ONTARIO BAR ASSOCIATION
A Branch of the Canadian Bar Association

CLASS ACT

Volume 3, No. 2 – May 2013 Class Action Law Section

Re: Sino-Forest Corporation – When is an Indemnity Claim Really Just an Equity Claim?

Dom Magisano and Jason Squire

Background

When public companies are accused of accounting irregularities, class action shareholder litigation often follows. The case of Sino-Forest Corporation ("**SFC**") is such an example. Weighed down by allegations of accounting irregularities and the class action lawsuits that followed, SFC sought and obtained court protection pursuant to the *Companies' Creditors Arrangement Act* ("**CCAA**") on March 30, 2012 (the "**CCAA Filing**").

While the CCAA proceeding stayed the class proceedings as against SFC, there were still many other defendants that remained, including SFC's auditors and underwriters. As the litigation against these other parties proceeded, the question was, who would bear the SFC liability in these class action claims? Would it be: the plaintiffs who would have one fewer defendant to which they could apportion liability; SFC's co-defendants under the concept of joint and several liability; or a combination of both?

This was the question before the Ontario Court of Appeal in its first review of the 2009 amendments to the CCAA relating to "equity claims".

Litigation History

In 2011 it was alleged that SFC had misrepresented its asset holdings and financial position, resulting in an artificial inflation of the share price. Four class proceedings followed, all of which named SFC and some of which named various underwriters and SFC's auditors during the relevant time period (BDO Limited and Ernst & Young LLP). The underwriter and auditor defendants cross-claimed against SFC for contribution and indemnity. In some cases, the contribution and indemnity claims were rooted in the underwriting agreements and audit engagement letters SFC had made representations about its financial condition to its underwriters and auditors, and had given contractual indemnities for their reliance on that information. Other contribution and indemnity claims against SFC were based on traditional common law and *Negligence Act* claims.

After the CCAA Filing, the Superior Court approved a claims procedure. Many of SFC's co-defendants submitted proofs of claim and the Monitor of SFC sought advice and directions from the court regarding whether the co-defendants' contribution and indemnity claims were "equity claims" as defined by the CCAA.

Section 6(8) of the CCAA subordinates all equity claims:

> No compromise or arrangement that provides for the payment of an equity claim is to be sanctioned by the court unless it provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.

In order to define "equity claim" under the CCAA, one must turn to section 2(1) of the CCAA which states that an equity claim is:

> a claim that is in respect of an equity interest, including a claim for, among others,
>
> a) a dividend or similar payment,
> b) a return of capital,
> c) a redemption or retraction obligation,
> d) *a monetary loss resulting from the ownership, purchase or sale of an equity interest* or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
> e) *contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d)*
>
> [emphasis added]

At first instance, Justice Mowawetz held that the auditors' and underwriters' contribution and indemnity claims against SFC were not general claims, but were "equity claims" under the CCAA. Justice Morawetz held that "it would be totally inconsistent to arrive at a conclusion that would enable either the auditors or the underwriters, through a claim for indemnification, to be treated as creditors when the underlying actions of the shareholders cannot achieve the same status".

The Ontario Court of Appeal dismissed the appeal. The Ontario Court of Appeal engaged in a careful statutory interpretation exercise and found that the plain meaning of "equity claim" in the CCAA subordinated the auditors' and underwriters' contribution and indemnity claims below general claims – that is, the auditors' and underwriters' claims ranked with the claims of shareholders, below the claims of SFC's general unsecured creditors (and particularly SFC's unsecured noteholders).

Effect on Shareholder Disputes

It is difficult to dispute the court's interpretation of the CCAA provisions in question. However, one must wonder if this outcome is what legislators really intended. The

outcome of the decision prevents cross-claimants in a class action suit from having a higher priority to its co-defendant's assets than that available to the plaintiff shareholders; however, the effect is to cause solvent defendants to shoulder a much larger portion of the monetary loss because of the operation of joint and several liability. The auditors and underwriters face potential joint and several liability for representations of a public company, but cannot seek recovery from its insolvent co-defendant. The effect is not abstract – it cannot be a coincidence that, within a few days of the release of the Court of Appeal's reasons confirming that the auditors and underwriters could not make a general claim on SFC's estate, one auditor announced a tentative settlement with the class of $117 million.

Professional auditors and underwriters are obviously key to the operation of capital markets. The risk that those professionals may have to effectively stand as insurers against the insolvency of issuers may increase their fees or cause them to be reticent to provide their services. On the other hand, causing them to bear greater potential risk of misrepresentations that can cause insolvency of issuers may arguably cause auditors and underwriters to heighten their diligence.

Perhaps the way to resolve the tension is for Parliament to create a statutory version of a Pierrenger Agreement between the parties where there is a dispute that gives rise to equity claims under the CCAA. Put differently, if a co-defendant in a shareholder dispute obtains CCAA protection, the plaintiff and the remaining defendants would treat the insolvent defendant as having entered into a *de facto* Pierrenger Agreement, and each liable defendant would be severally, not jointly, liable for each of their proportionate share of liability to the plaintiff.

Dom Magisano, 416-601-4121, Lerners LLP

Jason Squire, 416-601-2369, Lerners LLP