decision, Brief of Authorities, Tab 24, para. 29.

⁵ Appeal Decision, Brief of Authorities, Tab 24, para. 2.

⁶ Appeal Decision, Brief of Authorities, Tab 24, para. 33.

⁷ Appeal Decision, Brief of Authorities, Tab 24, para. 156.

⁸ Judgment, Brief of Authorities, Tab 21, para. 742.

13. On October 26, 1988, IWS terminated Morris' employment as the President of IWS.⁹

14. In 1988 Morris commenced five actions against numerous individuals and entities for damages arising from the loss of his ownership of IWS shares and the operation of IWS between 1979 and 1988 (the "Morris Litigation").¹⁰

15. Morris asserted that he had unknowingly entered into the various agreements while in ill health and in reliance upon Chester. Morris asserted claims for lost shares, lost profits from 1983 onwards, IWS profit diversions to corporations owned by Chester's sons, improper distributions of IWS equity via bonuses paid to Chester and his sons in 1979 and 1981-82, the lease of December 1983, and wrongful dismissal as the President of IWS on October 26, 1988.

16. On June 27, 2002, Justice Sanderson rendered her decision on the Morris Litigation. She found in favour of Morris on most of the claims.¹¹

17. On September 16, 2002, Justice Sanderson released additional reasons in support of the Judgment.¹² On January 10, 2003, further reasons were released with respect to costs of the trial proceedings and interest calculations on the damages award.¹³ On April 30, 2004, the Ontario Court of Appeal largely affirmed the Judgment and made only slight variations.¹⁴ On June 22, 2004, leave to appeal to the Supreme Court of Canada was denied.¹⁵

18. On January 4, 2007, Master Linton released the Reference Report. The Master quantified the loss of profit damages award owed to Morris resulting from the improper sale of his IWS shares.¹⁶ On August 30, 2007, Justice Sanderson upheld the Master's Reference Report.¹⁷

⁹ Appeal Decision, Brief of Authorities, Tab 24, para. 210.

¹⁰ Lists of the relevant decisions in the litigation and the different actions are set out in Schedules "C" and "D".

¹¹ Judgment, Brief of Authorities, Tab 21.

¹² *Waxman v. Waxman*, [2002] O.J. No. 3533 (Sup. Ct.), Brief of Authorities, Tab 22.

¹³ *Waxman v. Waxman*, [2003] O.J. No. 87 (Sup. Ct.), Brief of Authorities, Tab 23.

¹⁴ Appeal Decision, Brief of Authorities, Tab 24.

¹⁵ *Waxman v. Waxman*, [2004] S.C.C.A. No. 291, Brief of Authorities, Tab 25.

¹⁶ *Waxman v. Waxman*, (4 January 2007), 33234/88 (Sup. Ct.), Brief of Authorities, Tab 26.

¹⁷ *Waxman v. Waxman*, [2007] O.J. No. 3433 (Sup. Ct.), Brief of Authorities, Tab 27.

B. JUDICIAL FINDINGS IN THE MORRIS LITIGATION

(i) Loss of Profits from December 22, 1983 to June 27, 2002

19. Justice Sanderson determined that as of December 22, 1983, Chester held 50% of the IWS shares in a constructive trust for Morris. Chester was ordered to immediately transfer 50% of the IWS shares back to his brother.¹⁸

20. It was also found that IWS had conducted itself oppressively, contrary to s. 248 of the *OBCA*, through its involvement with the sale of Morris' shares.¹⁹ IWS and Chester, among others, were held liable for the subsequent loss of profits incurred by Morris.

21. Master Linton determined the fair value of Morris' loss of profits and awarded Morris damages in the amount of \$37,900,475 (inclusive of prejudgment interest up to January 4, 2007) as against IWS and Chester.²⁰ On August 30, 2007, Justice Sanderson confirmed Master Linton's Reference Report. As of September 20, 2007, Chester and IWS owed Morris \$39,711,278 (inclusive of pre-judgment interest up to August 30, 2007).²¹ IWS and Chester are severally liable for this amount.

(ii) Profit Diversion

22. It was found that IWS had conducted itself oppressively, contrary to s. 248 of the *OBCA*, by improperly diverting profits to various companies owned by Chester's sons.²² Chester and IWS, among others, were ordered to pay 50% of the profit diversions to Morris. The Court of Appeal varied this amount reducing the damage award to 25% of the profit diversions (i.e. \$590,036.50).²³ Again, IWS and Chester were severally liable.

