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VIA E-MAIL

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Dear Counsel:

Re: I. Waxman & Sons Limited: Estate No. 31-207468-T

Enclosed herewith is the factum of the unsecured creditors represented by Lerners LLP.

Yours very truly,


per: Robert J. Morris

RJM/ds
Encl.

cc: Jennifer Stam / Mario Forte
Stuart Walker
David Jackson
David Piccioni
Edmond Lamek / Robert Harrison
James W. Dunlop
Robert Swan
Robert Waxman
Paul van Eyk

**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 UNSECURED CREDITORS

PART I – OVERVIEW STATEMENT

1. At issue on this motion is whether a Judgment in favour of Morris Waxman made severally against I. Waxman & Sons Limited (hereinafter, "**IWS**"), a bankrupt Ontario corporation, and Chester Waxman should be paid rateably with or behind the claims of ordinary unsecured creditors of IWS. The Trustee and Morris Waxman maintain that his Judgment should be ranked alongside the claims of the unsecured creditors. Fourteen unsecured trade creditors represented by Lerner's LLP on the return of this motion (including Grace Transport Inc.) resist, contending that their claims as IWS creditors should be paid in full prior to any distribution to Morris Waxman, who was and is a 50% shareholder of IWS.

2. Under the traditional equity contract, company shareholders enjoy significant control over the decisions of the firm, are owed fiduciary duties by the firm's managers, and participate fully in the company's profits. In contrast, in the traditional debt contract, a firm's creditors are entitled to a fixed return and are not owed any duties by management unless they have constrained firm decisions by contract. Should a company fail to satisfy its obligations, creditors have the right to seize and sell the firm's assets to satisfy their claims, which enjoy priority over equity interests. However, creditor participation in the growth of the firm is effectively capped by the contractual rate of interest.

3. Existing Canadian law governing distribution priority upon liquidations of insolvent businesses depends universally on the distinction between debt and equity; all unsecured creditors must be paid in full before shareholders are entitled to receive anything.

4. Notwithstanding this, the Trustee in bankruptcy of IWS submits that, in this case, shareholder Morris Waxman should be permitted to rank *pari passu* with the claims of unsecured creditors in the bankruptcy of IWS. The basis of this submission seems to be that Morris Waxman has obtained a Judgment against IWS and that somehow that fact "transforms" his entitlement to share with Chester Waxman in the equity of IWS into "debt". Should effect be given to this argument, the unsecured creditors can expect a distribution no higher than 40% of the amounts of their several claims.

5. For the reasons set out in this factum, the unsecured creditors of IWS represented by Lerner's LLP urge this Court to reject the arguments of the Trustee and of Morris Waxman and to rule that he may only obtain payment of his Judgment (or, at least, of that part of it which represents his shareholder's interest in IWS) after all other creditors have been paid in full. This result accords with long-standing common-law principles and also is in line with the nascent development in Canada of the equitable doctrine of "subordination" already established in the United States of America ("U.S."). Should this result occur, the unsecured creditors will be paid in full and there will still be a sizeable sum left to pay down Morris Waxman's Judgment - which he also has the right to collect from others.

6. The necessary principled analysis involves two steps:

- (a) firstly, the Court must determine whether Morris Waxman's claim should be characterized as being in the nature of equity or in the nature of debt (even if it contains elements of both); and,
- (b) secondly, the Court should consider, if it decides that his claim can be characterized as debt, whether it can nevertheless be subordinated to the claims of the general body of creditors.

PART II – FACTS

7. The Trustee in bankruptcy of the estate of IWS seeks directions concerning the manner in which the proof of claim of defrauded IWS shareholder Morris Waxman is to be dealt with.

Notice of Motion, *Motion Record*, Tab 1, pp. 1-4

8. IWS became bankrupt on September 4, 2007, pursuant to the Order of Pepall J. made under the authority of the federal *Bankruptcy and Insolvency Act* ("**BIA**").

Order of Pepall J. dated September 4, 2007, *Motion Record*, Tab 2A, pp. 20-22

9. Morris Waxman was granted Judgment by Sanderson J. on June 27, 2002, following trial. The Judgment was varied in some respects by the Court of Appeal for Ontario on April 30, 2004. Following a reference, confirmed by Sanderson J. on August 30, 2007, the present value of that Judgment appears to be \$46,627,215.00, including interest accrued to September 4, 2007.

Trustee's 2nd Report, para. 34, *Motion Record*, Tab 2, pp. 9-19

10. Morris Waxman has filed a proof of claim in the IWS bankruptcy in which he characterizes his claim as unsecured and values it at \$46,627,215.21 as of September 4, 2007.

Proof of Claim of Morris Waxman dated September 20, 2007, *Motion Record*, Tab 2D, pp. 33-34

11. According to Schedule "A" of his proof of claim, his claim consists of:

- \$39,711,278.00 - the reference award (including prejudgment interest calculated through August 30, 2007)
- 2,312,000.00 - 1981-82 bonuses
- 590,036.50 - profit diversions
- 350,000.00 - punitive damages awarded by Sanderson J.
- 64,672.00 - wrongful dismissal damages

68,913.00	- prejudgment interest on the wrongful dismissal damages
3,047,851.38	- prejudgment interest in a related action (Court File no. 44142/89), also decided by Sanderson J.
<u>468,065.70</u>	- appeal costs awarded against IWS
\$46,612,816.58	- total principal claimed

Against these amounts, the proof of claim credits IWS with an amount already recovered by Morris Waxman from the sheriff (\$1,342,770.95), an off-setting amount Morris Waxman owes IWS pursuant to the same Judgment of Sanderson J., and prejudgment interest on the amount owed IWS. The total amount claimed of \$46,627,215.21 is derived by adding postjudgment interest (to September 4, 2007) to the principal claimed less credits; the postjudgment interest totals \$1,338,543.25.

12. The Morris Waxman Judgment arose from litigation which he commenced against IWS, his brother Chester Waxman, and others over the brothers' interests in IWS, a company founded by their father and in which they each became active participants and, following their father's death, 50/50 owners.

Trustee's 2nd Report, paras. 5-12, *Motion Record*, Tab 2, pp. 11-12

13. The genesis and the core result of that litigation were described in an Affidavit sworn on August 22, 2007, by Michael S. Waxman, a son of Morris Waxman, and delivered in support of the application for the bankruptcy Order against IWS. In his Affidavit, Michael S. Waxman made the following assertions:

1. My father, Morris Waxman ("Morris"), is a 50 percent shareholder of I. Waxman & Sons Limited ("IWS"), having been restored to this position by the Judgment of Sanderson J. dated June 27, 2002. ... I have acted as an advisor and liaison for my father in connection with his ongoing disputes with his brother Chester Waxman ("Chester") and Chester's sons. I am also the President of Solid Waste Reclamation Inc. ("**SWR**"), which was also a successful plaintiff in the actions against Chester, IWS and related parties. As such, I have knowledge of the matters to which I hereinafter depose. ...

