Fraud Claims in Business Transaction Litigation

Igor Ellyn, QC, CS, FCIArb.
Chartered Arbitrator, Mediator, Legal Counsel
Certified Specialist in Civil Litigation

ELLYN LAW LLP

Business Litigation & Arbitration Lawyers
Avocats en litiges et arbitrages commerciaux

20 Queen Street West, Suite 3000 Toronto, Ontario M5H 3R3
T 416-365-3700 F 416-368-2982 **www.ellynlaw.com**

Overview

- In this presentation, we discuss the salient legal and procedural features of litigation involving business transactions where fraud is in issue. The presentation will be made under the following headings:

    - Elements of fraud and fraudulent misrepresentation
    - Differences between public and private corporations
    - Sources of fraud in private company transactions
    - Selection of forum and governing law
    - Examples of private company fraud litigation
    - Procedural considerations when pleading fraud
    - Interlocutory remedies
    - Permanent remedies
    - Reliance and expectation damages
    - Punitive damages
    - Enforcement

- This presentation is limited to sale transactions involving private corporations and not to all types of business transactions.

What is fraud?

- The test for civil fraud requires a false representation made knowingly or without belief in its truth, or recklessly, careless of whether it is true or false. The representation must have induced the victim to act to its detriment. Motive is immaterial:
  - *Derry v. Peek (1889) 14 A.C. 337 (H.L.) referred to in Gregory v. Jolley, 2001 CanLII 4324 (ONCA) para. 15;*
- Fraud may be committed through an agent:
  - *Combined Air Mechanical Services Inc. v. Flesch*, 2011 ONCA 764 para. 170
- If an accused is found criminally guilty of fraud, the civil test for fraud on the same facts will usually have been satisfied, unless there are special reasons to disregard the finding of guilt:
  - *Andreadis v. Pinto, 2009 CanLII 50220 (ON S.C.)*
- Fraud is not a mistake, error in interpreting a contract; fraud is "something dishonest and morally wrong, and much mischief is… done, as well as much unnecessary pain inflicted, by its use where 'illegality' and 'illegal' are the really appropriate expressions:"
  - *Washburn v. Wright (1914) 31 O.L.R. 138, (ONCA) p. 147 ref'd to in Corfax Benefit Systems Ltd. v. Fiducie Desjardins Inc. 1997 CanLII 12195 para. 29*

What is fraudulent misrepresentation?

- The essential elements of fraudulent misrepresentation are:
  - (1) that the defendant made a false representation of fact;
  - (2) that the defendant knew that the statement was false or was reckless as to its truth;
  - (3) that the defendant made the representation with the intention that it would be acted upon by the plaintiff;
  - (4) that the plaintiff relied upon the statement; and
  - (5) that the plaintiff suffered damage as a result:
  - *Parna v. G&S Properties Limited, [1971] S.C.R. 306 (S.C.C.) at paras. 22-26; Mariana v. Lemstra, (2004) D.L.R. (4th) 489 (Ont. C.A.) at para. 12 referred to in Liquid Rubber v. Bilbija, 2012 ONSC 4203 para. 25*

Prevalence of fraud in business transactions

- The *Canadian Securities Administrators' 2012 Enforcement Report*, p. 11, states that:
  - Of 145 proceedings filed by securities commissions across Canada in 2012, 34 cases (23%) involved fraud.
  - Of 135 matters concluded across Canada in 2012, 23% involved fraud.
  - Fines and administrative penalties awarded in 2012 in cases involving fraud were $17,459,625, higher than any other type of offence.
  - Restitution, compensation and disgorgement awarded in 2012 in cases involving fraud totalled $99,743,113, which is 83% of the $120,562,956 recovered for all offences combined.
- With less public scrutiny, it is a fair conjecture that fraud is even more prevalent in private company transactions.
- A 2008 Statistics Canada report, *Fraud Against Businesses in Canada: Results from a National Survey http://goo.gl/uces40* records the scope of business fraud in Canada. Its conclusions support the conjecture that fraud is rampant in business but the report also deals with circumstances other than purchase and sale transactions.

Differences between public and private corporations

- Private corporations are subject to much less public scrutiny than public corporations:
  - *Securities Act* is not applicable unless there is a public offering;
  - The Ontario Securities Commission has no role unless investments are offered to the public contrary to the *Securities Act*;
  - No audit if all shareholders consent: *OBCA, s. 148, CBCA s. 161;*
  - There is rarely an audit committee;
  - Interim financial reporting is not required;
  - Cash transactions and underreporting are more likely;
  - Bookkeeping and records may be incomplete or haphazard;
  - Financial statements are not publicly disclosed;
  - Share ownership is not publicly disclosed;
  - Corporate filings and minute book are usually not up-to-date;
  - Annual reports need not be filed with a stock exchange; and
  - Adverse events are more likely to escape public scrutiny.

