

LITIGATION NOTES

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Supreme Court Agrees to Hear Conflicts Case

The Supreme Court of Canada has recently granted leave to appeal in a matter that has significant implications for lawyers and other professionals. For many years, Strother and his law firm, Davis & Company ("Davis"), advised their client Monarch Entertainment Corporation ("Monarch") in relation to certain tax-exempt vehicles. After those incentives were eliminated, Strother advised Monarch that there was no way to continue such investments and Monarch wound up its business and let go of many employees, including Darc, its chief operating officer.

The exclusive retainer agreement with Davis was terminated but Monarch continued to use Davis and Strother for related wind-up work. Unbeknownst to Monarch, Darc approached Strother with a plan for cir-

cumventing the new tax rules and creating a new tax credit shelter. Strother agreed to pursue an advance tax ruling for Darc's proposal and to participate with him in the proposed venture were it to succeed. Once a favourable tax ruling was obtained, Strother resigned from Davis and joined Darc in a new company, Sentinel Hill. The new venture was very successful with Mr. Darc and Strother earning over \$32 million each. Monarch sued Darc, Strother and Davis for breach of loyalty and breach of fiduciary duty.

The B.C. Court of Appeal found no liability on the part of Darc, finding that his fiduciary duties ended when he left Monarch, and that as a non-lawyer, he did not owe a duty of loyalty. However, the Court found that Strother was in a position of conflict on two fronts: a

conflict of duty between two clients, and a conflict of interest between himself and Monarch.

Although Monarch's exclusive retainer with Davis had expired, the solicitor-client relationship between Monarch and Strother continued. The scope of Strother's contractual duty to advise Monarch was also distinct from his fiduciary duties which were implied by law and incapable of exclusion or diminishment by contract. As soon as Strother and Darc entered into their agreement, Strother was found to be in a position of personal and professional conflict, regardless of whether his entitlement to profit was immediate or contingent on the tax ruling. Strother had a duty to withdraw from the conflict unless he received Monarch's informed consent

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Court of Appeal Considers Review Engagement

The Ontario Court of Appeal recently considered the duties of an accountant on a review engagement. Dr. Bernard Sherman was described by the court as "an astute businessman, an experienced investor and the chair of Apotex Inc." He invested in two limited

partnerships formed to invest in luxury yachts. Albert Title, a partner with Orenstein & Partners ("Orenstein"), performed review engagements of the financial statements of the limited partnerships. Peter Browning, another partner in the firm, reviewed Title's

work and also did some accounting and tax work for the general partner, Overseas Credit and Guarantee corporation ("OCGC").

The limited partnerships turned out to be a sham and Dr. Sherman was re-assessed

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Ontario Securities Act and Liability of Experts

In light of recent high-profile financial scandals, many governments have introduced legislation to increase the liability of primary and secondary actors in the securities market.

In November 2002, the Ontario government announced several changes to the *Securities Act*, and further amendments were introduced in May 2003 as Bill 41. Some of the changes have already been implemented and the changes that we are concerned with, involving the statutory civil liability of experts for misrepresentations, came into force on December 31, 2005.

Until now, statutory civil liability has been limited to the primary market; rights of action were limited to those who bought shares while relying on official documents, such as takeover bid circulars and prospectuses, issued before the initial public offering. The extension of liability into the secondary market means that investors who buy and sell shares on the open market now have legal recourse for misrepresentations against experts, such as accountants, actuaries and lawyers. Furthermore, investors used to have to allege outright fraud and reliance on misrepresentations; the amendments now make it easier to bring a civil action by removing these previous barriers. The key changes are set out below.

1. Right of Action

Investors now have a right of action for misrepresentations against experts, which include an accountant, appraiser, auditor, engineer, financial analyst, geologist or lawyer.

Misrepresentations are defined as an untrue statement of a material fact or an omission to state a material fact. Material facts are facts that would be reasonably expected to have a significant impact on the market price or value of the securities. The misrepresentations can take the form of documents or oral statements.