3. My company, SWR, is the party that applied for the Bankruptcy Order on May 9, 2007 ...

8. From essentially the beginning of his working life, my father worked together with his brother Chester in the business, IWS, founded by their father, Isaac. IWS, located in Hamilton, was in the business of scrap metal recycling. From 1964, Chester and Morris each held approximately 50 percent of the IWS common shares. Subsequently, Chester and Morris held exactly equal shareholdings, each with 50 percent of the IWS shares.

9. In 1988, Morris commenced litigation to set aside certain documents dated December 22, 1983 by which Chester purported to acquire Morris' 50% shareholding in IWS. The litigation also concerned large bonuses and related-party payments to Chester, his sons and related companies in the 1979-83 period. The litigation, which gave rise to five actions, went to trial before Madam Justice Sanderson between 1998-2000. ...

10. On June 27, 2002, Justice Sanderson ... set aside the share sale transaction, re-instated Morris as a 50% shareholder of IWS, and declared that Chester had held 50 percent of the shares in trust for Morris since the December 1983 transfer. ...

17. The vast majority of Morris' judgments against IWS, Chester and his sons were comprised of Morris' half of IWS profits between the date of the overturned share sale (December 1983) and the judgment of Sanderson J. (June 2002). As noted, Justice Sanderson directed a Reference to determine precisely how much Morris was owed in respect of these post-share sale profits.

In para. 23 of his Affidavit, commenting on the bonuses which Chester Waxman caused IWS to pay out to himself and his sons or companies they controlled, Michael S. Waxman deposed that Justice Sanderson concluded that "almost all of the bonuses were distributions of equity".

Affidavit of Michael S. Waxman sworn August 22, 2007,
paras. 1, 3, 8, 9, 10, 17, and 23, *Motion Record*, Tab
3, pp. 105, 106, 109, 112, and 115

14. At all material times, therefore, Morris Waxman owned 50% of the shares of IWS. As a result of the Judgment, Morris Waxman is now the owner, either actually or beneficially, of 50% of the shares of IWS. By virtue of the Judgment, as amended but affirmed by the Court of Appeal, Chester Waxman held 50% of the shares of IWS via a

constructive trust for his brother Morris between December 22, 1983 (the date of the so-called "share sale" which the trial judge found to be fraudulent and therefore unwound) and June 27, 2002 (the date of her Judgment).

15. As the Trustee observes, Morris Waxman's claims would not have arisen had Morris not been a shareholder in IWS. Therefore, neither would his Judgment.

Trustee's factum, para. 74(a)

16. The background facts essential to the disposition of this motion were set out by the trial judge and by the Court of Appeal for Ontario in their Reasons for Decision reproduced in the Trustee's Brief of Authorities at **Tabs 21** and **24**, respectively. (Passages in their paragraphs quoted below are **bolded** for emphasis.)

Basis for Morris Waxman's claims and the remedy granted

17. The Court of Appeal summarized Morris Waxman's claims as follows:

8 The claims and counterclaims in the five actions revolve around the operations of two corporate entities, IWS and Solid Waste Reclamation Inc. ("SWRI"). The claims concerning IWS...relate to the ownership of the shares in that company after December 1983, and the operation of IWS between 1979 and 1988. In essence, **Morris alleged that Chester breached his fiduciary duty to Morris by cheating Morris out of his fifty per cent interest in IWS and further breached that duty by operating IWS between 1979 and 1988 to the personal advantage of Chester and his sons, and to the exclusion of the legitimate interests of Morris and his sons. ...**

18. The Court of Appeal also outlined the trial judge's remedy:

572 In connection with the share sale, the trial judge imposed a constructive trust. She ordered that **Chester held fifty per cent of the shares of IWS on constructive trust for Morris** from December 22, 1983 (the date of the share sale) to June 27, 2002 (the date of her judgment), when she ordered Chester to transfer the shares from his name to Morris's name. **She provided a remedy for the profits and the equity taken out of the company during the existence of the constructive trust** by ordering that Morris could elect one of two ways, which she described in detail, for calculating his fifty per cent of those amounts. She then ordered that to recover his share of these post-sale payouts, **Morris could elect between a proprietary remedy, namely a**

constructive trust on his portion of those amounts, or a personal remedy against both Chester and IWS for damages equivalent to his portion of those amounts. ...

580 ... [A]s La Forest J. said in *Hodgkinson*, at 440, equity's objective in a circumstance like this is restitutionary, namely to put Morris in as good a position as he would have been in had the fiduciary breaches not occurred. Moreover, particularly where the breach is found to be dishonest, equity does not permit the failed fiduciary to profit from his wrongdoing. **The remedies ordered by the trial judge** in relation to the share sale and the post-sale profits accomplish just that. They **restore Morris to his ownership position as it was before December 23, 1983.** They also recognize his entitlement as owner since that time. They permit Chester and his sons reasonable bonuses beyond their generous salaries for their contributions to IWS during the period of the constructive trust. In our view, these remedies are appropriate. They represent no error in the exercise of the trial judge's remedial discretion.

Conduct preceding the "share sale" of December 22, 1983

19. The trial judge's summary of finding of facts included these paragraphs:

1137 Morris and Chester built IWS together from a horse and wagon in the 1940's into a large and lucrative commercial enterprise, which by the 1970's had been valued at around \$8 million.

1138 From childhood they depended on each other to an extraordinary extent. In IWS' early years, they were 50/50 partners in an unincorporated partnership, later 50/50 shareholders. They divided responsibility according to their different but complementary interests and aptitudes.

20. The trial judge's summary of findings of fact makes it clear Morris Waxman intended to leave his equity in IWS to support himself and his family indefinitely into the future. This indicates that he would not have realized on his investment when IWS was still solvent, as is now suggested by the Trustee.

1147 Despite the success of IWS, Morris' manner and lifestyle were unassuming. He drew money from IWS only as needed. He gauged IWS' financial success from the activity in the yard. He wanted to build IWS with Chester for the eventual benefit of his and Chester's sons. He perceived his own security was in IWS. ...

1154 After his sons joined IWS, Chester overstated their contributions to the profits, growth and value of IWS. In the early 1980s, he started to divvy up the profits and equity of IWS according to his own ideas of contribution. **Morris continued to take only what he needed, assuming the equity of IWS was being increased for the equal benefit of himself and Chester and the eventual benefit of the next generation, his and Chester's sons.**

Wrongful "share sale"

21. The largest loss occurred as a result of Chester Waxman cutting his brother Morris out of IWS in December, 1983. IWS continued to do well, and large bonuses were declared once the threat of Morris Waxman regaining control of IWS equity arose. Then IWS sold off much of its assets while Morris was still deprived of his interest. The trial judge wrote:

1067 At the end of 1989 IWS declared bonuses of \$6,450,000 in favour of Chester and his sons and dividends in Chester's favour of \$300,000. Based on the evidence of Cole, I have found that these bonuses and the 1988 bonuses of \$8,750,000 were a distribution of equity of IWS made after the Defendants had notice of the Plaintiffs' claims to ownership of 50% of IWS. ...

1099 ... I find that the bulk of the post-1983 bonuses were a distribution of equity. I also find that all bonuses paid out to Chester after January 1984 were received with knowledge of the facts outlined here. After the litigation was started, Chester's sons also clearly had notice of the facts.