Differences between public and private corporations #2

- However, there are regulatory factors applicable to private businesses which usually do not apply to public companies:
  - Transactions involving a regulated business or profession will usually involve private corporations.
  - For example, on sale of a construction company, the Tarion registration and record will be relevant. The same considerations apply to real estate brokers, insurance brokers, lawyers, accountants and health professionals, vocational schools and constructions trades.
  - A checkered professional history could be a sign of more serious problems. Details can be found online through regulatory body's website and canlii.org.
  - In some other jurisdictions, such as the United Kingdom, private companies must file the financial statements annually.

Selection of forum and governing law

- The sale agreement will provide for the method of resolution of all disputes which may arise. Arbitration clauses are common, especially if the parties are from different jurisdictions.
- The sale agreement will have a governing law clause unless both parties are local. The law of another jurisdiction may be applicable.
- Ontario courts will defer to arbitration clauses except in cases where the arbitration clause does not permit a statutory or inherent remedy the claimant is entitled to seek:
  - *Deluce Holdings Inc. v. Air Canada (1992) 12 OR(3d) 131.*
- The fundamental substantive rule of the autonomy of the parties prevails over the procedural rule of the single forum:
  - *GreCon Dimter inc. v. J. R. Normand inc., 2005 SCC 46*
- The agreement may also contain a limitation of liability clause. If arbitration is mandated by the agreement, some interlocutory remedies could be affected. In arbitration, the right to claim punitive damages may be limited or disappear.
- The agreement may also limit the right to make fraud claims.

Sources of Fraud in Business Transactions

- This is a non-exhaustive list of the types of frauds seen in business transactions involving private corporations:
  - Falsified financial statements
    - Overstatement of revenue
    - Understatement of expenses
    - Falsification of inventory
    - Fictitious revenues
  - Clandestine dealings and side businesses
  - Cash transactions
  - Kickbacks and hidden commissions
  - Falsified or misleading accounting records
  - Undisclosed competition and breaches of non-compete covenants
  - Undisclosed related party transactions
  - Failure to disclose criminal, regulatory or legal proceedings
  - Fraudulent acts by purchasers of the business
- *We thank Bruce Roher, CPA, CA•IFA, CBV, CFE, Partner responsible for Business Valuation and Forensic Accounting, at* ***Fuller Landau LLP****, Toronto for his assistance in identifying some of the sources of fraud.*

Example of Fraud #1 – Clandestine dealings

- A, B & S were partners in an international life insurance brokerage business. Mr. A purchased B & S shares under a complicated earnout transaction.
- A, B &S agreed to remain partners of a side business (WRI) in which a third person, R, owned 49%. WRI had a global reinsurance agreement with a life insurance company which paid a monthly commission for reinsurance of certain term life policies.
- A, B & S agreed that none of them would permit any diversion of WRI's reinsurance commissions, which were very small at first. The reinsurance commissions had just commenced.
- Shortly after closing, Mr. A clandestinely diverted commissions but managed to conceal his activities for several years. The amount of his fraud was not fully discovered until he had diverted over $700,000.
- In a derivative action, the parties agreed to refer the whole dispute to an arbitrator. The arbitrator disgorged all of the diverted funds and awarded $125,000 in punitive damages and substantial indemnity costs against A.

Example of Fraud #2 – Cash dealings

- In this 1993 case, S and L were partners for 30 years of a dry cleaning business which catered to an upscale clientele, many of whom were in Forest Hill, Rosedale and other tony neighbourhoods.
- S ran the cleaning business while L was a man about town. He ran the finances and cavorted with friends at racetracks and bars. Many of L's wealthy friends became good customers. L wanted to leave the business. S wanted to buy L's share. While they were negotiating the price, L and his wife were involved in a bitter divorce.
- One day, L's wife called S to say that for the last 20 years, L had been kiting cheques on the business bank account and was diverting over $1,000 per week in cash. Over 20 years, it amounted to over $1m.
- S didn't believe L's wife. L was his trusted partner for 30 years. S hired a forensic accountant to monitor L's activities for six weeks.
- Investigators found cash and uncashed cheques hidden under the cash register. Accounting records were irregular and suspicious.

Example of Fraud #2 continued – Cash dealings

- When some evidence of L's fraud was found, S commenced an action for breach of fiduciary duty and a motion without notice for an Anton Piller Order to get more details from L to support the claim.
- Execution of the Anton Piller Order was quite an event. A "posse" including Mr. S, his son, the forensic accountants, litigation counsel and two police officers descended on L's home on a Monday morning at 7 am. Mr. L was shocked by the "visit" and very indisposed – maybe even half asleep.
- Hundreds of incriminating records and documents were found in L's bedroom, basement and in a briefcase in the trunk of his car.
- Months after the claim was served, the parties settled. L was forced to transfer his share of the dry cleaning business and the building where it was located to S for $1 to remedy his fraud, He also paid costs. However, as a result of the settlement, no criminal charges were laid and no punitive damages were paid.
- As the business was a partnership not a corporation, S had to make a voluntary disclosure to CRA as his partnership income was than reported L had more serious issues to work out with CRA.