¹⁸ Judgment, Brief of Authorities, Tab 21, paras. 2590-91.

¹⁹ Judgment, Brief of Authorities, Tab 21, paras. 1530-31.

²⁰ *Waxman v. Waxman*, (4 January 2007), 33234/88, (Sup. Ct.), Brief of Authorities, Tab 26, para. 8.

²¹ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 30.

²² Judgment, Brief of Authorities, Tab 21, para. 1534.

²³ Appeal Decision, Brief of Authorities, Tab 24, para. 567.

(iii) Declared Bonuses 1979-1982

23. Justice Sanderson found that IWS had conducted itself oppressively, contrary to s. 248 of the *OBCA*, by improperly diverting the equity of IWS via bonuses to Chester and his sons in 1979 and 1981-82.²⁴

24. The Court of Appeal upheld these findings, and stated that the distribution of this equity was done at the expense of Morris' interest in IWS.²⁵

25. IWS and Chester, among others, were held liable for the improper bonus payments. Damages of \$125,000 were awarded for the 1979 bonuses.²⁶ Damages of \$2,312,000 were awarded for the 1981-82 bonuses.²⁷

(iv) December 22, 1983 Lease of Real Property

26. Justice Sanderson found that the fifty year Lease signed by Morris on December 22, 1983 was grossly unfair to Morris and that the rental amount was well below the actual market value for rental of the property.

27. No damages award was made in this regard since it was held that the shortfall in the market value of the Lease would be captured in the loss of profits award to Morris.²⁸ Nonetheless, Justice Sanderson suggested that the shortfall would have been approximately \$2,529,607.²⁹

(v) Punitive Damages

28. Justice Sanderson found that with respect to the staged share sale, the December 1983 lease, the 1979 and 1981-82 bonuses, and the profit diversion, both IWS and Chester had

²⁴ Judgment, Brief of Authorities, Tab 21, paras. 309, 1288-89, 1533 and 1692.

²⁵ Appeal Decision, Brief of Authorities, Tab 24, paras. 552 and 554.

²⁶ Judgment, Brief of Authorities, Tab 21, para. 1692.

²⁷ Judgment, Brief of Authorities, Tab 21, para. 1694.

²⁸ Judgment, Brief of Authorities, Tab 21, para. 1691.

²⁹ Judgment, Brief of Authorities, Tab 21, para. 747.

acted towards Morris in a high-handed and malicious manner.³⁰ IWS and Chester were therefore held severally liable for punitive damages of \$350,000.³¹

(vi) **Wrongful Dismissal**

29. Justice Sanderson found that IWS' termination of Morris was wrongful and that IWS had conducted itself oppressively, contrary to s. 248 of the *OBCA*, by dismissing Morris without cause from his position as the President of IWS on October 26, 1988.³²

30. IWS and Chester were held severally liable for the damages Morris sustained as a result of his wrongful termination. Damages of \$64,672 were awarded.³³

31. The award was calculated using Morris' base salary and a notice period of two years. However, if lost profits were not awarded, Justice Sanderson stated that the wrongful dismissal award would have been increased to \$266,370.³⁴

32. Pre-Judgment interest was awarded on the wrongful dismissal award using an average rate of 8.04% from March 31, 1989 to June 27, 2002.³⁵

C. IWS' DESCENT INTO BANKRUPTCY

33. Although historically IWS was a very profitable company, from 1988 onwards IWS' financial health began to decline as a result of the litigation, a decrease in the level of business activity, and a reduction in the customer base.

34. On September 1, 2005, the Court appointed Deloitte & Touche Corporate Finance Canada Inc. as a marketing agent for IWS.³⁶ As the marketing agent, Deloitte & Touche Corporate Finance Canada Inc. marketed the operating assets of IWS and ultimately sold a property known as Centennial, which had been used in the business of IWS, for \$16.5 million.³⁷

³⁰ Judgment, Brief of Authorities, Tab 21, para. 1664.

³¹ Judgment, Brief of Authorities, Tab 21, para. 1706.

³² Judgment, Brief of Authorities, Tab 21, para. 1448.

³³ Judgment, Brief of Authorities, Tab 21, para. 2609; Appeal Decision, Brief of Authorities, Tab 24, para. 636.

³⁴ Judgment, Brief of Authorities, Tab 21, para. 2200.

³⁵ *Waxman v. Waxman*, [2003] O.J. No. 87, (Sup. Ct.), Brief of Authorities, Tab 23, para. 22.

³⁶ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 14.

³⁷ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 15.