1100 On September 17, 1993 IWS transferred substantially all of its operating assets to Waxman Resources Inc. in exchange for 12000 class A preference shares and 15000 class B common shares. Subsequently, Philip Environmental Inc. purchased the Class A preference shares and Class B common shares for consideration of \$12,000,000 cash plus Philip shares which by 1997 had all been sold for a total of \$18,420,031.24. Therefore IWS received a total of \$30,420,031.24 from the Philip sale. Assets excluded from the sale included the Front 13 Acres at Centennial, the scale house at Windermere, the grease pit at Glow, the December 1983 lease and the name "I. Waxman & Sons."

1101 Therefore, between 1984 and 1993, Chester/his sons/IWS received a total of \$57,875,031 comprised of \$24,258,000 in bonuses to Chester and his sons, \$3,197,000 in dividends to Chester and

\$30,420,031.24 to IWS from Philip. IWS retained Centennial, its name and a number of other significant assets.

The 1981-82 bonuses

22. Even before Morris Waxman ceased (pursuant to the overturned “share sale”) to be a shareholder in late 1983, Chester Waxman depleted IWS equity by way of large bonuses to himself and his sons and highly unfavourable contracts with trucking companies owned by his side of the family. These activities stopped once Morris Waxman was gone; they started again when the threat of litigation arose. The Court of Appeal affirmed the characterization of the bonuses as unreasonable:

93 The trial judge decided that **the 1981 and 1982 bonuses were in fact a distribution of IWS shareholders' equity**, realized from the Laidlaw/Superior and Lasco transactions and **accumulated over the previous thirty years**, to individuals who were not shareholders. She further held that **there was no valid business reason for allocating millions of dollars in shareholders' equity to Chester's sons. ...**

94 The trial judge concluded that the decision to declare the 1982 bonuses in February 1982 was connected to the estate freeze discussions, which Chester was then having with his tax advisers. By declaring the bonuses in February 1982, **Chester hoped to lower the value of IWS for the purposes of the estate freeze, while at the same time putting the company's equity into the hands of the people he thought deserved it: himself and his sons.**

23. The Court of Appeal reduced this part of the award by half, finding the bonuses were only wrongful to Morris to the extent of his 50% share; but it emphasized the nature of the payments:

551 ... The trial judge based her conclusion on the finding that Chester's sons knew that the source of the money used to pay those bonuses was the proceeds of the sale of the two divisions of IWS of which Morris owned fifty per cent. She further found that reasonable young men in their position would have known that **the bonuses were a distribution of IWS equity and not the payment of reasonable compensation.**

552 Although she did not say so expressly, the trial judge clearly concluded from these findings that Chester's sons had constructive knowledge that **half their bonus monies represented Morris's equity in**

IWS and were paid to them in breach of Chester's fiduciary duty to Morris. ...

Profit diversions

24. The trial judge said of the profit diversions to the trucking companies owned by Chester's sons:

438 I find that IWS could have provided its own trucking services. Greycliffe was incorporated only because Robert wanted to make additional income for himself. All Greycliffe profits could have been earned within IWS. Each of Robert's Companies performed services that could have been performed by IWS or its subsidiaries, and the profits therefrom could have been retained in IWS. **Those profits came right off IWS' bottom line, and deprived its shareholders of equity, which should have remained in IWS.**

25. The Court of Appeal at para. **563** also limited this award to only the excessive profits realized by the trucking companies.

26. IWS is itself liable for the profit diversions only because the trial judge deemed the money to be held on its behalf by the other companies who received it. Conceptually, then, the money goes back to IWS first before Morris Waxman takes half:

1703 Greycliffe, Icarus, Servtross, Big Rig and Circuitel are **deemed to be holding profits diverted from IWS to those companies on behalf of IWS**. As assets available to IWS those assets can be made available to Morris in recovering amounts owed by IWS.

1704 While I recognise that this claim would ordinarily have been brought by IWS, in the particular circumstances of this case, where Chester would not direct IWS to bring a derivative claim and where I have found that Chester held 50% of the shares on constructive trust for Morris from December 1983 to the date of their transfer, and where derivative actions are not required under the oppression remedy, I am prepared to allow the Plaintiffs to pursue their remedy against Chester/IWS.

Punitive damages

27. The trial judge wrote:

1706 For reasons given earlier, I order **Chester** to pay punitive damages in connection with the Share Sale, bonuses and profit diversions of \$350,000.

28. In her Summary of Disposition (Part XI of her Reasons for Judgment), the trial judge again wrote:

2603 For reasons given earlier, I order **Chester** to pay punitive damages in connection with the Share Sale, bonuses and profit diversions of \$350,000.

29. The Court of Appeal wrote:

576 The trial judge also ordered **Chester** to pay punitive damages of \$350,000, in connection with the share sale, the bonuses, and the profit diversions.

At para. **585**, the Court of Appeal rejected the appeal against this award of punitive damages.

30. It is unclear and unexplained why the issued Court of Appeal Order directs that this sum is payable by Chester Waxman **and IWS**, severally. There may have been a slip or unintentional error made when that Order was taken out. In any event, the trial judge did *not* order that IWS was severally liable for these punitive damages, nor did the Court of Appeal; and the Trustee's statement in para. 28 of its factum (relying, as it does, on para. **1706** of the trial judge's Reasons) is incorrect on this point.

Court of Appeal Order, para. 18, *Motion Record*, Tab 2D,
p. 44

Wrongful dismissal

31. In addition, Chester Waxman caused IWS to dismiss Morris Waxman from his senior position of employment at IWS. For this wrong, Morris Waxman was awarded damages of two years' salary in lieu of notice against IWS alone (trial judge's Reasons, para. **2609**). The amount of these damages can only fairly be characterized as debt, not equity.

Lease of Centennial property

32. The trial judge held that the terms of a lease Morris Waxman executed in December, 1983, were oppressive to him but awarded no damages on that account so as to avoid double-counting in his favour. She wrote:

1691 I have held that the terms of the December 1983 lease were oppressive vis-à-vis Morris and Morriston [his personal holding company]. The lease deficiency determined prospectively was \$2,529,607. I have found that the December 1983 lease was unconscionable and oppressive within the meaning of s. 248 OBCA. But for my Share Sale disposition I would have declared the lease null and void. ... If it were necessary to do so, in light of the developments since 1998, I would have ordered a reference to determine the amount of the lease deficiency ... **However, given that I have found that Morris was entitled to 50% of the profits of IWS throughout and given that the benefits lost by Morriston accrued to IWS, any loss to IWS/Morrison should be caught in the profits owing to Morris in that connection.**

No "reference to determine the amount of the lease deficiency" has occurred.