Example of Fraud #3 – Clandestine Dealings

- B Ltd. operated a film distribution business whose main asset was 1000 Chinese feature films. It intended to sell the films to a production house which would adapt them for sale in the North American and European market.
- B Ltd. agreed to sell the film library to A LP for $15m with payment over time and post-production profit sharing. Access to the films was restricted until payment was complete. To avoid dealings by either party pending payment, the films were stored in a secure film warehouse. A LP defaulted in payment and the project stalled.
- A LP's CEO developed a clandestine rapport with a film warehouse employee, who permitted access to several films which A LP copied and distributed long before A LP was entitled to them.
- When B Ltd. learned about this, proceedings were commenced. An Anton Piller Order was obtained to determine the scope of the illegal access and distribution of the films.
- An injunction to restrain further access and to return the films was obtained. However, despite these interlocutory remedies, the damage was done. The copied films could not be recovered.

Example of Fraud #4 – Undisclosed Dealings

- PG+2 and RC+3 were two groups of shareholders who owned two older apartment buildings which were under major renovation.
- Both groups were active in construction. There was a lot of self-dealing on subcontracts. The parties mistrusted each other and couldn't agree on anything. When RC refused to sign any cheques, PG forged RC's signature to pay business expenses, which increased the mistrust.
- RC+3 hired a senior corporate lawyer who recommended a strategy of selling the property to a corporation of their own and then selling it to a 3rd party. PG+2 had not attended most shareholder meetings, which resulted in a lack of quorum.
- The notice of the shareholders meeting to approve the sale was intentionally short on details to discourage PG+2 from attending. The meeting proceeded even though there was no quorum. No order was obtained from the court.
- However, the invalid shareholder resolution enabled RC+3 to transfer the property to themselves and then sell to a third party. The closing of the sale was prevented by the commencement of litigation.
- After a 25-day trial, the Court directed a sealed auction of the business assets. Because of the self-dealing and fraud, both parties were denied costs.
  - *Giannotti et al. v. Wellington Enterprises Ltd. et al. 1997 Carswell 561*

Example of Fraud #5 – False Records and Kickbacks

- A dispensary pharmacy in a medical building with just one doctor was sold to Mr. L. Mr. L's due diligence focussed on the percentage of prescriptions referred by the local doctor. If the percentage was too high, that could be risky and he was not interested. Pre-closing investigation disclosed that the local doctor referred less than 20% of the prescriptions which was the upper limit Mr. L could accept. He waived all conditions and closed the deal.
- After closing, L learned that the vendor recorded prescriptions from the local doctor under three separate codes but had not disclose this. Prescriptions from the local doctor were actually over 35% of total prescriptions. This was "too many eggs in the same basket". Mr. L would not have purchased had this fact not been concealed.
- Also, on first day of the next month, the local doctor demanded a $1,000 referral fee which she said had been paid for years. Vendor's manager admitted the kickback. It was paid in cash for years "out of the till" and was not reflected in the records. When Mr. L refused to pay it , the local doctor referred patients to another pharmacy.
- An action for rescission and damages is pending.

Example of Fraud #6 – Absconding Purchaser

- R sold a 60-bed retirement home business and building to M, who had no experience in retirement home management. The purchase price included $400,000 down and a $1m second mortgage to R (VTB) repayable over 3 years. Security over rents and assets was also provided.
- Based on the closing date revenues, payment of the VTB should have been easy for M to manage.
- The business was too difficult for M. He couldn't deal with the staff and residents and was disorganized. He rejected external management advice.
- When food, cleanliness and staffing standards fell, many resident moved out. The home's reputation suffered and revenues dropped. M defaulted on the VTB and allowed the business to deteriorate. He moved all money out of the business bank account and removed equipment and furniture from the retirement home, contrary to the security agreement with R.
- R commenced enforcement proceedings. The Court appointed him as interim receiver. M absconded from the business, could not be located for a some time and made himself judgment proof. After lengthy litigation, R permanently reacquired the retirement home. M lost his investment:
  - *1754765 Ontario Inc. v. 2069380 Ontario Inc., 2008 CanLII 67403 (ON SC).*

Procedural Considerations #1 – Pleading Fraud

- Special considerations apply to actions where fraud is alleged:
- *Rules of Civil Procedure*:
  - 25.06(1) Every pleading shall contain a concise statement of the material facts on which the party relies for the claim or defence, but not the evidence by which those facts are to be proved.
  - 25.06(8) Where fraud, misrepresentation or breach of trust is alleged, the pleading shall contain full particulars, but malice, intent or knowledge may be alleged as a fact without pleading the circumstances from which it is to be inferred.
- Pleadings must include specific particulars, including when and where a misrepresentation was made, the basis for the conclusion that the representation made was false, and the damages that occurred as a result of the fraud:
  - *Economical Insurance Co. v. Fairview Assessment Centre, 2013 ONSC 4037 paras. 5-9.*

