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Re Tudor Sales Ltd. (2017 BCSC 119)

A: Introduction

In *Re Tudor Sales Ltd* (2017 BCSC 119) the BC Supreme Court considered whether certain payments purported to be secured loans advanced by a shareholder, Tavi Eggertson, to the bankrupt, Tudor Sales Ltd. ("Tudor"), were in substance contributions to equity ranking subsequent in priority to the claims of other creditors.

B: Factual Background

Tudor made an assignment in bankruptcy in November, 2013. Mr. Eggertson, a shareholder and Tudor's sole officer and director, claimed he was a secured creditor and was entitled to be repaid in priority to the claims of unsecured creditors. In support of this claim, Mr. Eggertson relied on a General Security Agreement (the "GSA") executed by Tudor in Mr. Eggertson's favour in March 2006.

Cascade Steel Rolling Mills Inc. ("Cascade"), Tudor's largest unsecured creditor, argued that the payments made by Eggertson to Tudor were more properly characterized as contributions to equity, and therefore subordinate to the claims of any creditors.

Mr. Eggertson's secured claim consisted of $1.4 million in shareholder loans advanced in 2005 and 2006 (the "2005-2006 Advances") and $1.9 million in shareholder loans advanced in 2011 and 2012 (the "2011-2012 Advances").

The 2005-2006 Advances were initially described in financial statements as "unsecured and non-interest bearing." After the GSA was executed in March 2006, the 2005-2006 Advances were described in financial statements as interest bearing but unsecured. Mr. Eggertson claimed that these notes were incorrect and that the GSA was intended to cover the Advances. The financial statements began to refer to the 2005-2006 Advances as being secured loans in 2011. Mr. Eggertson stated that the interest rate at which he was paid each year in respect of the Advances fluctuated with the fortunes of the company. When the company was doing well the interest rate was as high as 36%; when the interest rate was too high relative to the company's performance, Mr. Eggertson would forgive the interest payments.

Mr. Eggertson also argued that the 2011-2012 Advances were secured by the GSA. After making the 2011-2012 Advances, Mr. Eggertson directed that Tudor make the funds available to T.E. Sales Inc., a company controlled by his wife, which in turn used the money to fund a tequila venture in which Mr. Eggertson had an interest. Mr. Eggertson claimed that Tudor's financial statements erroneously did not include these advances as shareholder loans.

Cascade argued that the 2005-2006 Advances, though carried on the books of Tudor as loans, were property characterized as equity, and must be subordinated to the claims of Tudor's creditors. With respect to the 2011-2012 Advances, Cascade argued that Mr. Eggertson was merely using Tudor as a vehicle to invest in the tequila venture, and that it was impermissible for him to shelter those payments under Tudor's GSA, thereby defeating the legitimate commercial interests of Tudor's creditors.

C: Decision

The Court agreed with Cascade on both points.

Mr. Justice Saunders cited *Re U.S. Steel Canada Inc* (2016 ONSC 569) for the proposition that in a non-arm's-length transaction, there can be no certainty that the language of the agreements reflect the underlying substantive reality of the transaction.

The first task of the Court, therefore, was to determine whether the 2005-2006 Advances made by Mr. Eggertson to Tudor in substance constituted a contribution to capital, notwithstanding the expressed intention that the transaction be treated as a loan.

The Court cited the following indicia in coming to the conclusion that the transaction was, in substance, a contribution to capital:

1. Interest payments varied with Tudor's profitability. That is, interest payments were made after liabilities to secured and unsecured creditors were satisfied such that any interest payments were subordinated to all current liabilities, a fact inconsistent with Mr. Eggertson's claim that he was a secured creditor.

2. The fact that there was no schedule for repayment and no formula to determine interest rates was more consistent with the 2005-2006 Advances being contributions to equity rather than secured loans.
3. Certain increases in Mr. Eggertson's shareholdings coincided with the 2005-2006 Advances, suggesting that the Advances were consideration paid for an increased ownership stake in Tudor, making them equity contributions.
4. The GSA made no specific reference to the 2005-2006 Advances and the Advances were not described as secured loans in Tudor's financial statements until 2011 when the company went into default on its lending covenants. This further reinforced the view that the Advances were not originally intended to give rise to a secured debt.

Since the interests of creditors rank senior to the interests of equity holders, Mr. Eggertson's claim with respect to the 2005-2006 Advances was subordinated to the claims of the creditors.

With respect to the 2011-2012 Advances, the Court found that Mr. Eggertson was not entitled to the luxury of securing his investment in the tequila venture by relying on the GSA granted to Tudor, thereby defeating the legitimate interests of creditors. Mr. Justice Saunders found that 2011-2012 Advances were not proper debt transactions and therefore did not rank in preference to the claims of the creditors.

D: Implications

When examining non-arm's-length dealings, the Court will look past the stated intent of the parties and assess the substance of the transaction in order to determine its true character.

Shareholders should be aware that a transaction that is in substance a contribution to equity cannot be converted into a secured debt, despite the expressed intent of the parties. If funds advanced to a company are meant to be an actual loan, a shareholder should consider: 1) formalizing the loan with a loan agreement made prior to or concurrently with the advance; 2) granting a general security agreement prior to or concurrently with the advance; 3) continuing in compliance with the loan agreement; and, 4) confirming that the loan is accurately and consistently classified as a loan in the financial statements. While these steps may be challenged in insolvency, they will go towards establishing an actual loan between the shareholder and company.

Please contact us should you wish to discuss the implications of this decision in more detail.