Summary

33. The trial judge gave Morris Waxman the option of electing a reference "to determine with precision 50% of profits since December 22, 1983 during the period of the constructive trust" (Reasons, para. **1676**), such reference to be "confined" to the three issues set out in para. **1679**. In her para. **2592**, the trial judge ordered "Chester/IWS" to **pay Morris 50% of the profits/distribution of equity of IWS between December 22, 1983" and June 27, 2002, the date of her Judgment.**

34. The Order of the Court of Appeal was to the same effect, specifying that

4. ... Morris Waxman shall recover from Chester Waxman and IWS, severally but not jointly, 50 percent of the profits and distributions of equity of IWS between December 22, 1983 and June 27, 2002 (the "IWS Profits"), as determined on a reference before a Master ..., following an election by Morris in accordance with paragraph 2592(a) of the said Reasons for Decision ...

35. When Morris Waxman elected the reference, Master Linton conducted it and reported that, in accordance with para. 4 of the Order of the Court of Appeal, the amount owing to Morris was \$37,900,475 inclusive of compounded prejudgment interest through January 4, 2007. This Report was confirmed on August 30, 2007, as of which date, according to the Master, the amount owed was \$39,733,278.

Reasons for Decision of Sanderson J. (confirming the Report on Reference), para. 132 - **Tab 27**;

Daily calculation of Morris' Lost Profits, net of Payments, including Prejudgment Interest, *Motion Record*, Tab 3F, p. 156

36. Of the remaining amounts listed in Schedule A of Morris Waxman's proof of claim, the trial judge made the following characterizations, none of which were disturbed by the Court of Appeal:

item	principal amount	holding	source
1981-82 bonuses	\$2,312,000.00	equity	see paras. 22-23
profit diversions	\$590,036.50	equity	see paras. 24-26
punitive damages	\$350,000.00	not awarded against IWS	see paras. 27-30
wrongful dismissal	\$64,672.00	debt	acknowledged
wrongful dismissal interest	\$68,913.00	debt	acknowledged
pji in related action 44142/89	\$3,047,851.38		see para. 64
appeal costs	\$468,065.70		nothing filed

Liability of IWS and rights of third parties

37. While the breach was Chester Waxman's, the trial judge held IWS *also* liable, leading to the issues the Court and the Trustee now face on this motion.

1688 As I have also found Share Sale liability against IWS under s. 248 [of the *Ontario Business Corporations Act* ("OBCA")], Morris may also seek to recover to the extent of that liability against the assets of IWS.

1689 After all that has transpired, it may prove impossible for Morris and Chester to operate IWS as partners, or for their sons to work together in IWS. The Statement of Claim seeks a winding-up order, and I find that the preconditions set out in cases such as *Ebrahimi* have been met. **However, it was also apparent at trial (notwithstanding the pleading) that the continuation of IWS as a going concern is important to both brothers. I would prefer to see the parties work out the future of IWS on their own, this time one hopes with professional advice, whether by effecting a buy-sell arrangement or some other approach. A winding-up order is an extreme remedy and should be one of last resort.** The claim is refused, without prejudice to the right to renew the application. ...

38. The trial judge thus refused to wind up IWS, suggesting, firstly, that until very recently nobody would have thought insolvency was a risk, and, secondly, that the Court's silence on the issue we are facing today should not be taken to prejudice the unsecured creditors' rights. The remedy was ordered without contemplating the situation where not everybody would get paid.

39. Refusing to find joint liability between Chester and IWS, the trial judge wrote:

82 In all of the circumstances of this case, **I am of the view that it would be inequitable to allow Chester and to require Morris in effect to satisfy this judgment [on a claim over involving IWS] in large measure using Morris' own money or assets. The liability of IWS and Chester is several, not joint and several.**

40. This reasoning suggests the trial judge was not trying to give a specific right to Morris to go after IWS for everything without giving IWS a right of contribution against Chester and his sons, particularly if such an election would prejudice all creditors in the case of an unforeseen bankruptcy.

What occurred subsequent to the appeal decision

41. On March 31, 2005, the Supreme Court of Canada denied leave to appeal from the decision of the Court of Appeal for Ontario. At that point in time, therefore, the several liability of IWS and Chester Waxman to Morris Waxman became absolute and no longer controvertible, although some of the amounts payable by virtue of that liability still had to be determined via the reference.

42. The Master's report following the reference was released on January 4, 2007 (**Tab 26**) and was confirmed by Order of Sanderson J. on August 30, 2007 (**Tab 27**).

43. By Order dated March 26, 2007, made following the hearing of a motion brought by Morris Waxman pursuant to sections 207 and 248 of the *OBCA* and s. 101 of the *Courts of Justice Act*, Ground J. appointed Deloitte & Touche Inc. as receiver, without security, of all the assets, undertaking, and properties, including all proceeds thereof, of IWS. From that time, therefore, ordinary unsecured creditors were prevented from taking steps to recover the amounts owed to them.

Trustee's 2nd Report, para. 16, *Motion Record*, p. 13

Receivership Order dated March 26, 2007, paras. 12-15,
Respondents' Motion Record, Tab 1

44. When the receiver determined that it should seek Court approval to consent to the making of a bankruptcy Order against IWS, Michael S. Waxman, a son of Morris Waxman, delivered his Affidavit in support.

See para. 13, above

45. According to the Trustee, following the appeal, "Morris and Chester entered into negotiations with respect to payment under the Judgment. They were, however, unsuccessful in these negotiations."

Trustee's 2nd Report, para. 13, *Motion Record*, p. 12

46. The only other evidence before this Court as to whether Morris Waxman has sought to recover all or any part of his Judgment from his brother Chester is contained in Michael S. Waxman's Affidavit at paras. 25 and 26. There, he deposed that Morris Waxman has examined his brother and his brother's sons Warren and Robert as judgment debtors, that "almost no material assets have been disclosed", and that "Chester does not appear to have any other material funds in his name that could be used to reduce the amounts owing to Morris ...".

Affidavit of Michael S. Waxman sworn August 22, 2007,
paras. 25 and 26, *Motion Record*, Tab 3, p. 115

47. There is no indication, however, that Chester Waxman has filed for personal bankruptcy, that Morris Waxman has made use of the tracing order he was granted as part of his Judgment, or that he has been otherwise subjected to a detailed investigation under the Court's auspices of what he did with the millions of dollars that he was found to have siphoned out of IWS in breach of his obligations to his brother.

48. What is clear, though, is that Morris Waxman is entitled to recover his Judgment from Chester Waxman, severally, and not just from IWS. In contrast, the unsecured creditors of IWS may only claim payment through the Trustee of IWS; there is no evidence that any of them hold guarantees or other third-party obligations that would enable them to recover unpaid amounts from the shareholders of IWS.

49. The Trustee has reported that the amount available to unsecured creditors is \$34.5 million¹, not counting the costs of the bankruptcy. The total amount owed to ordinary unsecured creditors who have submitted proofs of claim is in the nature of \$8.4 million.

Trustee's 2nd Report, paras. 20 and 28-31, *Motion Record*, pp. 14 and 15

50. Therefore, if the Morris Waxman Judgment is held to rank *pari passu* with the claims of the unsecured creditors, each such creditor will receive approximately 40 cents on the dollar². However, if the Morris Waxman Judgment is payable only after all other unsecured creditors are paid in full, each such creditor will receive its money and Morris Waxman will also receive several million dollars with his right to pursue Chester Waxman for the balance owed to him unimpaired. (These numbers are subject to change, depending on such factors as the extent that other unsecured claims are proven hereafter, whether other "related party" claims are accepted, the outcome of Chester Waxman's announced appeal from the reference award, and the costs of the bankruptcy.)