35. Pursuant to an Order made on March 26, 2007, Deloitte & Touche Inc. became the court appointed receiver of IWS.³⁸ Upon its appointment, Deloitte & Touche Inc. began a realization of the assets of IWS through the sale of IWS, the collection of various accounts receivable, and the sale of securities held by IWS. After receiving court approval on June 19, 2007, Deloitte & Touche Inc. sold the operating assets of IWS for \$2.8 million (excluding the accounts receivable).³⁹ Total realizations to date are approximately \$35.8 million.

36. On September 4, 2007, a bankruptcy order was issued with respect to IWS.⁴⁰

37. The Trustee has received various unsecured claims against the estate of IWS. This number may increase. Claims of the unsecured creditors can be classified into the following groups: the Morris Claim, other Waxman family claims, Canada Revenue Agency claim, Ministry of Finance claim, Judgment claims, employee claims, trade claims, and contingent claims.⁴¹

38. One secured creditor, the Ministry of Finance, has filed a claim against the estate of IWS. The Trustee is unaware of any preferred claims.⁴²

D. EFFECTS OF MORRIS' CLAIMS

39. The Morris Claim, as set out in the proof of claim filed by Morris, is composed of the following amounts:⁴³

1979 bonuses award	\$150,961.50
1981-82 bonuses award	\$2,792,136.15
Profit diversions award	\$712,567.20
Punitive damages award	\$422,692.20
Wrongful dismissal award	\$78,107.55
Prejudgment interest on wrongful dismissal award	\$81,732.90
Prejudgment interest in the Taylor Leibow Action ⁴⁴	\$3,615,000.36

³⁸ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 16.

³⁹ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 17.

⁴⁰ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 1.

⁴¹ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 32.

⁴² Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, para. 30.

⁴³ Morris Waxman Proof of Claim, September 20, 2007, Motion Record, Tab 2, Exhibit "D", Schedule A to the Second Report of the Trustee.

Appeal Costs	\$522,946.00
Less Amount Received from Sheriff	(\$1,354,690.10)
Reference award	\$39,733,037.60
Less Amount Morris owes IWS (including prejudgment interest)	(\$127,276.15)
NET AMOUNT OWING TO MORRIS	\$46,627,215.21

40. The Morris Claim is the largest unsecured creditor claim against the estate of IWS as reflected in the Statement of Affairs. The ultimate proportion of the Morris Claim to the estate will vary depending on the number and quantum of claims finally allowed. Currently, the Morris Claim represents approximately 65% of the potential unsecured claims of \$71.4 million. On a *pari passu* distribution on current figures, Morris would receive \$18.6 million. This would represent a \$0.40 distribution for unsecured creditors.⁴⁵

41. If the Morris Claim is subordinated, unsecured creditors would likely be paid in full. Morris, however, would received an estimated distribution of only 8%, or approximately \$3.7 million.⁴⁶

E. PARTS OF THE MORRIS CLAIM NOT AT ISSUE

42. The Judgment has five major award components against IWS:

- (1) Lost profits for the years 1983-2002;
- (2) Profit Diversions to Robert Waxman's companies;
- (3) Declared Bonuses in 1979 and 1981-82;
- (4) Lost amounts relating to the Lease; and
- (5) Wrongful Dismissal.

43. The Lease and Wrongful Dismissal components have no direct connection to Morris' equity interest in IWS. The Trustee therefore expects these claims to rank *pari passu* notwithstanding the subordination arguments addressed in this motion.

⁴⁵ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, paras. 50-51.

⁴⁶ Second Report of the Trustee, December 4, 2007, Motion Record, Tab 2, paras. 50-51.

44. However, Justice Sanderson's quantification of these awards was interrelated with awards in the remaining portions of the Morris Claim. Accordingly, in the event the subordination arguments are accepted, the Lease and Wrongful Dismissal components may require re-calculation.

PART III – ISSUES

45. What legal principles are applicable to the Morris Claim:
- (a) the general principle is debt before equity;
 - (b) “hybrid” claims must be characterized through a fact specific analysis;
 - (c) what is the treatment of shareholder litigation claims;
 - (d) there is no bright line rule in Canada on subordinating shareholder claims; and
 - (e) declared dividends convert equity into debt.
46. Do the applicable principles suggest the subordination of the Morris Claim?
47. Does the doctrine of equitable subordination have any application?

