BERSENAS JACOBSEN CHOUEST THOMSON BLACKBURN LLP
BARRISTERS, SOLICITORS

LITIGATION NOTES

Legal Decisions and Developments in Canada

Volume 9, Issue 4 — April 2014

Livent Auditors Liable for $84.75 Million

The theatres have gone dark, but the litigation continues. In an action brought by Livent's Receiver, the Ontario Superior Court of Justice finds the Corporation's auditors liable for $84.75 million.

For a period of time, Livent Inc. was a major success in the business of live entertainment, producing hits such as Phantom of the Opera, Joseph and the Amazing Technicolor Dreamcoat and Kiss of the Spiderwoman – The Musical. Livent owned the Pantages Theatre in Toronto, as well as interests in theatres in New York, Chicago and Vancouver.

In the five years from May, 1993 to June, 1998, Livent raised some $280 million through the issuance of shares and debentures. In the Spring of 1998, Livent allowed two of its investors, Michael Ovitz and Roy Furman, to appoint part of a new management team. Robert Webster, a former partner with KPMG, was appointed Executive Vice President. Shortly after his appointment, he discovered "serious accounting irregularities" in the Corporation's financial records.

The principals of Livent, Garth Drabinsky and Myron Gottlieb, were fired and eventually convicted of fraud. Livent made a voluntarily petition for bankruptcy protection under Chapter 11 of the United States *Bankruptcy Code* and filed for protection under the *Companies Creditors Arrangement Act* in Canada. In September, 1999 the Corporation was placed in receivership and Ernst & Young was appointed receiver and manager of all of Livent's property, assets and undertakings.

In February, 2002, the Receiver commenced action against Deloitte & Touche Inc. ("Deloitte"). Deloitte had been the auditor of Livent from its inception in 1992 until its demise. The Statement of Claim alleged that the financial statements of Livent were materially false and misleading, largely as a result of fraudulent activities carried on by management in four areas: (1) the payment of false or inflated invoices to complicit third parties who would then provide kickbacks to Gottlieb and Drabinsky; (2) "expense rolls" which involved moving expenses to different quarters or to different productions; (3) the improper transfer of pre-production costs between shows; and (4) transactions that were disguised to look like sales of assets, but which were in substance loan arrangements.

By failing to discover the frauds, Deloitte "…effectively facilitated the continuance of the frauds. Drabinsky and Gottlieb were permitted to continue reporting inflated revenues, net income, total assets, and shareholder's equity, which in turn permitted them to continue to access the capital markets. From a damages perspective…the lack of timely disclosure meant that the net realizable value of [Livent's] remaining assets upon liquidation was less than it would have been had the fraud been discovered and disclosed earlier."

The Court began its analysis by confirming that Deloitte owed a duty of care to Livent, quoting from the House of Lords decision in *Caparo Industries Plc v. Dickman*:

"It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing … and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

The Court then went on to identify the standard of care to which Deloitte should be held. Deloitte relied on the well-known dictum of the House of Lords in the *Kingston Cotton Mill* case where Lord Lopes said that an auditor "…is a watch-dog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion he should probe it to the bottom; but in the absence of anything of that kind he is only bound to be reasonably cautious and careful."

The Court said that "the law has changed significantly since that bygone era", but observed that when the Livent audits were per-

(Continued on page 2)

Inside This Issue

Livent (continued)

(Continued from page 1)

formed the standard of care had not moved anywhere near the standard that has developed since *Sarbanes-Oxley*.

The Court went on to quote from various sections of the Handbook of the Canadian Institute of Chartered Accountants and expressed the view that an auditor must approach an audit with a degree of professional scepticism and plan the audit program to catch fraudulent financial reporting.

The Court went on to consider whether Deloitte had met the standard of care in this case. The plaintiff's own expert had indicated that Deloitte should have uncovered fraud in the 1996 and 1997 audits but could only put it as high as Deloitte "may have" uncovered the fraud in the pre-1996 years. The Court concluded that the plaintiff did "not cross the 'balance of probabilities' finish line" in establishing liability for the pre-1996 audits.

For the 1996 audit, the trial Judge found a number of deficiencies in Deloitte's work but could not conclude that the fraud should have been discovered or that any compensable harm had been caused as a result of Deloitte's negligence.