1 "Total Asset Realization (Cdn\$) – IWS" less total secured claims = \$34,503,476.00

2 Trustee's factum, para. 40

PART III - ISSUES

51. For purposes of the Trustee's distribution of IWS assets under the *BIA*, how should the Morris Waxman Judgment be characterized - as ordinary debt or as a return of equity that can not be paid out until the proven claims of all unsecured creditors are first retired in full?

52. If the Morris Waxman Judgment consists partly of debt and partly of return of equity, what portion consists of equity?

53. In the alternative, if the Morris Waxman Judgment is characterized as debt, can and should this Court, under equitable principles, subordinate payment of all or part of the Judgment to the claims of the unsecured creditors of IWS?

PART IV - LAW AND ARGUMENT

54. The Trustee and the unsecured creditors are at one in their submissions on this point: in bankruptcy, the claims of unsecured creditors must be satisfied prior to payment of the claims of shareholders for equity. This point is made simply and eloquently by Laskin J.A. in a case cited by the Trustee:

On the insolvency of a company the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital.

Re Central Capital Corporation (1996), 27 O.R. (3d) 494
(C.A.), per Laskin J.A. at p. 546 – **Tab 5** ("*Central Capital*")

55. Having accepted this truism, the Trustee seeks to persuade this Court that
- (a) this accepted principle should not apply to the bulk of the Morris Waxman Judgment in the IWS bankruptcy, or
 - (b) the bulk of the Morris Waxman Judgment is not a "claim ... for the return of capital".

These arguments ought to be rejected, however, because:

1. in the main, they do not accord with the determinations of the trial judge, as upheld by the Court of Appeal;
2. they are inconsistent with the general body of Canadian law in this area; and
3. they depend on an over-emphasis on "policy" considerations to up-end the existing law.

Issue 1: Characterization of the Morris Waxman Judgment

56. In determining the manner in which the Trustee is to pay the Morris Waxman judgment out of the assets of the bankrupt estate, this Court must first decide whether that Judgment is to be characterized as being in the nature of debt or in the nature of equity.

57. This decision involves ascertaining the "substance" of Morris Waxman's claim. "This is the lesson of Justice Iacobucci's judgment" in *CDIC v. CCB*:

Central Capital, at p. 536h – **Tab 5**

- referring to *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.), at p. 406 d-h – **Tab 4** ("CCB")

58. In this case, however, the "substance" of Morris Waxman's claim is determined by the Reasons for Decision of the trial judge and of the Court of Appeal, not (as in *CCB* and in *Central Capital*) by construing contractual documents made by the disputing brothers.

The courts' prior determinations in this case

59. As is set out in detail in the Facts section, above, the trial judge and the Court of Appeal described almost all of the amounts awarded to Morris Waxman as being "equity". The amount determined on the reference consists of "profits and distributions of equity" that are to be "recovered", together with prejudgment interest thereon. The "1981 and 1982 bonuses were in fact a distribution of IWS shareholders' equity". The profit diversions "deprived its shareholders of equity, which should have remained in

IWS". Morris Waxman's son Michael, in his sworn Affidavit, conceded that "the vast majority" of the Judgment comprised his father's half "of IWS profits" and that "almost all of the bonuses were distributions of equity".

See paras. 13, 21, 22, 23, 24, 33, and 34, above

60. Morris Waxman's claim for his rightful share of the proceeds of the sale of "substantially all of [IWS's] operating assets" (trial judge's paras. **1100-1101**) is certainly in the nature of equity. The bonuses and dividends ought not to be treated as valid debt since they were a wrongful distribution of equity. As with the pre-"share sale" distributions, reasonably deemed dividends and bonuses would almost certainly be lower in light of the findings of fact. It would overcompensate Morris Waxman and be inconsistent with the nature of the oppression remedy to say he was entitled to deplete the equity of IWS just as Chester did, when the resulting harm would still exist, only shifted onto the unsecured creditors.

61. Morris Waxman seeks to prove for that portion of his Judgment which pertains to punitive damages. Punitive damages were ordered only against Chester Waxman, not IWS. The basis for this award was the improper treatment Chester accorded his brother Morris in connection with the "share sale", the bonuses, and the profit diversions - each of which were held to be manipulations of IWS equity to the disadvantage of Morris Waxman. The punitive damages were *not* given as added compensation for the wrongful dismissal payment he was awarded in lieu of reasonable advance notice of termination.

62. These unsecured creditors submit that the wrongful dismissal damages component of the Judgment, together with postjudgment interest thereon, should be treated as debt.

63. The appeal costs are incidental to the Court of Appeal judgment, which upheld Morris Waxman's claims to redress for the siphoning-off of IWS equity, of which he was deprived. In any event, no Court of Appeal Order respecting costs of the appeals has been filed.

64. By order of the Court of Appeal dated April 30, 2004, Morris Waxman obtained Judgment against *Wayne Linton and IWS* for many of the same items for which he (Morris) had obtained his Judgment against IWS and his brother Chester, severally, and also for prejudgment interest. This Order was obtained following the appeals in the so-called "Taylor, Leibow" action (Court File no. 44142/89), which was tried together with the main action (33234/88). The award of prejudgment interest which Morris Waxman now claims against IWS (in the amount of \$3,047,851.38) was, it is respectfully submitted, therefore incidental to the Judgment Morris Waxman has obtained for his share of IWS equity. (There is no evidence of what efforts have been made or achieved in trying to recover from Wayne Linton.)

Proof of Claim of Morris Waxman dated September 20,
2007, *Motion Record*, Tab 2D, pp. 33-35 and 57-61

Canadian-law precedents

65. While it is true, as the Trustee points out, that Laskin J.A. wrote in *Central Capital* that declared dividends constitute company indebtedness to its shareholders, that argument is of little assistance to Morris Waxman in this case because:

- (a) Laskin J.A. did not suggest that, in that situation, equity is "converted" or "transformed" into debt;
- (b) he did not address whether such "debt" would rank *pari passu* with the claims of ordinary creditors in an insolvency situation; but
- (c) he did rule that prospective claims as shareholders, characterized as such, would not rank with claims of creditors; and
- (d) he preferred the approach of U.S. cases in characterization issues to that in *Re East Chilliwack Agricultural Co-operative* (1989), 74 C.B.R. (N.S.) 1
- **Tab 9.**

66. In any event, very little of the amount awarded Morris Waxman represented his share of IWS declared dividends, according to the trial judge.

Central Capital, at pp. 540a-543d and 545g-546c - **Tab 5**

67. The Canadian case presenting facts most similar to those on this motion is the decision of Romaine J. of the Alberta Court of Queen's Bench in *Re Blue Range Resource Corp.* (**Tab 3**). In that case, Romaine J. rejected the efforts of the sole shareholder of Blue Range to be treated as a creditor with respect to misrepresentation damages it allegedly sustained when it acquired the shares, after that shareholder had taken steps to place Blue Range under the protection of the *Companies' Creditors Arrangement Act*. She decided that the shareholder's claim "is in substance a claim by a shareholder for a return of what it invested *qua* shareholder. The claim therefore ranks after the claims of unsecured creditors of Blue Range".