PART IV – THE LAW

A. THE MORRIS CLAIM AND APPLICABLE PRINCIPLES

(i) The General Principle: Debt before Equity

48. At common law, equity investors rank below general creditors in bankruptcy.⁴⁷

49. The subordination of equity elements is premised on two underlying considerations: the choices made by shareholders versus the choices made by creditors.⁴⁸

⁴⁷ *Meade (A Bankrupt) (Re)*, [1951] Ch. 774 at 778 (Div. Ct.), Brief of Authorities, Tab 11; *Patricia Appliance Shops Limited (Re)*, [1922] 52 O.L.R. 215 at 217 (S.C., High Ct. Div.), Brief of Authorities, Tab 15; *Sukloff v. A.H. Rushforth & Co. Estate*, [1964] S.C.R. 459 at 467 (S.C.C.), Brief of Authorities, Tab 18; *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 511, 519 (C.A.), Brief of Authorities, Tab 5.

50. Shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. The Alberta Court of Queen's Bench has observed, citing American authorities, that shareholders are "presumed to have been bargaining for equity type profits and assumed equity type risks."⁴⁹ As such, it has been determined that shareholders should not be permitted to rank with creditors at the point when the fortunes of the corporation turn sour. The Ontario Court of Appeal, also drawing on relevant American authorities, affirms the risk-investment principle that

seeks to protect creditors by refusing to permit selling stockholders, who were risk investors, to withdraw their capital on the same terms as general creditors in the event of insolvency.⁵⁰

51. This consideration also appears to be embodied in section 139 of the *Bankruptcy and Insolvency Act* ("BIA")⁵¹, which specifies that a putative unsecured creditor's claim shall nevertheless be postponed if the return on the loan is tied to the changing fortunes of the corporation:

Where a lender advances money to a borrower engaged or about to engage in trade or business under a contract with the borrower that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the trade or business, and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied. [emphasis added]

52. The corollary to the consideration of equity risk is that creditors choose a lower level of exposure. Creditors bargain to have their investment protected by what American authorities refer to as an "equity cushion."⁵² This concept has also been accepted by Canadian courts:

Holding that the appellants do not have provable claims accords with sound corporate policy. On the insolvency of a company the claims of

⁴⁸ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 541-543, 546 (C.A.), Brief of Authorities, Tab 5; *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at paras. 29-57 (Alta. Q.B.), Brief of Authorities, Tab 3; *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at paras. 26, 67 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13; *Robinson v. Wangemann*, 75 F.2d 756 at 757 (5th Cir. 1935), Brief of Authorities, Tab 16; *Stirling Homex Corporation (Re)*, 579 F. 2d 206 at 213-214 (2nd Cir. 1978), Brief of Authorities, Tab 17; *Telegroup, Inc. (Re)*, 281 F.3d 133 at 142 (3d. Cir. 2002), Brief of Authorities, Tab 19.

⁴⁹ *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at para. 33 (Alta. Q.B.), Brief of Authorities, Tab 3.

⁵⁰ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 542 (C.A.), Brief of Authorities, Tab 5.

⁵¹ R.S.C. 1985, c. B-3, as amended.

⁵² *Stirling Homex Corporation (Re)*, 579 F. 2d 206 at 214 (2nd Cir. 1978), Brief of Authorities, Tab 17.

creditors have always ranked ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment. Creditors rely on these protections in making loans to companies. Permitting preferred shareholders to be turned into creditors by endowing their shares with retraction rights runs contrary to this policy of creditor protection.⁵³

...

Creditors do business with companies on the assumption they will rank ahead of shareholders on insolvency - the focus of this analysis is the degree of risk-taking respectively assumed by shareholders and creditors.⁵⁴

(ii) **Characterization of “Hybrid” Claims: The Fact-Specific Analysis**

53. Not all claims are immediately classifiable as debt or equity. The Supreme Court of Canada has recognized the existence of “hybrid” claims, in which elements of equity and debt coexist:

As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of \$255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. ...It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement. [emphasis added]⁵⁵

⁵³ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 546 (C.A.), Brief of Authorities, Tab 5.

⁵⁴ *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at para. 67 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13.

⁵⁵ *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 at 406 (S.C.C.), Brief of Authorities, Tab 4.

54. Justice Iacobucci employed a fact-specific analysis to conclude that certain equity features (for example, warrants for the purchase of stock) of a \$255 million loan were “incidental” to a transaction that was in “substance” a form of debt and must rank with the claims of general creditors, and not behind them.