The 1997 audit was another matter. In 1997, Livent entered into a letter of intent with Dundee Realty Corp. ("Dundee") to sell air rights above the Pantages Theatre and lands contiguous to the theatre for the purpose of the construction of a condominium/hotel tower and a new theatre. Myron Gottlieb wanted to have a $6 million gain in respect of this transaction reflected in Livent's second quarter results. Deloitte's audit partner, Bob Wardell, opposed this treatment because the agreement had not been signed, Dundee had not paid enough of the purchase price up front for it to qualify as a sale and the agreement contained a "Put" which would enable Dundee to avoid making a payment to Livent.

Notwithstanding Wardell's objections, Gottlieb took the draft Q2 financial statements to the Audit Committee for approval, showing a $6 million gain on the sale of the air rights. When Wardell learned of this fact, he advised Gottlieb that Deloitte was going to insist on an Audit Committee meeting being convened at which time Deloitte would advise the Committee that the second quarter results were materially misstated.

At this point, Gottlieb had Livent's lawyer redraft the agreement with Dundee, deleting the Put. However, the Put was added back by way of a side agreement which was not brought to the attention of Deloitte. In any event, this did not satisfy Deloitte, who thought that it was still misleading to include the revenue in Q2 for the other reasons referred to above.

Deloitte was on the brink of resigning, which Gottlieb was apparently prepared to have them do, because he considered that he could get the opinion that he wanted from another accounting firm. However, other members of the Board and management of Livent were concerned about the optics of having Deloitte resign prior to a proposed debt placement in the Fall of 1997. Ultimately, Deloitte agreed to a compromise whereby $4.8 million would be recognized in Q3 instead of Q2 of 1997. Nevertheless, following this imbroglio, Gottlieb contrived to have Deloitte remove Wardell and his team from the Livent audit.

In the Court's opinion "Deloitte should have remained firm in its resolve to sever its relationship with Livent at the end of August, 1997 at the earliest, but no later than the end of Q3, or September 30 at the latest. The red flags, were certainly aflutter by that time...".

It so happened that Deloitte were also the auditors of Dundee and in April, 1998 the Deloitte engagement partner on the Dundee audit discovered that the Put was still operative. He informed his Deloitte colleagues who were responsible for the Livent audit and "all hell broke loose". Livent's explanation was that the Put had been verbally cancelled in the third quarter of 1997, an explanation which Deloitte ultimately accepted. The Court concluded that the behaviour of Livent's management should have alerted Deloitte to the fact that there was fraudulent activity and that Deloitte should not have signed off on the 1997 audit in the Spring of 1998.

The trial Judge goes on to draw a correlation between Deloitte's negligence and the damages sustained by Livent. He identifies that the plaintiff's theory of the case is that Deloitte should have identified material misstatements and that if it had, it would have been obliged to withhold its clean opinion of the financial statements for that year. The lack of audited financial statements would have meant that Livent could not have accessed the capital markets and no further losses would have been incurred past that point.

For the purposes of calculating Livent's loss, he settles on August 31, 1997 as the "Measurement Date", which is the date when "(a) Deloitte breached its standard of care, (b) the fraud would have been discovered but for the breach, (c) if the fraud had been uncovered, Livent would have been unable to access the capital markets, and (d) this would, in turn, have led to a formal insolvency". He then goes on to calculate how much Livent lost between the Measurement Date and its bankruptcy.

Deloitte argued that even if it was negligent, it was not responsible for Livent's losses. It argued that Livent was involved in a risky business and made a number of bad decisions which resulted in ordinary business losses which could not be attributed to Deloitte. The essence of Livent's claim was that Deloitte failed to take the actions which would have resulted in the plug being pulled on the Corporation and further losses being avoided. This theory has been rejected in the case of *Galoo Ltd. v. Bright Grahame Murray*, where the Court of Appeal of England and Wales said:

"It is necessary, to determine whether there is a causal relationship, to look more closely at the breach and what (to use a neutral term) flowed from it. In the present case, the company's loss resulted from the defendants' breach in the sense that the course of events vis-a-vis the company would have gone in a different direction had it not been for that breach. But that, I think, is not, or is not necessarily, sufficient. Thus, the breach allowed the company to continue in business. If its net worth had fallen because, for example, the main buildings it owned had been destroyed by an earthquake, I do not think that the loss would have been causally related to the breach which let the company continue in business."