In the case of a misrepresentation in a document, a right of action for damages will arise if the investor acquired or

disposed of securities of an issuer on a stock exchange or other secondary market while there was an uncorrected misrepresentation, during the period between the time the document was released and the time it was publicly corrected, without regard to whether the investor relied on the misrepresentation.

Experts are liable where the misrepresentation is contained in a report, statement or opinion made by the expert and that misrepresentation is included, summarized or quoted in a document released by a person or company other than the expert, where the expert consented in writing to the use of the report, statement or opinion in the document.

These include any written communications, including those in electronic form, filed with the OSC, a government agency, or a stock exchange. They could also include any written communications that would “reasonably be expected to affect the market price or value of a security of the responsible issuer.”

Investors also have a cause of action arising from a public oral misrepresentation during the time between when it was made and corrected, without regard to whether they relied on the misrepresentation.

A public oral statement will only give rise to a right of action if it relates to the business or affairs of the issuer and is made by a person with actual, implied or apparent authority to speak on behalf of the issuer or an influential person, who actually quotes or summarizes from the report, statement or opinion of the expert that contains the misrepresentation and the expert consents in writing to its use in public opinion.

An oral statement may result in liability if it is made in circumstances in which it would be reasonable to conclude that the statement would become generally disclosed, i.e.: public speeches or statements to the press.

Experts are held to the general standard of strict liability. Once it is found that a

document or public oral statement contained a misrepresentation, it does not matter whether or not the expert knew or ought to have known of the misrepresentation.

2. Key Defences

Leave of the court is required before an action may be commenced, so that frivolous actions may be reduced. An action must be commenced within 3 years of the release of the document or statement containing the misrepresentation. Any action brought may not be discontinued or settled without approval of the court. The prevailing party is entitled to costs as determined by a court.

Persons other than the expert, can plead the defence of reliance on an expert report—any part of their document or oral statement that includes the expert’s report with written consent, is exempt from liability, if that person did not know or had no reasonable basis to believe it contained a misrepresentation.

Withdrawn Consent

Experts are not liable if their written consent to have their report, statement or opinion included in a document or public oral statement was withdrawn in writing prior to the document’s release or public oral statement being made.

Inadvertent Release

Defendants may escape liability for a misrepresentation contained in a document, other than a document filed with the Commission, by proving they did not know and had no reasonable grounds to believe that the document would be released.

Reasonable Investigation

Defendants will not be liable if they can prove that they had conducted or caused to be conducted a reasonable investigation and did not have reasonable grounds to believe that there was a misrepresentation in the document or public oral statement.

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Conflict of Interest

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which was impossible, given the non-disclosure. He was also precluded from going into business with Darc, even if he had first left his law office, without the consent of Monarch. Monarch's decision not to re-enter the investment field after learning of the favourable tax ruling was irrelevant because equity did not require Monarch, the beneficiary of a fiduciary duty, to prove any loss consequent upon breach. Strother was ordered to account for all benefits and profits he had received or remained entitled to receive through his participation in the venture.

The Appeal Court dismissed Monarch's claim for direct liability of Davis for the profits Strother received from Sentinel Hill. The Court of Appeal held that the partners of Davis were not aware that they were assisting in a breach of duty by Strother to Monarch. However, the Court found that different considera-

tions applied to Davis's disgorgement of the profits it earned in the form of legal fees as a result of acting for Sentinel Hill in conflict with its duty to its original client, Monarch. Although the partners did not appear to be aware of the advice that Strother was giving, Davis's vicarious liability for that breach was clear—the firm acted for both Monarch and Sentinel Hill in the ordinary course of business and with the authorization of its partners. The Court held that it is important to maintain the integrity of fiduciary relationships by ensuring that persons who are subject to fiduciary duties cannot profit from them, except to the extent permitted by the beneficiary of the duty. Davis was ordered to account for and disgorge the profits it earned from acting for Sentinel Hill in breach of its duty to Monarch.