55. The Ontario Court of Appeal reiterated the fact-specific approach to hybrid claims in *Central Capital Corp. (Re)* (“*Central Capital*”),⁵⁶ which involved a “question of characterization” as to whether the “appellants’ retraction rights created debts of Central Capital.”⁵⁷ The Court concluded that the appellant preferred shareholders could not escape the insolvency of the corporation by claiming as debt, and must be subordinated in accordance with the prevailing considerations.⁵⁸

(iii) Treatment of Shareholder Litigation Claims

56. Shareholder litigation claims are subject to the hybrid analysis to determine whether they are in substance debt or equity.⁵⁹

57. In two decisions, *Blue Range Resource Corp. (Re)* (“*Blue Range*”) and *National Bank of Canada v. Merit Energy Ltd.* (“*Merit Energy*”), the Alberta Court of Queen’s Bench has held that damages and rescission claims for misrepresentation, asserted near or after insolvency, were in substance claims for return of capital. In *Blue Range*, it was held that

...the alleged share exchange loss derives from and is inextricably intertwined with Big Bear’s shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested qua shareholder, rather than an ordinary tort claim.⁶⁰

58. Similarly, the Court in *Merit Energy* stated,

It is true these shareholders are using statutory provisions to make their claims in damages or rescission rather than the tort basis used in *Re: Blue Range Resource Corp*, but in substance they remain shareholder claims for the return of an equity investment. The right to a return of this equity

⁵⁶ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 (C.A.), Brief of Authorities, Tab 5.

⁵⁷ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 535 (C.A.), Brief of Authorities, Tab 5.

⁵⁸ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 519-546 (C.A.), Brief of Authorities, Tab 5.

⁵⁹ *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at paras. 19-21 (Alta. Q.B.), Brief of Authorities, Tab 3; *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at paras. 27-28 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13.

⁶⁰ *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at para. 25 (Alta. Q.B.), Brief of Authorities, Tab 3.

investment must be limited by the basic common law principle that shareholders rank after creditors in respect of any return of their equity investment.⁶¹

The hybrid analysis was explicitly applied in both decisions.

59. In *Blue Range*, Justice Romaine also reviewed the policy considerations underlying the American authorities,⁶² including authorities dealing with the “absolute priority” rule set out in § 510 of the U.S. Bankruptcy Code, which deals with claims arising from the purchase or sale of shares:

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock⁶³

60. Justice Romaine relied upon the central equitable principles underlying this provision while stopping short of adopting an “absolute priority” rule:

Although the court in *Stirling Homex* refers to its responsibility under US bankruptcy law to ensure that a plan of reorganization is “fair and equitable” and to the “absolute priority” rule of classification under US bankruptcy principles, it is clear that the basis for its decision is the general rule of equity, a “sense of simple fairness” (supra, page 215). Despite the differences that may exist between Canadian and American insolvency law in this area, this case is persuasive for its reasoning based on equitable principles.

...

It is not necessary to adopt the U.S. absolute priority rule to follow the approach [the cases] espouse, which is based on equitable principles of fairness and policy. There is no principled reason to disregard the approach set out in these cases, which have application to Canadian business and economy, and I have found them useful in considering this issue.⁶⁴

⁶¹ *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at para. 50 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13.

⁶² *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at paras. 33, 43-57 (Alta. Q.B.), Brief of Authorities, Tab 3.

⁶³ 11 U.S.C. § 510; *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at paras. 33, 43-57 (Alta. Q.B.), Brief of Authorities, Tab 3.

⁶⁴ *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 at paras. 44, 56 (Alta. Q.B.), Brief of Authorities, Tab 3.

61. Justice Romaine's approach is consistent with the fact-specific characterization of hybrid claims mandated by the Supreme Court of Canada and the Ontario Court of Appeal.

62. A recent U.S. decision under §510 affirms that the underlying principle in the U.S., as in Canada, is to hold investors to their chosen risk exposure:

Since claimants in this case are equity investors seeking compensation for a decline in the value of Telegroup's stock, we believe that the policies underlying § 510(b) require resolving the textual ambiguity in favor of subordinating their claims. Put differently, because claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that § 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. Were we to rule in claimants' favor in this case, we would allow stockholders in claimants' position to retain their stock and share in the corporation's profits if the corporation succeeds, and to recover a portion of their investment in parity with creditors if the corporation fails [emphasis added].⁶⁵

(iv) No Bright Line Rule in Canada on Subordinating Shareholder Claims

63. The Canadian authorities, with one partial exception, have declined to adopt an absolute rule in relation to the subordination of shareholder claims.

