National Insolvency Review

General Editor: Adam M. Slavens, B.A., LL.B.

VOLUME 30, NUMBER 2 | Cited as (2013), Nat. Insol. Review | APRIL 2013

• *INDALEX*, SHMINDALEX–PART II: THE REVENGE! SUPREME COURT OF CANADA CONFIRMS DIP PARAMOUNTCY BUT CREATES ADDITIONAL CONUNDRUMS •

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Introduction

In September 2011, when the Court of Appeal for Ontario ("OCA") released its decision in *Indalex Ltd., Re* [*Indalex (OCA)*],[1] it elicited a stream of debate within the insolvency, lending, and pension communities. *How could the OCA undermine the priority of DIP financing!?!* Or, if you were on the other side of the debate:

• In This Issue •

INDALEX, SHMINDALEX–PART II: THE REVENGE! SUPREME COURT OF CANADA CONFIRMS DIP PARAMOUNTCY BUT CREATES ADDITIONAL CONUNDRUMS

R. Graham Phoenix and Aubrey E. Kauffman 17

THREE RECENT CASES DEVELOP A FRAMEWORK TO DETERMINE COMI: BUT CORPORATE GROUPS REMAIN THE ELEPHANT IN THE CASTLE

Jeremy R. Opolsky 25

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How come it took so long!?! The decision was appealed to the Supreme Court of Canada ("SCC").[2]

In the OCA's decision, however, the court left an "out." The OCA held that, in proceedings under the *Companies' Creditors Arrangement Act* [*CCAA*],[3] the supervising court (the "*CCAA* court") could invoke the doctrine of paramountcy to order a super-priority debtor-in-possession ("DIP") charge, provided the judge specifically considered the same. In the *CCAA* proceedings of *Timminco Ltd., Re* [*Timminco*],[4] Justice Morawetz of Toronto's Commercial List Court did just that. In the *Timminco* decision, Morawetz J. found that if the requested charge in favour of the DIP lender were not given super-priority, it would frustrate the company's ability to restructure and avoid bankruptcy. Justice Morawetz, therefore, expressly invoked the doctrine of paramountcy to grant priority to the DIP charge ahead of any deemed trusts that

NATIONAL INSOLVENCY REVIEW

The **National Insolvency Review** is published bi-monthly by LexisNexis Canada Inc., 123 Commerce Valley Drive East, Suite 700, Markham, Ontario L3T 7W8

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ISBN: 0-409-91078-3 **ISSN: 0822-2584**
ISBN: 0-433-44393-6 (Print & PDF)
ISBN: 0-433-44694-3 (PDF)

Subscription rates: $425/year (Print or PDF)
$515/year (Print & PDF)

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may be related to pensions. On appeal, the OCA refused to grant leave and confirmed the decision of Morawetz J.[5]

Justice Morawetz's decision in *Timminco* stood, in effect, as an application of the principles espoused by the OCA in *Indalex*. This fact, combined with the fact that his findings were "*par-for-the-course*" in *CCAA* proceedings, suggested that, regardless of the SCC's decision, it would be business as usual for DIP lenders. In other words—"*Indalex* Shmindalex!"[6]

On February 1, 2013, the SCC released its decision in *Indalex*, siding squarely in favour of the paramountcy of court-ordered DIP priority. In fact, the SCC went further than the OCA: holding unanimously that the doctrine of paramountcy applied to the priority of a DIP charge regardless of whether or not the *CCAA* judge expressly considered it. However, the SCC was divided on the other elements of the case. The result, though comforting to DIP lenders, left conventional lenders, directors, and pension professionals wondering *what's next?*, as well as insolvency professionals adapting to new realities for traditional stakeholders.

Background

Statutory Framework

Under the Ontario *Pension Benefits Act* [*PBA*],[7] on the wind-up of a pension plan, the employer is obligated to pay into the plan all amounts that "are due or that have accrued and have not been paid into the pension fund" and, over a period of five (5) years, the amount by which the liabilities exceed the value of the plan assets (the "wind-up deficiency").[8] The *PBA* also provides that

> [On wind up of a pension plan] an employer who is required to pay contributions to the pension fund shall be deemed to hold in trust for the beneficiaries of the pension plan an amount of money equal to employer contri-

> butions accrued to the date of the wind up but not yet due under the plan or regulations [emphasis added].[9]

The fundamental issues before the SCC in *Indalex* were (a) whether the provincial statutory deemed trust under the *PBA* extended to the wind-up deficiency and, regardless, (b) whether the amount of the wind-up deficiency could be subject to a super-priority remedial constructive trust. However, before going to the SCC, the case was hotly contested in the lower courts.