Procedural Considerations #2 – Pleading Fraud

- It is insufficient for the plaintiff to say that the details are within the knowledge of the defendants and that they will be determined at discovery.
- If the plaintiff does not at the outset have knowledge of the facts that give rise to the conclusions of malice, breach of duty, conspiracy to intentionally injure, etc., then it is inappropriate to make these allegations in the statement of claim.
  - *Region Plaza Inc. v. Hamilton-Wentworth (1990) 12 OR(3d) 750 (HCJ) p. 757*
- The full particulars required by rule 25.06 (8) must set out precisely each allegation of wrongful conduct and the who, where, when, what, and how of that alleged misconduct.
  - *Balanyk v. Univ. of Toronto, [1999] O.J. No. 2162 (SCJ) para. 28.*
  - *EnerWorks Inc. v. Glenbarra Energy Solutions Inc., 2012 ONSC 414, paras. 36-40*

Procedural Considerations #3 – Pleading Fraud

- When pleading misrepresentation, the plaintiff must set out with careful particularity the elements of the misrepresentation relied upon, including:
  - the alleged misrepresentation itself;
  - when, where, how, by whom and to whom it was made;
  - its falsity;
  - the inducement;
  - the intention that the plaintiff should rely upon it;
  - the alteration by the plaintiff of his or her position in reliance on the misrepresentation;
  - the resulting loss or damage to the plaintiff; and
  - if deceit or fraud are alleged, there must also be an allegation that the defendant knew of the falsity of the statement.
  - *Lana Int'l Ltd. v. Menasco Aerospace Ltd., 1996 CanLII 7974 (ON SC)*

Procedural Considerations #4 – Pleading Fraud

- Directors and Officers' liability insurance polices typically do not cover fraud:
  - *S, Donley, N. Kent, Directors & Officers Liability in Canada: Review of Exposures & Coverages Available under D&O Policies p.17*
- This is may be a factor in determining how to frame claim.
- If the case involves allegations of both negligence and fraudulent misrepresentations, counsel should assess whether the fraud allegations are likely to be provable and if proved, whether they will be significant.
- If allegations of fraud are pleaded, the D&O insurer may deny coverage. A potential recovery could neutralized when the fraud claim may not be necessary to achieve a remedy for the plaintiff's losses.

Procedural Considerations #5 – Costs Sanction

- Clients are often sure they have been defrauded. On closer scrutiny, the fraud will be difficult to prove or is not substantial enough.
- Fraud should be pleaded only when there are clear, provable facts to support the claim. Counsel has a duty to inform clients about the serious consequences of pleading fraud and being unable to prove it.
- In *Bargman v. Rooney (1998) 30 CPC(4th) 259 (OntGD) paras. 18-19,* Blair J. stated:
  - It matters not … at what stage in the proceedings the unproved allegations are levelled. Because of their extraordinarily serious nature - going, as they do, directly to the heart of a person's very integrity - allegations of fraud and dishonesty are simply not to be made unless there is every reasonable likelihood that they can be proved. The cost sanction exists in these circumstances to help ensure that such will be the case.
  - The cost sanction should be imposed sharply and firmly by the Courts … at any stage in the proceedings when unsupported and unproven allegations of fraud and dishonesty are put forward.

Procedural Considerations #6 – Costs Sanction

- An unsuccessful attempt to prove fraud or dishonesty on a balance of probabilities does not lead inexorably to the conclusion that the unsuccessful party should be held liable for solicitor-and-client costs, since not all such attempts will be correctly considered to amount to "reprehensible, scandalous or outrageous conduct".
- However, allegations of fraud and dishonesty are serious and potentially very damaging to those accused of deception.
- When a party makes such allegations unsuccessfully at trial and with access to information sufficient to conclude that the other party was merely negligent and neither dishonest nor fraudulent, costs on a solicitor-and-client scale are appropriate:
  - *Hamilton v. Open Window Bakery Ltd., 2004 SCC 9 para 26.*

Procedural Considerations #7 – Costs Sanction

- The discretion to penalize for unproven fraud allegations is not applicable in the face of misconduct by the plaintiff before or during the litigation:
  - The trial judge was aware of the normal rule that a successful plaintiff who has failed to establish fraud should be deprived of its costs. [She] provided reasons for exercising her discretion in favour of the respondent. In this case there was "every reasonable likelihood" that the allegations of fraud would be made out. We have not been persuaded that she erred in so doing.
  - As it was, the trial judge found that the appellant made false allegations against Mr. Cohen, that his motive for the "Berg Put" was entirely improper, that he threatened to collapse the company's capital structure if his wishes were not carried out, that he completely lost sight of his obligations to the company, that he "failed utterly" in his duties to the company, that his conduct was "exactly opposite to the conduct that the law required of him as a fiduciary", and that he was "greedy and overreaching and failed miserably in his duties to Repap".
  - *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc., 2004 CanLII 9479 (ON CA), para. 13*

Other undesirable consequences of pleading fraud

- Counsel should verify with the client whether pleading fraud will have other undesirable consequences.
- This is important where the case involves the acquisition of a business in a regulated industry or if the client is a licenced professional, such as a lawyer, engineer, real estate broker, chartered life underwriter, insurance broker or accountant.
- Most professional regulatory organizations require licencees to file an annual report. Licencees are typically asked is whether the registrant "is involved in any proceeding where fraud is claimed or alleged".
- For example, if the case involves the acquisition of an insurance brokerage, your client will have to answer "Yes" to the above question even if the allegation of fraud is against the defendant.
- Counsel and client will have to balance the benefit of alleging fraud and the likelihood of its success against potential repercussions both inside and outside the litigation.