Re Blue Range Resource Corp., [2000] 4 W.W.R. 738
(Alta. Q.B.), at p. 743 - **Tab 3** ("*Blue Range*")

68. In her reasons, Romaine J. started with the "basic principles governing priority disputes", including that "It is clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full". She then correctly identified *CCB* and *Central Capital* as authorities defining that one must look at the "true nature" of the relationship or claim in evaluating whether one's standing is that of a creditor or shareholder. Applying that analysis to the situation of Blue Range's sole shareholder, she determined that a tort award, if made, "could only represent a return of what [the shareholder] invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment". On this basis, she characterized the "nature of the claim" as "in substance a claim by a shareholder for a return of what it invested *qua* shareholder, rather than an ordinary tort claim".

Blue Range, at paras. 16-25 - **Tab 3**

69. Thus, the chief distinction between this case and Blue Range is that IWS shareholder Morris Waxman has a Judgment against IWS whereas the shareholder of Blue Range did not. Yet it has long been recognized that obtaining a judgment does not "convert" or "transform" the quality of a creditor's claim - for example, a trade creditor

which has obtained a judgment is still an unsecured creditor ranking equally with non-judgment creditors, rather than one which has attained higher status. The principle that one must look at the "true nature" or the "substance" of the claim is not altered or avoided by obtaining a judgment.

70. Having characterized the Blue Range shareholder's status as a shareholder, rather than a creditor, Romaine J. then addressed where its claim should rank relative to the claims of unsecured creditors. Reviewing a variety of policy considerations, she concluded that the shareholder's claim must be subordinated to the claims of the ordinary creditors.

71. Amongst the authorities Romaine J. considered were U.S. cases, including *Re Stirling Homex Corporation* (**Tab 17**), a 1978 decision of the Court of Appeals, Second Circuit. She found that the issue in *Stirling Homex* was "directly on point: whether claims filed by allegedly defrauded shareholders of a debtor corporation should be subordinated to claims filed by ordinary unsecured creditors ...". She quoted the Court of Appeals for its statement that

where the debtor corporation is insolvent, the equities favour the general creditors rather than the allegedly defrauded shareholders, since ... the real party against which the shareholders are seeking relief is the general creditors whose percentage of realization will be reduced if relief is given to the shareholders.

Romaine J. also considered the U.S. doctrine of equitable subordination (discussed below). She concluded that the shareholder's claim "must rank after the unsecured creditors of Blue Range".

Blue Range, at paras. 26-57 - **Tab 3**

Re Stirling Homex Corporation, 579 F. 2d 206 (2nd Circ. 1978) - **Tab 17**

72. The decision in *Blue Range* was applied in *Merit Energy*, a 2001 decision of the Alberta Court of Queen's Bench that was affirmed the next year by the Alberta Court of Appeal.

National Bank of Canada v. Merit Energy Ltd., [2001] 10
W.W.R. 305 (Alta. Q.B., aff'd. [2002] 3 W.W.R. 215
(Alta. C.A.) - **Tab 13**

73. The *Blue Range* reasoning should also be applied to the facts of this case.

The Trustee's "policy" arguments

74. The Trustee submits, in urging this Court to treat the Morris Waxman Judgment as "debt" that ranks *pari passu* with the claims of the general body of creditors, that one can subject the analysis to that of "hybrid" instruments.

75. In this case, however, there are no "hybrid" instruments. There is simply the Reasons for Decision of the trial judge, as sustained (albeit modified respecting amounts) by the Court of Appeal.

76. That a small portion of the Reasons for Judgment awards a "debt" recovery does not make the Judgment of a "hybrid" nature.

77. In any event, the "hybrid" analysis, as enunciated by the Supreme Court of Canada, obliges the court to "search for the substance of a particular transaction" and not be "distracted by aspects which are, in reality, only incidental or secondary in nature".

CCB, at p. 406h - **Tab 4**

78. The Trustee also analogizes to *obiter* passages respecting declared dividends as "suggesting" that a shareholder's claim "can change from equity to debt". This implies that before dividends are declared, shareholders' interests are equity in nature.

79. The Trustee similarly points to case law where shareholders who exercised the right of redemption of their shares were treated as unsecured creditors. As was the case with declared dividends, the exercise of the right of redemption is a necessary element of crystallization of risk investment which converts the otherwise equitable interest into debt. The Trustee does not acknowledge that an act of crystallization of the equitable interest into debt is a necessary element of that conversion. This element is not present in respect of most of the Morris Waxman claim.

80. The trial judge directed a reinstatement of Morris Waxman to his shareholder status. There is no evidence before the court that, had he retained his shareholder status and not been defrauded by his brother, Morris Waxman would have liquidated his equity interest when IWS was prosperous. In fact, the findings of the trial judge support the contrary conclusion. In the trial judge's Reasons in paras. **1147** and **1154**, she found that Morris "...drew money from IWS **only as needed**" because he assumed that "...the equity of IWS was being increased for the equal benefit of himself and Chester and **the eventual benefit of the next generation**, his and Chester's sons." Morris had no intentions of realizing on his investment.

81. Morris Waxman never did nor would he have acted to crystallize his equity claim into a debt. His claim remains, in substance, of an equitable nature. Furthermore, the true nature of Morris' relationship with IWS continues to be that of a shareholder and not that of a creditor.

Issue 2: Portion of the Morris Waxman Judgment that consists of debt

82. That part of the Morris Waxman Judgment consisting of the damages awarded him for being wrongfully dismissed from his executive position at IWS would not constitute equity or profits distribution and, therefore, Morris Waxman should be permitted to share rateably for that portion of his Judgment with other unsecured creditors who prove their claims. It follows that the same would be true respecting the accrued interest on that portion of his Judgment.

83. These two amounts apparently totaled (subject to the Trustee's review) \$133,585.00 as of the date of bankruptcy, September 4, 2007.

Morris Waxman's proof of claim, Schedule "A", *Motion*
Record, Tab 20, pp. 34-36

84. Those are the only components of the Judgment for which Morris Waxman's claim should *not* be subordinated to the claims of the other ordinary unsecured creditors of IWS.

Issue 3: Subordination of the Morris Waxman claim under equitable principles

85. The *BIA* provides, in s. 141, simply that "Subject to this Act, all claims proved in a bankruptcy shall be paid rateably". Notwithstanding this simplicity, however, the *BIA* clearly recognizes that the claims of secured creditors outrank those of unsecured creditors and that defined preferred claims are also to be paid in priority to those of unsecured creditors.

86. Furthermore, the *BIA* also recognizes instances where an ordinary creditor is not to be paid rateably with others. For example, the *BIA* provides, in s. 139, that where a lender advances money to a borrower engaged in business under a contract providing that the lender shall receive a share of the profits arising from the business, and the borrower subsequently becomes bankrupt, the lender is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied. Such a lender is seen to be a "silent partner", akin to a shareholder.