Round #1: The *CCAA* Court

In early 2009, Indalex Ltd. *et al.* (collectively, "Indalex") sought and obtained protection under the *CCAA*. Indalex was, together with its U.S. affiliates, the second-largest manufacturer of extruded aluminum products in North America. Shortly after the Initial Order was made, Indalex sought court approval of a DIP financing agreement for the purpose of funding its restructuring. As is typically the case in the context of DIP agreements, the approval sought included a court-ordered charge over the assets of the debtors that secured advances made under the DIP agreement. Also, as is typically the case, the proposed DIP charge was to be granted a super-priority ranking, so as to ensure that the DIP lender would be repaid ahead of all other stakeholders. The *CCAA* court made the order approving the DIP agreement and the DIP charge, including the super-priority ranking in favour of the DIP lender.

In the course of the restructuring, Indalex negotiated the sale of its business as a going concern and brought a motion in the *CCAA* proceedings to approve the same. Indalex also sought the approval of the distribution of the proceeds to the DIP lender. Importantly, as at that point in time, Indalex's U.S. parent had already repaid the original DIP lender pursuant to a guarantee. The U.S. parent was subrogated into the position of the original DIP lender under the DIP charge. The United Steelworkers union opposed the planned distribution of the sale proceeds on behalf of its members who were employees of Indalex and members of Indalex's pension plan for salaried employees (the "Salaried Plan"). A group of former executives also opposed the distribution. These executives were members of Indalex's pension plan for executive employees (the "Executive Plan"; together with the Salaried Plan, the "Pension Plans"). The union and executives argued that the U.S. parent had acted unfairly and inappropriately and should not be permitted to collect under the DIP charge. Significantly, the Salaried Plan was in the process of being wound up as at the date of the Initial Order, whereas the Executive Plan was closed but not wound up. The Pension Plans were each underfunded. The union and the executives asked that an amount be reserved out of the distribution to account for the Pension Plans' respective deficiencies, pending further order of the court.

The *CCAA* court approved the sale but, as a result of the opposition of the union and the executives, $6.75 million was held on reserve (the "Reserve Fund"), pending the resolution of the entitlements of the Pension Plans. The union and the executives brought motions seeking payment of the Pension Plan deficiencies out of the Reserve Fund. The *CCAA* court denied the relief and ordered that the beneficiary of the DIP charge was entitled to be repaid out of the Reserve Fund.

Round #2: Court of Appeal (Ontario)

The union and the executives appealed. On appeal, the OCA surprised the lending and insolvency communities by holding in favour of the Pension Plans on the reach of the deemed trust, the equitable interest of the plan beneficiaries, and the priority of the DIP charge.

(Expanded) Reach of the Deemed Trust

The *PBA* deemed trust only applied to the Salaried Plan, as it was the only plan that had been wound up. The OCA held that the entire wind-up deficit of the Salaried Plan was subject to the deemed trust.[10] As stated, on wind-up, subs. 57(4) of the *PBA* deems an employer to hold an amount equal to the employer contributions "accrued to the date of the wind up but no yet due" in trust for the plan beneficiaries. The OCA reasoned that all plan liabilities "accrued" as of the wind-up date, meaning the deemed trust applied to all unpaid contributions as well as the wind-up deficiency that is disclosed in the wind-up valuation.[11] This holding was contrary to the prevailing understanding of the *PBA* deemed trust. Wind-up deficiencies can be substantial and can run into the millions of dollars (or more). Having deemed trusts in such amounts will create significant challenges in a restructuring. Notably, subs. 30(7) of Ontario's *Personal Property Security Act* [*PPSA*][12] provides that the beneficiaries of the *PBA* deemed trust have a super-priority interest in the employer's accounts and inventory.