64. In a brief endorsement dealing with the arrangement of Bell Canada International, Justice Farley opined that a shareholder claim would remain subordinate, even in the event of a favourable judgment in a misrepresentation action. No reasons were provided for this conclusion. Notably, the Court was dealing with a shareholder claim that had already been dismissed twice as disclosing no reasonable cause of action.⁶⁶ Additionally, in a prior judgment, Justice Farley declined to make a summary ruling on this issue:

What in essence I am being asked to do is to give my opinion in a declaration of the Court that the doctrine of subordination of an equity claim is recognized as the law of Ontario and, indeed it seems, of Canada on a bright line basis. I raised with counsel at the time of the hearing whether this was the appropriate way of determining that issue. . . .

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 recognized as "involving difficult, complex policy issues with broad social ramifications". . . .

⁶⁵ *Telegroup, Inc. (Re)*, 281 F.3d 133 at 142 (3d. Cir. 2002), Brief of Authorities, Tab 19.

⁶⁶ *Bell Canada International Inc. (Re)* (14 September 2004), 02-CL-4553, Brief of Authorities, Tab 2.

I would therefore dismiss the AT&T motion without prejudice to AT&T raising the issue when there is a suitable full record to deal with this.⁶⁷

(v) **Declared Dividends: The Conversion of Equity into Debt**

65. *Blue Range* and *Merit Energy* suggest that shareholder claims for misrepresentation will often be treated as equity claims. The authorities do not, however, establish a proposition that a claim that originates in equity will always remain in equity.

66. The treatment of declared dividends, as set out below, suggests that a claim can change from equity to debt. There may be a distinction between a claim for a return of capital rather than a claim for a return on capital.

67. The declared dividend rule provides that equity is transformed into debt once a dividend is declared by a corporation, and that such a debt is provable in bankruptcy.⁶⁸ In *Central Capital*, Justice Laskin stated,

It seems to me that these appellants must be either shareholders or creditors. Except for declared dividends, they cannot be both.⁶⁹

68. Similarly, Section 121(1) of the *BIA* provides that

All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act [emphasis added].

69. On related principles, the British Columbia Court of Appeal has held that an agricultural co-operative member who has exercised a right of redemption, and remains only to be paid, is an unsecured creditor.⁷⁰

70. The status of a declared dividend as a provable debt is consistent with the applicable policy considerations. A shareholder who is entitled to a declared dividend has made

⁶⁷ *AT&T Canada Inc. (Re)*, [2003] O.J. No. 5086 at paras. 6, 9, 11 (Sup. Ct.), Brief of Authorities, Tab 1.

⁶⁸ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 516, 530, 540, 545 (C.A.), Brief of Authorities, Tab 5; *Custodian v. Blucher*, [1927] S.C.R. 420 at 425 (S.C.C.), Brief of Authorities, Tab 7; Lloyd W. Houlden and G.B. Morawetz, *Bankruptcy and Insolvency Law of Canada*, vol. 2, looseleaf (Scarborough: Carswell, 1989) at 5-37, Brief of Authorities, Tab 20.

⁶⁹ *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 540 (C.A.), Brief of Authorities, Tab 5.

⁷⁰ *East Chilliwack Agricultural Co-operative (Re)* (1989), 58 D.L.R. (4th) 11 (B.C.C.A.), Brief of Authorities, Tab 9, cited in *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 at 513, 525 and 541 (C.A.), Brief of Authorities, Tab 5.

a risk-investment that has paid off or crystallized in part. There is no longer any speculation attached to the investment as far as the amount of the dividend is concerned. Considerations regarding queue jumping and creditor knowledge become similarly attenuated.

71. The Court in *Merit Energy* found the declared dividend analogy to be “appealing” in regards to the issue of a shareholder’s potential to rank with general creditors, but not applicable on the facts, which did not involve any element of crystallization of risk investment.⁷¹

72. The declared dividend rule therefore allows shareholders to prove a claim in bankruptcy, despite their claim originating *qua* shareholder. The rule is implicitly contrary to an absolute rule that a claim *qua* shareholder must be subordinated.

B. APPLICATION TO THE MORRIS CLAIM

73. The application of the relevant principles to the Morris Claim has led the Trustee to conclude that the Morris Claim should not be subordinated.

74. The following facts are relevant in considering the policies raised by the authorities and in characterizing the Morris Claim:

- (a) The Morris Claim would not have arisen if Morris was not a shareholder in IWS;
- (b) The amounts that make up the bulk of the Morris Claim were realized by Chester and his sons when IWS was solvent;
- (c) These amounts would have been realized by Morris when IWS was solvent;
- (d) The Morris Claim is founded on a judgment declared by the Superior Court of Justice;
- (e) IWS was likely solvent when the Judgment was declared;
- (f) The Judgment itself may have precipitated the insolvency of IWS; and

⁷¹ *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at para. 53 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13.