BIA, R.S.C. 1985, ch. B-3, s. 139

87. Although the *BIA* does not address the issue of equitable reordering of priorities in a bankruptcy, the concept has already begun to develop in Canadian courts in much the same way it has been developing in the U.S. for decades.

88. U.S. courts have, since 1939, developed the doctrine that they can subject the claims of one creditor to those of all other creditors of apparently-equal rank where the circumstances warrant their doing so. The Trustee, in submitting (in paras. 78-81 of its factum) that this doctrine is "inapplicable" to this case, has been, with respect, much too superficial.

(a) Whether "equitable subordination" requires creditor "misconduct"

89. This doctrine of "equitable subordination" was first enunciated by the United States Supreme Court in 1939 in *Taylor v. Standard Gas and Electric Company*, and the underlying principles were more fully discussed by that Court that same year in *Pepper v. Litton*. The basis for development of the doctrine is the equitable jurisdiction of the Court.

Taylor v. Standard Gas and Electric Company, 306
U.S. 307 (1939) (U.S. S.C.);

Pepper v. Litton, 308 U.S. 295 (1939) (U.S. S.C.)

90. When the doctrine first developed in the United States, courts of equity came to hold that the grounds for application of the doctrine were:

- (a) that the party claiming to be a creditor must have engaged in some type of inequitable conduct;
- (b) that the misconduct must have resulted in injury to the other creditors of equal rank or conferred an unfair advantage on the claimant; and
- (c) that the result must not be inconsistent with any statutory provisions (such as those contained in bankruptcy legislation).

In re Mobile Steel Company, 563 F. 2d 692 (5th Circ.
1977) – **Tab 12**

91. However, in the decision of *In re Virtual Network Services Corp.*, the U.S. Court of Appeals, Seventh Circuit, held that the doctrine "no longer requires, in all circumstances, some inequitable conduct on the part of the creditor"; instead, the decision depends upon a consideration of the fairness of the circumstances of each case. Therefore, according to that Court, the doctrine permits U.S. courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity with other unsecured creditors. That Court affirmed the conclusion of the Court below that the goal of equitable subordination focuses not on the conduct of the creditor claiming parity but on fairness to the creditors in each particular case.

In re Virtual Network Services Corp., 902 F. 2d 1246 (7th
Circ. 1990) at p. 1250

92. Although the doctrine of equitable subordination was developed by U.S. courts in the exercise of their equitable jurisdiction, the right to make use of the doctrine was subsequently codified in the *Bankruptcy Reform Act* of 1978. Section 510(c)(1) of that Act provides:

... 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;

The Seventh Circuit Court of Appeals analyzed the doctrine at length, noting that the statutory phrase "under principles of equitable subordination" is not defined in the Bankruptcy Reform Act of 1978. That Court summed up its analysis in the following words:

After considering the congressional statements and legislative history and scheme, we agree with the district court that Congress intended the courts to "develop" the "principles of equitable subordination". We further conclude, as did the district court, that the principles of equitable subordination are broader than the doctrine which developed prior to s. 510 (c)(1)'s enactment. It is clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor.

Bankruptcy Reform Act, 11 U.S.C. s. 510(c)(1);

In re Virtual Network Services Corp., at pp. 1249-50

93. The Supreme Court of Canada addressed the U.S. doctrine in 1992 in *CCB*, two years following release of the decision in *In re Virtual Network Services Corp.* In its decision, the Supreme Court "expressly refrain[ed]" from answering "whether a comparable equitable doctrine should exist in Canadian law". That Court decided that the doctrine should *not* be applied to the facts of that case, however, relying *solely* on its own determination (admittedly, without benefit of the views of the Alberta Courts, below) that there was no evidence of "inequitable conduct" on the part of the claimants whose claim was sought to be subordinated.

Canada Deposit Insurance Corp. v. Canadian Commercial Bank (1992), 97 D.L.R. (4th) 385 (S.C.C.), at 419-422 - **Tab 4**

Blue Range, at para. 51 - **Tab 3**

94. There is little value to be gained from the Supreme Court of Canada's decision in assessing the situation in the case at bar, however, for the following reasons:

- (a) the Court's comments on the U.S. doctrine were entirely *obiter dicta* and therefore not binding on Courts below;
- (b) the Court expressly refused to state whether the U.S. doctrine has a place in Canadian law, leaving that decision "open for another day";
- (c) whether this Court's equitable jurisdiction ought to be applied now falls to be determined on the facts of this particular case, not by reference or analogy to the very different facts in the *Canadian Commercial Bank* case; and
- (d) most importantly, the Court's stated "understanding" of the U.S. doctrine was inexact because outdated and incomplete - the Court made no mention of the evolution that had occurred in that doctrine with the watering-down or elimination of the "requirement" that there must have been "inequitable conduct" on the part of the claimant seeking equal standing with the claims of other creditors in an insolvency. Although the *In re Virtual Network Services Corp.* case was cited to it, the Court chose not to refer to it in setting out, in *obiter*, its "understanding" of the U.S. doctrine.

95. Whether the U.S. doctrine of equitable subordination forms part of Canadian insolvency law, therefore, is a live issue not yet resolved by the Supreme Court of Canada and is open to this Court to determine. In doing so, this Court should consider how the U.S. doctrine has evolved to the present day, and not consider the description of that doctrine to have been frozen for all time by the Supreme Court's recitation of its "understanding" 15 years ago.

96. "Inequitable" conduct on the part of the creditor sought to be subordinated is no longer regarded as necessary for the doctrine of equitable subordination to be applied under U.S. law. Certainly, such conduct is no longer a "requirement" of the doctrine, as the Supreme Court of Canada suggested in 1992.

97. Instead, the core of the doctrine is that bankruptcy courts, exercising their equitable jurisdiction, are empowered to apply the doctrine on a case-by-case basis whenever the failure to do so would give rise to inequality of distribution in a manner considered unfair. The source of this empowerment is not Congress, which merely recognized that "principles of equitable subordination" exist when it amended the Bankruptcy Code in 1978 by enacting s. 510(c)(1), but, rather, the inherent equitable jurisdiction which Superior Courts in common-law jurisdictions (including Ontario) possess.

98. A good example of how the doctrine has evolved in the U.S. is afforded by *In re Envirodyne Industries, Inc.* ("*Envirodyne*"), a decision of the U.S. Court of Appeals, Seventh Circuit, released in 1996, some four years after the decision in *Canadian Commercial Bank*. In *Envirodyne*, the defendants had failed to tender their shares of a corporation entering into a merger under Delaware law. Consequently, their equity interest was converted into debt and they retained the right to redeem their cancelled shares for a specified sum, without interest. Before they redeemed, however, the merged company became bankrupt.

99. There was no evidence of any wrong-doing at all on the part of the defendants, and Cummings C.J., writing for a unanimous Court of Appeals, noted that the "sole issue on appeal is whether the Bankruptcy Court properly subordinated defendants' claims to those of other general unsecured creditors ... without requiring proof of wrongful conduct on the part of defendants". The Court upheld the decision below. It wrote that the "principles of equitable subordination" referred to in the Bankruptcy Code were intended to be developed by the Courts and that the decision in *Virtual Network* had "disposed of" the issue of whether "inequitable conduct on the part of the creditor" was "required" as part of the doctrine:

... In sum, we conclude that s. 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a **case-by-case basis** without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors. ...