In *R v Neil*, [2002] 3 S.C.R. 631, the Supreme Court of Canada held that it is the firm, and not just the individual lawyer, that owes a fiduciary duty to its

clients and a bright line is required. The bright line is the general rule that a lawyer may not represent one client whose interests are directly adverse to the immediate interests of another current client, even if the two mandates are unrelated, unless both clients consent after receiving full disclosure.

It will be interesting to see how the Supreme court deals with the *Monarch* case, which expands the duty in *Neil*. Not only does one's fiduciary duty encompass one's retainer, the lawyer has a duty to advise the client of issues of "interest" that go beyond the retainer. Furthermore, any decisions that a lawyer makes, such as leaving a firm and undertaking a new business opportunity, breaches loyalty and is subject to disgorgement of profits, if that opportunity arose while working for the client.

Davis & Co. v 3464920 Canada Inc., S.C.C Docket No. 30838

Review Engagement

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by Revenue Canada. His partnership losses, interest expenses and other costs related to the limited partnerships were disallowed. He sued Orenstein, Title and Browning for twenty monthly interest payments totalling about \$635,000. He claimed that a going concern note should have been included in the financial statements of the limited partnerships, which would have alerted him to the fact that they were not viable enterprises and caused him to stop making interest payments. His case was dismissed by the Ontario Superior Court and he appealed to the Court of Appeal.

His appeal was dismissed. The Court of Appeal considered the standard of care required for a review engagement, including the principles enunciated in the case of *Bloor Italian Gifts v Dixon*,

(2000) 48 O.R. (3d) 760 (C.A.). The Court held that a review engagement has a limited objective: the accountant must assess the information reported on against the standard of plausibility. Plausibility is a matter of professional judgment, although the accountant must have sufficient knowledge of the enterprise to be able to make intelligent enquiries. Unlike an audit, the accountant performing a review engagement does not undertake to verify the accuracy of the information provided, but is entitled to assume that the client is telling the truth. A review engagement is even less likely than an audit to detect fraud or error.

A going concern note is so serious that it requires a level of enquiry that is incompatible with a review engagement. In fact, the section of the *CICA Handbook* dealing with review engagements

contains no mention of a going concern note.

The plaintiffs argued that there were "red flags" which were ignored by Orenstein, including the fact that the limited partnerships were being audited by Revenue Canada, the fact that no yachts had been built and the fact that the earnings of OCGC had been revised downwards. The lack of ships had been explained by problems with the original shipbuilder, Revenue Canada audits are not unusual in the case of aggressive tax shelters and the earnings write-down was said to have been for tax planning purposes. These explanations were held to have been plausible and to hold otherwise would be to judge the accountants with the benefit of hindsight.

Sherman v Orenstein & Partners [2005] O.J. No. 5161



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Liability of Experts

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Plaintiff's Knowledge

A defendant is not liable if the plaintiff knew that the document or public oral statement contained a misrepresentation.

Forward Looking Information Cautions

Defendants will not be liable with respect to "forward-looking" information, provided that the document or public oral statement contains cautionary language, identifies material factors that could cause actual results to differ, states the material factors or assumptions that were applied in making a forecast, and the defendant had a reasonable

basis for making the forecast. Forward-looking information means all disclosure regarding possible events and future-oriented financial information, based on assumptions about future economic conditions that is presented as a forecast or a projection.

Corrective Action

A defendant who becomes aware of an uncorrected misrepresentation may avoid liability by notifying the issuer's board of directors. If the issuer fails to take corrective action within 2 days, the defendant must promptly notify the commission in writing to avoid liability (unless prohibited by law or professional confidentiality rules).

3. Damages

Damages are awarded on a proportionate level. The total liability of an expert is limited to the greater of \$1 million and the revenue that the expert has earned from the issuer and its affiliates during the 12 months preceding the misrepresentation. However, if the expert is found to have knowingly made the misrepresentation or knowingly influenced the making of the misrepresentation, then the expert is exempt from the proportionate liability provisions and liability caps.

These Litigation Notes are intended to provide general information and do not constitute legal advice. Readers should consult legal counsel on matters of interest or concern raised by anything contained in this publication.