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on

Insolvency Law

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FRASER MILNER CASGRAIN LLP

LEGAL FEES OF DIRECTORS INCURRED ON BEHALF OF BANKRUPT CORPORATION RANK WITH UNSECURED CREDITORS

In *Enernorth Industries Inc. (Re)*, [2008] O.J. No. 274 (Ont. S.C.J.) the Directors and Officers of Enernorth (the “Applicants”) brought a motion for an order requiring Enernorth to pay their legal fees in connection with proceedings commenced in India by Oakwell Engineering Ltd. (“Oakwell”).

Oakwell commenced proceedings against Enernorth and the Applicants regarding an intra-corporate transfer of assets (the “Action”). The Trustee did not bring a motion to discontinue or dismiss the Action but instead sought and obtained a series of adjournments and other legal relief, on a consensual basis with Oakwell. The relief obtained by the Trustee did not address Oakwell’s demand to examine the Applicants. The Applicants then brought a motion to restrain Oakwell from advancing the Action. Ultimately, Oakwell consented to an order of discontinuance of the Action “with prejudice” whereby the order required the Applicants to submit to examinations for discovery.

The Applicants, in seeking indemnification for their past legal costs as well as future costs, acknowledged that the costs claimed were not legal costs incurred in the administration of the estate pursuant to 136(1)(b)(iii) of the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 (“BIA”) which would have afforded them priority over unsecured creditors.

The Applicants argued that sections 136(4.2) and 136(5) of the Ontario Business Corporations Act (the “BCA”) have the effect of converting the Applicants legal expenses into legal expenses of the corporation liable to indemnify them. They also acknowledged that they would require a court order under section 197(4) of the BIA authorizing such legal costs. Section 197(4) states:

197(1) Subject to this Act and to the General Rules, the costs of and incidental to any proceedings in court under this Act are in the discretion of the court.

...

(4) No costs shall be paid out of the estate of the bankrupt, excepting the costs of persons whose services have been authorized by the trustee in writing and such costs as have been awarded against the trustee or the estate of the bankrupt by the court.

The Court declined to exercise its discretion under s. 197(4) of the BIA as it was found that the Applicants failed to prove “the Trustee had no valid business purpose for forbearing from such action and, therefore had a duty to take action”.

Further, the Court found that section 136(4.2) of the BCA provides for an unsecured right of indemnification in favour of the directors against the corporation as there is no wording to suggest directors are intended to have a higher priority than other unsecured claims. Also, there is no indication of any intention in the BCA that an indemnification claim have a preferred status under the BIA in the event of an insolvency.

Finally, the Court found that an order made pursuant to s. 136(5) of the BCA would be limited to an order for indemnification on an unsecured basis. If an order were made pursuant to 136(5) of the BCA granting priority under the BIA, constitutional issues would arise and such an order would amount in substance to an order under 197(4) of the BIA.

The Applicants also made a failed attempt to argue unjust enrichment on the part of the corporation for the legal fees incurred by them.

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