... The **flexible approach** of *Virtual Network* makes sense in light of the Bankruptcy Code's primary goal of equality of distribution and the fluid concept of equity at the heart of s. 510(c) subordination. ...

We thus adopt the flexible approach of *Virtual Network* in which **a court must look to the origin and nature of the unsecured claim** and decide whether equity requires that it be subordinated to claims of other general unsecured creditors. ...

[Emphasis added.]

In re Envirodyne Industries, Inc., 79 F. 3d 579 (7th Circ.
1996) at pp. 581-582

100. Cummings C.J. then went on to assess the position of the defendants in language that is particularly applicable to the situation the general body of creditors here face with the assertion that the Morris Waxman Judgment should enjoy parity with their own claims. Noting that the "defendants are legally creditors of [bankrupt] Envirodyne, no doubt", he added:

But defendants' claims are, in substance, based on equity interests. ... **No amount of maneuvering can obscure the true nature of defendants' interest. ... Their claims indisputably arose out of an equity interest** in [the pre-merger company], and **the essential nature of the claims did not change** after the merger. ... The form of the transaction does not alter the origin and nature of defendants' claims as essentially equity interests.

In re Envirodyne Industries, Inc., at p. 583

101. The comment of the Court of Appeals that a court "must look to the origin and nature of the unsecured claim" echoes the observation of the Supreme Court of Canada, in *CCB*, that the court is to search out and recognize the "*substance*" of the transaction.

CCB, at p. 406 d-h – **Tab 4**

102. The U.S. Supreme Court last considered the doctrine in *U.S. v. Noland*, decided May 13, 1996. In that case, the Court unanimously ruled that Congress, by inserting the expression "principles of equitable subordination" into s. 510(c) of the Bankruptcy Code, had intended to start with the doctrine as it had evolved to 1978 and to give courts some leeway to develop the doctrine rather than to freeze the pre-1978 law in place. The Court indicated that "several" Circuit Courts of Appeal had "done away with the requirement [of inequitable conduct] when the claim in question was a tax penalty" and stated that courts are permitted "to make exceptions to a general rule when justified by

particular facts". But the Court did not limit application of the relaxed standard to "tax penalty" cases nor overrule that development. The essence of the decision is that

... we need not decide today whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. We do hold that ... the circumstances which prompt a court to order equitable subordination must not occur at the level of policy choice ... [B]ankruptcy courts may not take it upon themselves to make [a] categorical determination under the guise of equitable subordination.

The result of the decision, then, is that the U.S. Supreme Court has directed that the doctrine may not be applied categorically but recognized that it can continue to evolve. This suggests approval of a case-by-case analysis of whether the doctrine should be applied. Furthermore, the Court recognized that the "requirement" of creditor misconduct does not always obtain and elected not to rule whether that was appropriate.

U.S. v. Noland, 517 U.S. 535, 116 S.Ct. 1524 (1996)

103. It should be noted that the *Envirodyne* decision (which did *not* deal with a "tax penalty") was decided on March 15, 1996, 10 days before the *Noland* case was argued, and does not appear to have been brought to the attention of the U.S. Supreme Court.

104. These passages therefore reflect that the Court-developed doctrine of equitable subordination has evolved and that the "understanding" expressed by the Supreme Court of Canada in 1992 does not accurately reflect that doctrine.

(b) Whether Morris Waxman's actions qualify as "misconduct"

105. Should this Court feel constrained to hold that the doctrine of equitable subordination can only be considered or applied in Ontario where there is evidence of creditor "misconduct", as the Trustee urges, then it is respectfully submitted that the following steps undertaken by Morris Waxman in pursuit of his own self-interest bring this case within even the conservative description of the doctrine:

- (a) the actions of Morris Waxman and his family members in petitioning IWS first into receivership and later into bankruptcy were, on the evidence, undertaken solely to effect collection of his Judgment. There is no

evidence that, at the time the Receivership Order was issued, IWS was failing to meet its obligations generally as they fell due. Indeed, trade creditor Grace Transport Inc. has adduced evidence that its services were satisfactorily paid for from 2003 until shortly before the receivership. Yet the fact and the terms of the receivership prevented trade and other unsecured creditors from enforcing collection of their accounts incurred prior to the date of receivership;

- (b) Morris Waxman has sought to prove as an unsecured creditor, as against IWS, for the punitive damages award, even though that award was not made against IWS by either the trial judge or the Court of Appeal.

106. Although these activities in seeking to collect his Judgment ought not to be considered morally blameworthy, the result of his attempts to rank rateably with unsecured creditors would mean, under the circumstances, that he would take the lion's share of the available assets from a company which he and his family petitioned into receivership and then bankruptcy to facilitate collection, *after* the ordinary unsecured creditors provided goods and services to that company (of which he is and was 50% shareholder), for which they have not been paid.

107. There is no evidence that IWS was not paying its trade and other creditors prior to the time of its receivership at the instance of Morris Waxman. Indeed, trade creditor Grace Transport Inc. has provided evidence that its accounts were being paid satisfactorily prior to April, 2007.

*Affidavit of Carolyn Grace, para. 4, Respondents' Motion
Record, Tab 2*

108. Should this Court conclude that the Morris Waxman Judgment must be characterized as debt, not equity, it can still subordinate, under equitable principles, payment of that Judgment to the proven claims of the other unsecured creditors; and, in the circumstances of this case, it is submitted that this Court should exercise its equitable jurisdiction to do so.

PART IV – ORDER REQUESTED

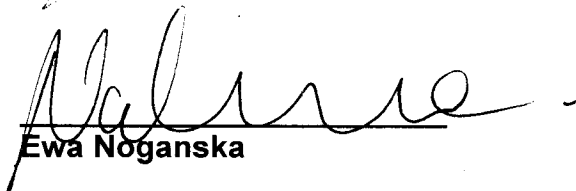
109. The unsecured creditors represented by Lerner's LLP request this Court
- (a) to direct the Trustee to treat Morris Waxman as an unsecured creditor only for the principal amount of his wrongful dismissal damages award plus interest accrued thereon to September 4, 2007;
 - (b) to direct that the balance of Morris Waxman's claim be subordinated to all proven claims of unsecured creditors;
 - (c) in the alternative to (a) and (b), to direct that all of Morris Waxman's claim be subordinated to all proven claims of other unsecured creditors;
 - (d) in any event, to order that the legal costs incurred by the unsecured creditors in responding to this motion be paid out of the estate of IWS, in bankruptcy, as a first charge against the estate in priority to all other claims save those of the secured creditors, if any, and *pari passu* with the legal and trustee costs of the Trustee.

ALL OF WHICH IS RESPECTFULLY SUBMITTED.

December 10, 2007



Robert J. Morris



Ewa Noganska

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 UNSECURED CREDITORS

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