Interlocutory remedies #1 - Anton Piller Order

- The Ontario Superior Court has inherent jurisdiction to issue a private search warrant known as an Anton Piller order. An Anton Piller order is not given to a public authority for execution, but authorizes a private party to insist on entrance to the premises of its opponent to seize and preserve evidence to further its private dispute.
- There are four essential conditions. Plaintiff must show: 1) a strong *prima facie case*; 2) damage to the plaintiff of the defendant's alleged misconduct, potential or actual, must be very serious; 3) convincing evidence that defendant possesses incriminating documents or things; and 4) a real prospect that the defendant may destroy the material before discovery.
- Protection of the defendant requires: 1) a carefully drawn order identifying the material to be seized and sets out safeguards for privileged documents; 2) an independent court-appointed supervising solicitor; and 3) a sense of responsible self-restraint by those executing the order with a focus to preserve relevant evidence not to rush to exploit it.
  - *Celanese Canada Inc. v. Murray Demolition Corp. 2006 SCC 36*
  - *Promo-Ad v. Keller, 2013 ONSC 1633 paras. 48-50*

Interlocutory remedies #2 – Mareva Injunction

- A Mareva injunction is an extreme remedy granted in exceptional circumstances to freeze a defendant's assets before judgment.
- The Plaintiff must do each of the following:
  - 1) make full and frank disclosure of all material matters;
  - 2) give full particulars of the claim against the defendant and highlight potential defences;
  - 3) show that the defendant has assets in the jurisdiction;
  - 4) show that there is a real risk of the assets being removed out of the jurisdiction, or disposed of before trial and that the plaintiff will be unable to satisfy a potential judgment; and
  - 5) give an undertaking as to damages.
  - *Sibley & Associates LP v. Ross, 2011 ONSC 2951 referring to Chitel v. Rothbart (1982), 39 O.R. (2d) 513 (ONCA) and Aetna Financial Services Ltd. v. Feigelman, 1985 CanLII 55 (SCC)*

Interlocutory remedies #2 cont. – Mareva Injunction

- The court may order a freeze a defendant's exigible assets where there is a genuine risk those assets will disappear before trial.
- As a Mareva injunction is in essence an interlocutory injunction, the plaintiff must also satisfy the criteria for interlocutory injunctions:
  - *RJR-MacDonald Inc. v. Canada 1994 CanLII 117 (SCC)*
- As far as possible, the Mareva injunction should be asset-specific.
- An arbitrator has jurisdiction to grant an interlocutory injunction but it cannot be enforced without application to the Court under the *Arbitration Act, 1991, s. 50.*
- An arbitrator does not have jurisdiction to issue a Mareva injunction because the Tribunal lacks jurisdiction to bind non-parties to the arbitration:
  - *Farah v. Sauvageau Holdings Inc., 2011 ONSC 1819 paras. 60-73*

Interlocutory remedies #2 - No fraud exception

- It is now well-settled in Ontario law that when applying for a Mareva injunction, there is no fraud exception:
  - Proof of a serious risk of removal or disposition of assets is required even where the action is based on fraud and it is shown that the defendant has committed a fraudulent act.
  - *Hon. Justice Robert J. Sharpe, Injunctions and Specific Performance para. 2.880, ref'd to in Sibley & Associates LP v. Ross, 2011 ONSC 2951 para. 27;*
  - *Promo-Ad v. Keller, 2013 ONSC 1633 para. 52.*
- The same stringent requirements apply to a motion for a Mareva injunction even where fraud is shown, but:
  - Rather than carve out an "exception" for fraud, the risk of removal or dissipation can be established by inference, as opposed to direct evidence, and that inference can arise from the circumstances of the fraud itself, in the context of all the surrounding circumstances:
  - *Sibley, supra., para. 63-64*