- (g) Most of the known creditors of IWS extended credit after the Morris Litigation was initiated and after the Judgment was rendered.⁷²

75. The prevailing consideration relating to an equity-holder's risk investment is queue jumping on insolvency. This concern does not apply to the Morris Claim. The Morris Claim is based on activities and litigation claims that significantly preceded the insolvency of IWS. The risks Morris had taken as shareholder had, like declared dividends, crystallized in the awards of lost profits.

76. Similarly, the Judgment, like a declared dividend, separates the Morris Claim from claims for a return of investments. With a declared judgment, the shareholder interest in the corporation is replaced by a fixed debt for past amounts.⁷³ None of the Canadian authorities involved circumstances with the kind of finality provided by a court judgment.

77. The prevailing consideration relating to a creditor's legitimate expectation of an equity cushion also has little application to the Morris Claim. The Judgment was rendered in 2002. Many of the present creditors may have been aware of the Judgment. The expectation of any cushion relating to Morris' damage claims may have been accordingly reduced.

C. THE DOCTRINE OF EQUITABLE SUBORDINATION IS INAPPLICABLE

78. The American doctrine of equitable subordination enables a court to subordinate a claim in bankruptcy based on inequitable conduct.⁷⁴ This doctrine, which has an uncertain status in Canada,⁷⁵ appears to be inapplicable in the present circumstances.

79. Equitable subordination, in its American form, has three requirements:

- (1) the claimant must have engaged in some type of inequitable conduct;
- (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and
- (3)

⁷² Chronological Summary of Claims, Motion Record, Tab 2, Exhibit "C" to the Second Report of the Trustee.

⁷³ *Cybersight LLC (Re)*, 2004 U.S. Dist. LEXIS 24426 at 8 (D. Del. 2004), Brief of Authorities, Tab 8.

⁷⁴ *Mobile Steel Co. (Re)*, 563 F.2d 692 (5th Cir. 1977), Brief of Authorities, Tab 12.

⁷⁵ *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 at 419 (S.C.C.), Brief of Authorities, Tab 4; *New Solutions Financial Corp. v. 952339 Ontario Ltd.* (2007), 29 C.B.R. (5th) 222 at para. 32 (Ont. Sup. Ct.), Brief of Authorities, Tab 14.

equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy statute.⁷⁶

80. The Courts have generally refrained from entertaining or applying equitable subordination where the first requirement, that of inequitable conduct, has not been met.⁷⁷

81. There is no evidence of any wrongdoing on the part of Morris to satisfy the first part of the test. There is no suggestion that his conduct has injured the creditors or given him an unfair advantage to satisfy the second part. Equitable subordination is not applicable in the present circumstances.

PART V – ORDER REQUESTED

82. The Trustee is of the opinion that the Morris Claim should be allowed in concept, and seeks the direction of the Court in this regard.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

December 6, 2007



ALAN B. MERSKEY

Counsel for Deloitte & Touche Inc., in its capacity as trustee in bankruptcy of the estate of I. Waxman & Sons Limited

⁷⁶ *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 at 420 (S.C.C.), Brief of Authorities, Tab 4.

⁷⁷ *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305 at para. 67 (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.), Brief of Authorities, Tab 13; *Harbert Distressed Investment Fund, L.P. v. General Chemical Canada Ltd.*, [2006] O.J. No. 3087 at paras. 92-95 (Sup. Ct.), affirmed [2007] O.J. No. 3296 (C.A.), Brief of Authorities, Tab 10; *New Solutions Financial Corp. v. 952339 Ontario Ltd.* (2007), 29 C.B.R. (5th) 222 at para. 32 (Ont. Sup. Ct.), Brief of Authorities, Tab 14.