Breach of Fiduciary Duty and Constructive Trust

The Executive Plan had not been wound up prior to the *CCAA* proceedings or at the date of the sale of the company's assets. The OCA held that, in such circumstances, the *PBA* deemed trust did not apply. However, the OCA was "troubled" that such a holding would mean that an employer could avoid the deemed trust through its own failure or delay to wind up a plan.[13]

Under the *PBA*, an employer who acts as the administrator of a pension plan has a fiduciary duty to act in the best interests of the plan beneficiaries. Although Indalex sought protection under the *CCAA* as an employer, that did not mean it could ignore its fiduciary duty as pension plan administrator.[14] The OCA held that Indalex breached that duty by, among other things, commencing proceedings under the *CCAA*, failing to give notice of the proceedings to the plan beneficiaries (including notice of the motion for the DIP approval) or take steps to resolve its conflicting roles. The OCA found that Indalex did nothing to protect the best interests of the plan beneficiaries.[15] As a remedy, the OCA imposed a constructive trust over Indalex's assets equal to the wind-up deficiency in both plans. In the result, the deficiency in the Executive Plan was protected by a constructive trust although it did not benefit from a statutory deemed trust, and the deemed trust relating to the Salaried Plan was, effectively, extended to all assets although the *PPSA* limited the reach of the statutory trust to the accounts and inventory.[16]

Priority of Pension Deficiencies

The OCA then held that both trusts (the deemed trust for the Salaried Plan and the constructive trust) ranked in priority to the DIP charge ordered by the *CCAA* court. This was because, according to the OCA, (a) the issue of the *PBA* deemed trust was not identified by the *CCAA* judge at the time that the charge was ordered, (b) the doctrine of paramountcy was not invoked to render the *PBA* subservient to the *CCAA*, and (c) there was no evidence that the deemed trust priority would frustrate the *CCAA* process.[17] Moreover, the OCA held that, without a remedy, the funds that would flow to Indalex's U.S. parent (which was subrogated to the original DIP lender) were directly connected to Indalex's breach of fiduciary duty.[18] Accordingly, as discussed above, the OCA employed a constructive trust to achieve priority for all pension deficiencies.

Round #3: Decision of the Supreme Court

On February 1, 2013, the SCC released its decision. To the surprise of few, the SCC reaffirmed the *CCAA* court's ability to create super-priority charges in favour of DIP lenders. However, the balance of the SCC's decision will require the insolvency community to more carefully consider stakeholder roles when restructuring in a pension environment.

Confirmed: Expanded Reach of Deemed Trust

A slim majority of the SCC (4:3) upheld the OCA's finding that the deemed trust under the *PBA* extended to wind-up deficiencies for the Salaried Plan. This issue was strictly a matter of statutory interpretation. Justice Deschamps (Moldaver, LeBel, and Abella JJ. concurring) held that a contribution under a pension plan has "accrued" when the liabilities are completely constituted (*i.e.*, at the time of wind-up) even though the payment itself will not fall due (or be calculated) until a later date.[19] Justice Cromwell (with McLachlin C.J.C. and Rothstein J. dissenting on this point) held that plain wording of the *PBA*, the broader statutory context, and the legislative history of the relevant provisions of the *PBA* showed that the legislature never intended to include wind-up deficiencies as part of the *PBA* deemed trust.[20]

Overturned: Priority of Deemed Trust

The SCC was unanimous in its holding that a DIP charge, given super-priority by the *CCAA* court, would rank ahead of any statutory deemed trust under the *PBA*. (Although, as discussed below, dissenting LeBel and Abella JJ. would have upheld the constructive trust, thereby defeating the court-ordered DIP priority.) The SCC found that a claim for priority based on a provincial statute (such as the Ontario's *PBA)* was in direct conflict with an order made pursuant to the *CCAA* granting a super-priority to DIP lenders. The doctrine of paramountcy requires that, where a direct conflict exists between a provincial and federal statute, the federal statute must prevail. Moreover, the SCC held that it was not necessary for the supervising judge to expressly consider the doctrine of paramountcy when considering that priority of a DIP charge. Instead, the doctrine of paramountcy dictates that, where a conflict exists between a provincial priority and the priority granted to a court-ordered charge pursuant to the *CCAA*, the court-ordered priority will prevail. As Deschamps J. held (all members of the SCC concurring):