Interlocutory remedies # 3 - Specific fund

- On a sale transaction, there may be a need to ensure that a specific fund is not dissipated, sold or otherwise made to disappear.
- Where the claim is for a specific fund, the claim can be under R. 45.02 rather than for an interlocutory injunction:
  - *Where the right of a party to a specific fund is in question, the court may order the fund to be paid into court or otherwise secured on such terms as are just.*
- An order under R. 45.02 is a fund-specific Mareva injunction. The test is akin to that for an interlocutory injunction and the circumstances must be clear:
  - 1) Serious issue to be tried as to plaintiff's entitlement to the specific fund;
  - 2) balance of convenience favours the plaintiff. An undertaking as to damages should also be given.
  - *Conn v. Twenty Two Degree Energy Corp. 2010 ONSC 4598 para. 7*
- Surprisingly, a motion under R.45.02 may be heard by a Master:
  - *American Axle Mfg. v. Durable Release Coaters 2007 CanLII 20094 (ON SC) paras. 24-33.*

Interlocutory remedies # 4 –Injunction

- There are three elements to the test for granting an interlocutory injunction under the *Courts of Justice Act, s. 101*:
  - 1) a preliminary assessment must be made of the merits of the case to ensure that there is a serious question to be tried;
  - 2) it must be determined whether the applicant would suffer irreparable harm if the application were refused; and
  - 3) an assessment must be made as to which of the parties would suffer greater harm from the granting or refusal of the remedy pending a decision on the merits. In other words, the balance of convenience must favour the plaintiff;
    - *RJR-MacDonald Inc. v. Canada (Att-Gen) 1994 CanLII 117*
    - *Just Speakers Inc. v. Benia 2002 CarswellOnt 1713 paras. 15-17*
- In Ontario, the plaintiff must also provide an undertaking as to damages: *Rule 40.03*.

Interlocutory remedies # 5 – Norwich Order

- A Norwich order compels a third party to provide the applicant with information where the applicant believes it has been wronged and needs the third party's assistance to determine the circumstances of the wrongdoing and allow the applicant to pursue its legal remedies. The order can also be described as a tracing order.
  - *Isofoton S.A. v. Toronto Dom. Bank 2007 CanLII 14626 (ON SC) para. 40.*
- The test for such an order is:
  - Evidence of a valid or *bona fide* claim.
  - Third Party Involvement, such as a bank that is "innocently involved" as a conduit for the wrongful receipt and possible transfer of funds.
  - The Third Party is the only practical or reliable source of required information.
  - Indemnity for the costs of the Third Party.
  - The order must be in the interest of justice. For example, the alleged wrongdoers should not be entitled to the confidentiality normally imposed on bank records.
  - *Enbridge Gas Distribution Inc. v. Toronto Dominion Bank 2008 CanLII 13363 (ON SC), para. 7*

Which remedies should the plaintiff pursue?

- Your client purchased a business. The deal closed last month. Your client discovers that financial records were falsified and that a major client was receiving a hidden kickback. Had your client known these matters, he probably would not have purchased the business or the price would have been much lower.
- The typical remedy for breach of contract is damages. Other remedies should also be considered, such as rescission, disgorgement, rectification. Apart from the legal principles, a pragmatic and factual inquiry is required:
  - Does the purchaser still want the business?
  - How serious are the fraud and the fraudulent misrepresentations?
  - Was there detrimental reliance on the representation?
  - Could better due diligence have detected the fraud before closing?
  - Are there other benefits for your client to staying in the business?
  - What will happen in the business until trial which could be 3 years away?
  - Can records and funds be preserved until trial?
  - Can the purchase money be secured?
  - Is the defendant fraudulently relying on an error in the agreement?

Rescission

- Rescission in most cases of misrepresentation will require it to be possible to substantially restore the party seeking rescission to his or her pre-contractual position. Where fraud is alleged, courts may exercise discretion to impose rescission of the agreement even where it is not possible to achieve the pre-contractual position completely:
  - *Nesbitt v. Redican 1923 CanLII 10 (SCC)*
- As rescission is an equitable remedy, delay or affirmation can bar its application:
  - *Shortt v. MacLennan, [1959] SCR 3, p. 6*
- The misrepresentation must be "substantial", "material", or "go to the root of the contract" for the remedy of rescission to be available:
  - *Guarantee Co. of North America v. Gordon Capital, 1999 CanLII 664 (SCC)*
- There may be a clause of the sale agreement which restricts a claim for rescission or other equitable remedies. If the agreement mandates arbitration, counsel must consider whether the arbitrator has jurisdiction to grant equitable relief.

Rectification

- Rectification is an equitable remedy whose purpose is to prevent a written document from being used as an engine of fraud or misconduct "equivalent to fraud". Rectification is now available for unilateral mistake where:
  - 1) There is a prior oral contract whose terms are definite and ascertainable.
  - 2) The plaintiff establishes that the terms agreed to orally were not written down properly.
  - 3) The error may be fraudulent, or it may be innocent. What is essential is that at the time of execution of the written document the defendant knew or ought to have known of the error and the plaintiff did not.
  - 4) The attempt of the defendant to rely on the erroneous written document must amount to "fraud or the equivalent of fraud".
- The court's task in a rectification case is corrective, not speculative. It is to restore the parties to their original bargain, not to rectify a belatedly recognized error of judgment by one party or the other.
  - *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd., 2002 SCC 19 para. 31*

Intentional interference with economic interests

- Where fraud is proved by a purchaser in a business transaction, the purchaser may have lost more than the purchase price. The purchase may claim a loss for the vendor's interference with the purchaser's economic interests.
- On such a claim, the plaintiff must prove three elements:
  - (i) that there was an intent to injure the plaintiff;
  - (ii) that the defendant interfered with the plaintiff's business by illegal or unlawful means; and
  - (iii) that as a result of the interference, the plaintiff suffered economic loss .
  - *Reach M.D. Inc. v. Pharmaceutical Manufacturers Association of Canada 2003 CanLII 27828 (ON CA) para. 44.*
- This tort is frequently pleaded but is rarely a basis for recovery.