However, the trial Judge pointed out that other cases have reached a different conclusion, quoting the case of *Sasea Finance Ltd. v. KPMG* where the same Court (Court of Appeal of England and Wales) said:

"One of the Australian decisions referred to [in *Galoo*] was *Alexander v. Cambridge Credit Corp Ltd.* (1987) 9 NSWLR 310. In that case it had been pointed out that to allow a company to continue in existence did not, without more, cause losses occasioned by the ordinary risks associated with carrying on business. So it will be seen that a distinction may be made between the present case and the *Galoo* case. We are concerned with losses brought about by fraud or irregularities the

(Continued on page 3)

Livent (continued)

(Continued from page 2)

risk of which KPMG ought to have apprehended and reported. Albeit in the *Galoo* case the auditors had failed to detect a fraudulent overstatement of assets going back several years and by continuing to trade the companies were acting fraudulently in that they were insolvent, the auditors were not under a duty to warn against the possibility of losses of the type incurred."

The Court went on say that cases like *Galoo* are at one end of the spectrum, because the only connection between the auditors' breach and the consequential loss is that the breach allowed the company to stay in business. At the other end of the spectrum are cases like *Sasea* in which the company's losses were directly caused by the very fraud that the auditors negligently failed to detect.

The Court then concludes that:

"The case at bar does not fall squarely into either category. On the one hand, Livent's losses after the Measurement Date are largely attributable to the very fraud which Deloitte should have detected. The fraudsters may not have been directly stealing from the company, but they did directly cause the company to improperly incur greater liabilities than it would otherwise have incurred. The use of fraudulently misstated financial statements to induce people to invest in a company is entirely predictable. Livent's losses—to the extent they are attributable to this improper increase in liabilities—cannot be said to be too remote."

The trouble with this last statement is that there was no evidence, at least none referred to in the judgment, to the effect that financial statements were used to induce people to invest in Livent. Indeed, it seems likely that the action was brought by the Receiver for that very reason. Had the investors sued on their own behalf, they would have been faced with the Supreme Court of Canada decision in *Hercules Management Ltd. v. Ernst & Young*, which would deny them a cause of action unless they actually relied on the financial statements.

Furthermore, there is no connection drawn between the frauds and the losses sustained by Livent. In fact, the Corporation doesn't seem to have suffered at all, except in the sense that the frauds enabled it to stay in business and raise more money that could be frittered away. This suggests that the *Galoo* analysis is the one that should have been applied.

Livent v. Deloitte & Touche LLP, 2014 ONSC 2176

Of Lathes and Lampshades

Where two businesses were carried on in a premises, insurance coverage was only available in respect of accidents arising from the business operations of the insured.

Mr. Virdi is the principal of a company called Multilamps Shades Co. ("Multilamps), which is a manufacturer and importer of lamp shades. Mr. Virdi applied to Intact Insurance Company ("Intact") for commercial general liability insurance covering Multilamps' operations. In February, 2010 Intact inspected the premises of Multilamps and determined that 85% of its business was importing lamp shades from China while 15% involved manufacturing lamp shades on the premises (the "Property"). There is no evidence that any other type of business was being operated at the Property when the inspection took place.

Intact issued an insurance policy covering the period March 7, 2010 to March 7, 2011. The Declarations page stated that the insured's business operations were "manufacturing and importing of lamp shades". Multilamps' customers were described as additional insureds but "only with respect to liability arising out of the operations of Multilamps".

Mr. Virdi also operated another business, American Industrial Machines Inc. ("AIM"). AIM is in the business of buying and selling industrial machines, including lathes, for use in the automotive industry. This business was also operated out of the Property.

In February 2011 an employee was injured while delivering a number of lathes to the Property. He commenced action against Mr. Virdi, AIM and the employees operating the forklift truck at the time of the accident.

In November 2011 AIM purchased insurance coverage from Intact for its business operations at the Property. Intact issued a new policy covering the period November 11, 2011 to November 11, 2012.

Intact denied coverage in respect of the lawsuit, presumably because AIM was not insured at the time of the accident. The injured employee then commenced a second action relating to the accident, adding Multilamps as a defendant. Intact denied coverage in respect of this action as well, on the basis that the claim did not arise out of Multilamps' operations at the Property.

On behalf of Multilamps, counsel argued that there was at least a possibility that the Intact policy should respond to the claim in the second action. The argument was that Multilamps might be liable on the basis of occupiers' liability.

The Court reviewed the case law relating to duty to defend, which provides that where there is a "mere possibility" that the claim will fall within policy coverage then the insured has a duty to defend. However, "… where it is clear that the claim falls outside of the policy, either because it does not come within the initial grant of coverage or is excluded by an exclusion clause, there will be no duty to defend".