> This court-ordered priority [the DIP charge] based on the CCAA has the same effect as a statutory priority. The federal and provincial laws are inconsistent, as they give rise to different, and conflicting, orders of priority. As a result of the application of the doctrine of federal paramountcy, the DIP charge supersedes the deemed trust.[21]

Confirmed: Breach of Fiduciary Duty

The SCC was also unanimous in holding that Indalex—as administrator of the Pension Plans—had breached its fiduciary duty to the plan beneficiaries. However, the SCC disagreed on the precise nature of that duty and how the unavoidable conflict of interest between Indalex acting in its corporate capacity and Indalex acting as pension plan administrator could best be handled.

Justice Deschamps (Moldaver J. Concurring)

Justice Deschamps first rejected the appellants' argument that, when a company acts in its corporate capacity, it is not burdened by its fiduciary duties as pension plan administrator (*i.e.*, the Two Hats Doctrine). The *PBA* permits employers to act concurrently as administrators, but the employer must be prepared to resolve conflicts when they arise.[22] Justice Deschamps wrote:

> When the interests the employer seeks to advance on behalf of the corporation conflict with interests the employer has a duty to preserve as plan administrator, a solution must be found to ensure that the plan members' interests are taken care of. This may mean that the corporation puts the members on notice, or that it finds a replacement administrator, appoints representative counsel or finds some other means to resolve the conflict. The solution has to fit the problem, and the same solution may not be appropriate in every case.[23]

Justice Deschamps added that the decision to commence proceedings does not, on its own, entail a breach of fiduciary duty. Justice Deschamps considered the facts of the case and concluded that, on such facts, Indalex's decision to commence *CCAA* proceedings did not put the company in a conflict of interest.[24] However, the decision to seek a priority DIP charge did give rise to a conflict. Justice Deschamps held that the plan beneficiaries were at least entitled to notice of the same. In failing to give notice, Indalex breached its duty to the plan beneficiaries and its duty to address its conflict of interest.[25]

Justice Cromwell (McLachlin C.J.C. and Rothstein J. Concurring)

Similar to Deschamps J., Cromwell J. wrote that Indalex's "breach" was not failing to avoid a conflict of interest but was failing to manage the conflict to ensure the plan beneficiaries' interests where protected. Justice Cromwell held that a conflict of interest arises "when there is a substantial risk of the employer-administrator's representation of the plan beneficiaries would be materially and adversely affected by the employer-administrator's duties to the corporation."[26] Like Deschamps J., he stated that Indalex did not create a conflict of interest simply by commencing insolvency proceedings. On an examination of the facts, Cromwell J. found no such conflict.[27] He did, however, agree that Indalex breached its duty by failing to deliver notice of the application for the DIP charge to the pension beneficiaries—relief that clearly gave rise to a conflict of interest.[28]

Justice LeBel (Abella J. Concurring)

Justice LeBel had a more stark view of Indalex's conflict of interest. Justice LeBel held that Indalex was in a conflict of interest "from the moment it started to contemplate putting itself under the protection of the *CCAA* and proposing an arrangement to its creditors."[29] Justice LeBel wrote that Indalex could not wear "two hats" and that the *PBA* offered no protections or "lesser" fiduciary obligations to pension plan administrators who were also employers. According to LeBel J., Indalex could apply for *CCAA* protection, but it needed to make arrangements to avoid conflicts of interest. In failing to do so, Indalex was in breach of its duty. Justice LeBel faulted Indalex for not relinquishing its role as pension plan administrator at the time of the *CCAA* application.[30]

Overturned: Constructive Trust

Notwithstanding the unanimous decision that Indalex had breached its fiduciary duty to the pension plan beneficiaries, the SCC was not unanimous as to the availability of a remedy. Instead, a majority of the SCC (5:2) overturned the decision of the OCA to impose a constructive trust on Indalex's assets in favour of the pension plan beneficiaries. Justice Cromwell, writing for the majority, held that a remedial constructive trust for breach of fiduciary duty is only appropriate where the subject of the trust (in this case, the assets) is directly related to the wrong arising from the breach of fiduciary duty such that it would be unjust to allow the breaching party to retain it. In the circumstances, the legal test was not met.[31] In this case, the wrong—the failure to give notice—did not result in a deprivation to the pension plan mem-

bers. Accordingly, the SCC was not prepared to use a constructive trust to reorder priorities. Justice Deschamps added:

> In an insolvency process, a *CCAA* court must consider the employer's fiduciary obligations to plan members as their plan administrator. It must grant a remedy where appropriate. However, courts should not use equity to do what they wish Parliament had done through legislation.[32]

Justices LeBel and Abella disagreed. They agreed with the OCA's reasoning and would have upheld the remedial constructive trust subordinating the court-ordered priority of the DIP charge, notwithstanding that they concurred with the unanimous SCC as to the priority afforded to such charge by operation of the doctrine of paramountcy.[33]

Indalex Shmindalex Redux

As a result of the decision of the SCC, the insolvency community is left with a number of certainties. It is certain that a duly ordered DIP charge can attain super-priority (or such other priority as the *CCAA* court may grant). It is certain that the *PBA* deemed trust captures wind-up deficiencies in wound-up plans. It is certain that a restructuring debtor who is also a pension plan administrator owes a fiduciary duty to the plan beneficiaries. However, what is not certain is how, precisely, the decision will impact practice.

Ontario and Beyond?

First and foremost, it cannot be lost that this is a decision based on Ontario law (*i.e.*, the *PBA*). Whether or not the reasoning of the SCC applies equally in other jurisdictions in Canada is not clear.

Safeguarding the DIP Priority?

The SCC's decision reaffirms the *CCAA* court's discretion to create super-priority charges. In the case of a DIP charge, the *CCAA* explicitly requires notice on the secured creditors having a prior interest in the collateral. (Notably, the same notice requirement exists with respect to administration charges and charges in favour of directors and officers.) The definition of "secured creditor" includes the holder of a trust in respect of all or any part of the debtor's property. Accordingly, where a plan has been wound up, the plan beneficiaries are entitled to notice; failing which, the priority of the DIP charge is not secure. Practitioners have already suggested that, in a case with a large number of plan beneficiaries, notice on each beneficiary may not be practical (or even achievable). If so, will the practice develop an alternative form of service that is acceptable to the courts? Could appointing and serving representative counsel be sufficient? Or will the granting of a charge and the granting of the priority be staggered? For example, in the aforementioned *Timminco* proceedings, the debtor obtained approval of certain court-ordered charges but sought priority over pension interests on a subsequent motion on notice to the pension beneficiaries.

Getting Wound Up over Wind-Ups?

In a non-insolvency scenario, lenders holding security in a borrower's personal property now have greater cause for concern (at least in Ontario). The *PBA* and the *PPSA* operate in conjunction to grant to the *PBA* deemed trust priority over the accounts and inventory of a debtor. In light of the SCC's decision that wind-up deficiencies form part of the *PBA* deemed trust, lenders who finance businesses with pensions must take into account a potentially large claim having first priority in respect of the accounts and inventory of the borrower. In an insolvency scenario, the act of commencing *CCAA* proceedings does not preclude the subsequent wind-up of a pension plan during the course of the restructuring. Accordingly, incentives exist for lenders to take

steps to ensure the borrowers do not wind up Pension Plans. However, Deschamps J. expressed doubt that any employer could avoid the consequences of the *PBA* deemed trust simply by refusing to wind up a plan.[34] Will future restructurings in pension environments feature fights over wind-ups? Will the plan beneficiaries move as soon as possible for an order to wind up the plan? Will the debtors and lenders strategize against the same? What position will a monitor take?

Fiduciary Duty: A Moving Target?

It is clear that an employer who is also a pension plan administrator has a fiduciary duty to the plan beneficiaries and that, though permitted under the *PBA*, such dual role will give rise to a conflict of interest. It is also clear that, in the context of a restructuring, an employer-administrator must take proactive steps to manage that conflict of interest. However, what those steps may be is not clear or necessarily practicable. As Deschamps J. enigmatically stated, "the solution has to fit the problem, and the same solution may not be appropriate in every case."[35] Moreover, the SCC did not categorically reject the notion that considering or commencing insolvency proceedings might potentially give rise to a conflict of interest and a breach of fiduciary duty. Two of the justices held that it did; whereas, the balance of the court held that it did not, *on the facts*. Accordingly, employer-administrators (and their directors) need to carefully consider how the pension plan beneficiaries will be impacted by each step in a restructuring, without inadvertently jeopardizing the same.