Disgorgement

- Disgorgement involves an award to the plaintiff of the benefits secured by the defendant through wrongful conduct.
  - *Serhan Estate v. Johnson & Johnson, 2006 CanLII 20322 (ON SCDC) at para. 109*
- An appellate court will be vigilant to ensure that the trial judge does not give the plaintiff double recovery.
- Where compensatory damages were awarded for the defendant's fraud, it is not appropriate to also award punitive damages to ensure that the profit was disgorged unless the court finds the defendants conduct so egregious that punishment is warranted:
  - *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd., 2002 SCC 19 paras. 83-84*

Expectation and Reliance Damages

- The ordinary measure of damages in tort is reliance damages. The court tries to put the injured party in the position it would have been in had the tort not been committed.
- The ordinary measure of damages for breach of contract is expectation damages. The court tries to put the injured party in the position it would have been in had the contract been performed.
- In some breach of contract cases, an injured person cannot prove expectation damages or loss of profits, or the contract has been unprofitable. In those cases, an injured party may elect to claim reliance damages.
- In awarding reliance damages, the court recognizes that the injured party has changed its position in reliance on the contract. The court tries to put the injured party in the position it would have been in had it not entered into the contract at all.
- Thus, reliance damages amount to wasted expenditures – expenses that the injured party incurred in reliance on the contract but would not have incurred had it known that the contract would be or had been breached.
- The damages award should not, however, put the injured party in a better position than it was in before the contract was made:
  - *PreMD Inc. v. Ogilvy Renault LLP, 2013 ONCA 412 paras. 65-66, 70 (per* Laskin JA)

Punitive Damages

- Punitive damages are awarded against a defendant in exceptional cases for "malicious, oppressive and high-handed" misconduct that "offends the court's sense of decency". The test thus limits the award to misconduct that represents a marked departure from ordinary standards of decent behaviour.
- Torts such as deceit or fraud already incorporate a type of misconduct that to some extent "offends the court's sense of decency" and which "represents a marked departure from ordinary standards of decent behaviour", yet not all fraud cases lead to an award of punitive damages.
- Fraud is generally reprehensible, but only in exceptional cases does it attract punitive damages. Punitive damages are not damages "at large". Both the award and the assessment of quantum must meet the test of rationality. was the misconduct of the defendant so outrageous that punitive damages were rationally required to act as deterrence?
  - *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd., 2002 SCC 19 paras. 79-81, 84. 87, 92*

Enforcement

- The *Bankruptcy and Insolvency Act RSC 1985, c B-3, s. 178(1)(d)-(e)* provides that discharge from bankruptcy does not release any debt or liability:
  - *(d) arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity or, in the Province of Quebec, as a trustee or administrator of the property of others;*
  - *(e) resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim;*
- Simply stated, this means that a defendant against whom a judgment for damages arising fraud or fraudulent misrepresentations is recovered carries the debt, including any costs awarded, with him/her until payment so long as the writ of execution remains valid.
  - *Kovachis v. Dunn, 2011 ONSC 4174 para. 16*
- If costs of the proceedings were awarded on the substantial indemnity scale, enforcement costs will also be awarded on the same scale.

Table of Cases, Rules, Statutes and References #1

- *1754765 Ontario Inc. v. 2069380 Ontario Inc., 2008 CanLII 67403 (ON SC)*
- *Aetna Financial Services Ltd. v. Feigelman, 1985 CanLII 55 (SCC)*
- *American Axle Mfg. v. Durable Release Coaters 2007 CanLII 20094 (ON SC)*
- *Andreadis v. Pinto, 2009 CanLII 50220 (ON S.C.)*
- *Balanyk v. University of Toronto, [1999] O.J. No. 2162 (SCJ).*
- *Bargman v. Rooney (1998) 30 CPC(4th) 259 (OntGD)*
- *Celanese Canada Inc. v. Murray Demolition Corp. 2006 SCC 36*
- *Chitel v. Rothbart (1982), 39 O.R. (2d) 513 (ONCA)*
- *Combined Air Mechanical Services Inc. v. Flesch, 2011 ONCA 764*
- *Conn v. Twenty Two Degree Energy Corp. 2010 ONSC 4598*
- *Corfax Benefit Systems Ltd. v. Fiducie Desjardins Inc. 1997 CanLII 12195*
- *Deluce Holdings Inc. v. Air Canada (1992) 12 OR(3d) 131.*
- *Derry v. Peek (1889) 14 A.C. 337 (H.L.)*
- *Economical Ins. Co. v. Fairview Assessment Centre, 2013 ONSC 4037*
- *Enbridge Gas Dist. Inc. v. Toronto Dom. Bank, 2008 CanLII 13363 (ON SC)*
- *EnerWorks Inc. v. Glenbarra Energy Solutions Inc., 2012 ONSC 414*
- *Farah v. Sauvageau Holdings Inc., 2011 ONSC 1819*
- *Giannotti et al. v. Wellington Enterprises Ltd. et al. 1997 Carswell 561*