**SCHEDULE “A”
LIST OF AUTHORITIES**

1. *Meade (A Bankrupt) (Re)*, [1951] Ch. 774 (Div. Ct.)
2. *Patricia Appliance Shops Limited (Re)*, [1922] 52 O.L.R. 215 (S.C., High Ct. Div.)
3. *Sukloff v. A.H. Rushforth & Co. Estate*, [1964] S.C.R. 459 (S.C.C.)
4. *Central Capital Corp. (Re)* (1996), 27 O.R. (3d) 494 (C.A.)
5. *Blue Range Resource Corp. (Re)*, [2000] 4 W.W.R. 738 (Alta. Q.B.)
6. *National Bank of Canada v. Merit Energy Ltd.*, [2001] 10 W.W.R. 305; (Alta. Q.B.), affirmed [2002] 3 W.W.R. 215 (Alta. C.A.)
7. *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935)
8. *Stirling Homex Corporation (Re)*, 579 F.2d 206 (2nd Cir. 1978)
9. *Telegroup, Inc. (Re)*, 281 F.3d 133 (3d. Cir. 2002)
10. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.)
11. *Bell Canada International Inc. (Re)* (14 September 2004), 02-CL-4553
12. *AT&T Canada Inc. (Re)*, [2003] O.J. No. 5086 (Sup. Ct.)
13. *Custodian v. Blucher*, [1927] S.C.R. 420 (S.C.C.)
14. Lloyd W. Houlden and G.B. Morawetz, *Bankruptcy and Insolvency Law of Canada*, vol. 2, looseleaf (Scarborough: Carswell, 1989)
15. *East Chilliwack Agricultural Co-operative (Re)* (1989), 58 D.L.R. (4th) 11 (B.C.C.A.)
16. *Cybersight LLC (Re)*, 2004 U.S. Dist. LEXIS 24426 (D. Del. 2004)
17. *Mobile Steel Co. (Re)*, 563 F.2d 692 (5th Cir. 1977)
18. *New Solutions Financial Corp. v. 952339 Ontario Ltd.* (2007), 29 C.B.R. (5th) 222 (Ont. Sup. Ct.)
19. *Harbert Distressed Investment Fund, L.P. v. General Chemical Canada Ltd.*, [2006] O.J. No. 3087 (Sup. Ct.), affirmed [2007] O.J. No. 3296 (C.A.)

SCHEDULE "B"
THE TEXT OF ALL RELEVANT PROVISIONS
OF STATUTES AND REGULATIONS

BANKRUPTCY AND INSOLVENCY ACT, R.S.C. 1985, C. B-3

Claims provable

121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

Postponement of claims of silent partners

139. Where a lender advances money to a borrower engaged or about to engage in trade or business under a contract with the borrower that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the trade or business, and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

U.S. BANKRUPTCY CODE, 11 U.S.C.

§ 510. Subordination

(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may--

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

**SCHEDULE “C”
WAXMAN DECISIONS**

Decision	Citation
Trial Decision: Part I – II	<i>Waxman et al. v. Waxman et al.</i> , [2002] O.J. 2528 (Sup. Ct.) (Sanderson, J.)
Trial Decision: Part III – XI	<i>Waxman et al. v. Waxman et al.</i> , [2002] O.J. No. 3533 (Sup. Ct.) (Sanderson, J.)
Costs and Prejudgment Interest Decision	<i>Waxman et al. v. Waxman et al.</i> , [2003] O.J. No. 87 (Sup. Ct.) (Sanderson, J.)
Court of Appeal Decision	<i>Waxman et al. v. Waxman et al.</i> , [2004] O.J. No. 1765 (C.A.)
Supreme Court of Canada Decision	<i>Waxman et al. v. Waxman et al.</i> , [2004] S.C.C.A. No. 291.
Reference Report	<i>Waxman et al. v. Waxman et al.</i> (4 January 2007), 33234/88 (Sup. Ct.) (Master Linton)
Confirmation of Reference Report Decision	<i>Waxman et al. v. Waxman et al.</i> , [2007] O.J. No. 3433 (Sup. Ct.) (Sanderson, J.)

SCHEDULE "D"
MORRIS LITIGATION ACTIONS

Action	Court File Number
Main Action (share sale, loss of profits, bonuses, December 1983 lease, and Ancaster property)	33234/88
Wrongful Dismissal Action	36583/89
Inducing Breach of Contract Action	37616/89
Action Against the Lawyer, Ennis	42114/89
Action Against the Accountants (Taylor Leibow, Linton/IWS)	44142/89

IN THE MATTER OF THE BANKRUPTCY OF I. WAXMAN & SONS LIMITED,
a corporation incorporated under the laws of the Province of Ontario,
carrying on business in the City of Hamilton, in the Province of Ontario

Estate No: 31-207468-T

ONTARIO
SUPERIOR COURT OF JUSTICE
(IN BANKRUPTCY AND INSOLVENCY)

Proceeding commenced at Toronto

FACTUM OF THE TRUSTEE IN BANKRUPTCY
(Motion returnable December 14, 2007)

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