Conclusion

With respect to the specific questions left in the wake of *Indalex*, the practice will inevitably evolve to deal with each of them. However, for the time being, such questions remain open. In the end though, the more significant impact of the SCC's decision in *Indalex* may be on the general dynamics of restructuring in a pension environment.

First, the SCC's decision guarantees pension beneficiaries a seat at the table. They will be entitled to notice, in most cases, of critical steps in the *CCAA* process. Moreover, once at the table, the SCC's confirmation that the *PBA* deemed trust includes wind-up deficiencies guarantees the pension beneficiaries more clout. Whether through representative counsel or grassroots collaboration, pension beneficiaries have the potential to become significant participants in at least some of Canada's larger restructurings.

Second, and perhaps less obvious, is the potential impact on the relationship between debtors and their secured lenders. In certain circumstances, secured lenders may prefer a bankruptcy filing under the *Bankruptcy and Insolvency Act*,[36] which likely renders provincial statutory deemed trusts inoperable. In such circumstances, debtors wishing to restructure will need to commence proceedings against the wishes of their senior lenders and (likely) source alternative DIP financing (as senior secured lenders often provide DIP financing). Of course, secured lenders will not stand idly by while their security is eroded.

Accordingly, not only does the SCC's decision guarantee pension beneficiaries a seat at the table, it will force secured lenders to more critically analyze whether a *CCAA* filing is in their best interests. In certain cases, these new realities may not only change the dynamics of restructuring in a pension environment, but they may also undermine the restructuring altogether.

[*Editor's note*: R. Graham Phoenix and Aubrey E. Kauffman are members of the Insolvency and Restructuring Law Group in the Toronto office of Fasken Martineau DuMoulin LLP.]

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1 [2011] O.J. No. 1621 (Ont. C.A.) [*Indalex (OCA)*].
2 [2013] S.C.J. No. 6 (S.C.C.).
3 R.S.C. 1985, c. C-36 [*CCAA*].
4 [2012] O.J. No. 596 [*Timminco*].
5 *Timminco Ltd. (Re)*, [2012] O.J. No. 3931 (Ont. C.A.).
6 Aubrey E. Kauffman and R. Graham Phoenix, "*Indalex*, Shmindalex! Ontario Court of Appeal Decision Confirms that DIP Priority Is in the Hands of the *CCAA* Court," Nat. Insol. Review 20, No. 5 (October 2012): 67.
7 R.S.O. 1990, c. P-8 [*PBA*].
8 *Ibid.*, s. 75.
9 *Ibid.*, s. 57(4).
10 *Indalex (OCA)*, *supra note 1*, para. 107.
11 *Ibid.*, paras. 97, 99 and 101.
12 R.S.O. 1990, c. P.10 [*PPSA*].
13 *Indalex (OCA)*, *supra* note 1, paras. 110–111.
14 *Ibid.*, para. 132.
15 *Ibid.*, para. 139.
16 *Ibid.*, paras. 201–205.
17 *Ibid.*, paras. 178–180.
18 *Ibid.*, para. 205.
19 *Ibid.*, para. 36.
20 *Ibid.*, para. 120.
21 *Ibid.*, para. 60.
22 *Ibid.*, paras. 63–64.
23 *Ibid.*, para. 66.
24 *Ibid.*, paras. 70–71.
25 *Ibid.*, para. 73.
26 *Ibid.*, para. 201.
27 *Ibid.*, paras. 203–205.
28 *Ibid.*, para. 214.
29 *Ibid.*, para. 269.
30 *Ibid.*, paras. 268–273.
31 *Ibid.*, paras. 226–229.
32 *Ibid.*, para. 82.
33 *Ibid.*, para. 276.
34 *Ibid.*, paras. 46–47.
35 *Ibid.*, para. 66.
36 *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.