Table of Cases, Rules, Statutes and References #2

- *GreCon Dimter inc. v. J. R. Normand inc., 2005 SCC 46*
- *Gregory v. Jolley, 2001 CanLII 4324 (ONCA)*
- *Guarantee Co. of North America v. Gordon Capital, 1999 CanLII 664 (SCC)*
- *Hamilton v. Open Window Bakery Ltd., 2004 SCC 9*
- *Isofoton S.A. v. Toronto Dominion Bank 2007 CanLII 14626 (ON SC)*
- *Just Speakers Inc. v. Benia 2002 CarswellOnt 1713*
- *Kovachis v. Dunn, 2011 ONSC 4174*
- *Lana International Ltd. v. Menasco Aerospace Ltd., 1996 CanLII 7974 (ON SC)*
- *Liquid Rubber v. Bilbija, 2012 ONSC 4203*
- *Mariana v. Lemstra, (2004) D.L.R. (4th) 489 (ONCA)*
- *Nesbitt v. Redican 1923 CanLII 10 (SCC)*
- *Parna v. G&S Properties Limited, [1971] S.C.R. 306 (S.C.C.)*
- *Performance Industries Ltd. v. Sylvan Lake Golf & Tennis Club Ltd., 2002 SCC 19*
- *PreMD Inc. v. Ogilvy Renault LLP, 2013 ONCA 412*
- *Promo-Ad v. Keller, 2013 ONSC 1633 .*
- *Reach M.D. Inc. v. Pharmaceutical Manufacturers Assoc. 2003 CanLII 27828 (ON CA)*
- *Region Plaza Inc. v. Hamilton-Wentworth (1990) 12 OR(3d) 750 (HCJ)*

Table of Cases, Rules, Statutes and References #3

- *RJR-MacDonald Inc. v. Canada (Att-Gen) 1994 CanLII 117*
- *Serhan Estate v. Johnson & Johnson, 2006 CanLII 20322 (ON SCDC)*
- *Shortt v. MacLennan, [1959] SCR 3*
- *Sibley & Associates LP v. Ross, 2011 ONSC 2951*
- *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi 2004 CanLII 9479 (ON CA)*
- *Washburn v. Wright (1914) 31 O.L.R. 138, (ONCA)*

- *Ontario Rules of Civil Procedure, Rr. 25.01(6), 25.01(8), 40;.03, 45.02 , 60.07(2)*
- *Arbitration Act, 1991, SO 1991, c 17, s. 50.*
- *Bankruptcy and Insolvency Act RSC 1985, c B-3, s. 178(1)(d)-(e)*
- *Business Corporations Act, RSO 1990, c B.16, s. 148*
- *Canada Business Corporations Act, RSC 1985, c C-44*
- *Courts of Justice Act, RSO 1990, c C.43 s. 101*
- *Securities Act, RSO 1990, c S.5*

Table of Cases, Rules, Statutes and References #4

- *Canadian Securities Administrators' 2012 Enforcement Report http://goo.gl/VEnkxS,*
- *S, Donley, N. Kent, Directors & Officers Liability in Canada: Review of Exposures & Coverages Available under D&O Policies http://goo.gl/sEN4z p.17*
- *Hon. Justice R. J. Sharpe, Injunctions & Specific Performance para. 2.880, Carswell http://goo.gl/iaG13q*
- *A. Taylor-Butts, S. Perreault, Fraud Against Businesses in Canada: http://goo.gl/uces40*

Conclusion

- As we have seen, fraud claims arise frequently in business transaction litigation. The cases usually involve complicated fact situations requiring meticulous proof .
- A large body of law and procedure has developed to deal with these situations. Fraud claims arising from business transactions will become more frequent and will continue to occupy a large amount of the attention of counsel, judges, arbitrators and forensic accountants.
- An appreciation of the procedures and remedies described in this presentation will assist in achieving favourable results.
- Of course, there other important topics to consider, including marshalling financial expert evidence, which arises in nearly all litigation arising from business fraud. For an analysis of the use of financial experts in business litigation, topic, please see *I. Ellyn and E. Perez, Using Financial Expert Witnesses in Business Litigation - http://goo.gl/Bbtbg.*

Thank you for your attention.

Igor Ellyn