The Court found that there was no coverage, stating:

"Where the insurance policy is issued and specified to be for certain business operations of the insured, where the business operations undertaken by the insured or a third party giving rise to the claim are entirely different and unrelated to the insured or the insured operations, then the policy will not provide coverage".

To hold otherwise would make the insured's declaration of operations meaningless and would make the insurers' evaluation of the risk meaningless.

The Court went on to say that, even if the employees involved in unloading the forklift truck at the time of the accident were Multilamps' employees, "…the fact that they were engaged at the time in completely different and unrelated business operations would eliminate any coverage under the

(Continued on page 4)

Lathes and Lampshades (continued)

(Continued from page 3)

Policy. If Multilamps' employees were used to manufacture explosives on the Property and damage ensued arising from this activity, surely this would not be a business operations covered by the Policy".

Intact Insurance Company v. Virdi, 2014 ONSC 2322 (CanLII)

Crown Not Entitled to Procedural Fairness

On January 12, 2011, Richard Kachkar stole a truck equipped with a snow plow. He ran over and killed police officer Ryan Russell. He was charged with first degree murder and on March 27, 2013 was found not criminally responsible of that offence by reason of mental disorder.

He therefore came under the jurisdiction of the Ontario Review Board and at a hearing held in April of 2013, the Crown and the Hospital made a joint submission to the effect that he should be detained in a medium secure unit at the Ontario Shores Centre for Mental Health Sciences (the "Hospital") and, in the discretion of the Hospital, be given privileges to access the Hospital grounds escorted by Hospital staff.

The Board accepted these conditions but added a condition giving Kachkar privileges, in the discretion of the Hospital, to enter the community of Whitby, escorted or accompanied by staff.

The Crown appealed on the basis that the community access provision was unsupported by the evidence and because the Crown had not been given an opportunity to address the issue, which was a denial of procedural fairness.

The Court of Appeal rejected the Crown's arguments. The medical evidence at the hearing was to the effect that Mr. Kachkar's psychotic episodes could be controlled by medication that he could be safely managed on passes accompanied by Hospital staff, whether on Hospital grounds or in the community.

With respect to the Crown's argument on procedural fairness, the Court quoted from the case of *Cardinal v. Director of Kent Institution* where the duty of procedural fairness was described as follows:

"This Court has affirmed that there is, as a general common law principle, a duty of procedural fairness lying on every public authority making an administrative decision which is not of a legislative nature and which affects the rights, privileges or interests of an individual."

The Court said that although the Board is a public authority making an administrative decision, it could not be said that the Crown is "an individual, nor to have a right, privilege of interest affected by the Board's disposition….

…In my view, the Attorney General does not advance an interest that the Crown can claim as its own. What is being asserted is the public interest, not a private interest. This is to be contrasted with the respondent's liberty interest, which is clearly his own and equally clearly affected by the Board's disposition".

The Criminal Code requires the Review Board to ensure that its disposition is least onerous and least restrictive to the accused, while protecting public safety. If the Crown considers that a disposition does not do so, its right is to appeal on the grounds of unreasonableness rather than assert a breach of procedural fairness.

Kachkar (Re), 2014 ONCA 250 (CanLII)

V.R.P. (Sas) Bersenas
(416) 982-3802
sas@lexcanada.com

Peter M. Jacobsen
(416) 982-3803
pjacobsen@lexcanada.com

Gerard A. Chouest
(416) 982-3804
chouest@lexcanada.com

James P. Thomson
(416) 982-3805
jthomson@lexcanada.com

Janice E. Blackburn
(416) 982-3806
jblackburn@lexcanada.com

James R. Lane
(416) 982-3807
jlane@lexcanada.com

Carlos Martins
(416) 982-3808
cmartins@lexcanada.com

Tae Mee Park
(416) 982-3813
tpark@lexcanada.com

Andrew MacDonald
(416) 982-3830
amacdonald@lexcanada.com

Julia Lefebvre
(416) 982-3810
jlefebvre@lexcanada.com

Elliot Saccucci
(416) 982-3812
esaccucci@lexcanada.com

BERSENAS JACOBSEN CHOUEST THOMSON BLACKBURN LLP
BARRISTERS, SOLICITORS

33 Yonge Street Suite 201,
Toronto, Ontario, CANADA
Phone: 416 982-3800
Fax: 416 982-3801

Our firm specializes in Insurance, Professional Liability & Indemnity, Media & Defamation, Health & Administrative Law, Transportation and Dispute Resolution. These Litigation Notes focus on decisions, actions and events of interest to our clients.

We welcome your comments and suggestions.