Ontario

Ontario Securities Commission | Commission des valeurs mobilières de l'Ontario | P.O. Box 55, 19th Floor, 20 Queen Street West, Toronto ON M5H 3S8 | CP 55, 19e étage, 20, rue queen ouest, Toronto ON M5H 3S8

IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S.5, AS AMENDED

- AND -

IN THE MATTER OF
FACTORCORP INC., FACTORCORP FINANCIAL INC., AND
MARK TWERDUN

REASONS FOR DECISION
(Section 127 of the Act)

Hearing:	October 3, 5, 6, 7, 12, 13, 14 and 17, 2011 November 24, 2011	
Decision:	February 22, 2013	
Panel:	Christopher Portner	- Commissioner and Chair of the Panel
Appearances:	Cullen Price	- For Staff of the Commission
	James Grout	- For FactorCorp Inc. and FactorCorp Financial Inc.
	Mark Twerdun	- Represented himself

TABLE OF CONTENTS

REASONS FOR DECISION

I. BACKGROUND

A. Overview

[1] This was a hearing before the Ontario Securities Commission (the "**Commission**") pursuant to section 127 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the "**Act**") to consider whether FactorCorp Inc. ("**FCI**"), FactorCorp Financial Inc. ("**FFI**") and Mark Twerdun ("**Twerdun**" and, together with FCI and FFI, the "**Respondents**") breached the Act and acted contrary to the public interest. In these Reasons, "**FactorCorp**" means FCI or FFI as the context requires and FCI and FFI together will be referred to as the "**Companies**".

[2] The proceeding arose from a Notice of Hearing issued by the Commission on May 12, 2009 and a Statement of Allegations filed by Staff of the Commission ("**Staff**") on May 12, 2009, as amended on October 13, 2011. Staff alleges that, during the period from 2004 to 2007 (the "**Material Time**"), the Companies sold non-prospectus qualified debentures issued by FFI (the "**Debentures**") to approximately 700 Ontario investors for proceeds of approximately $58.0 million.

[3] Staff further alleges that FactorCorp's offering memoranda (collectively, the "**OMs**"), which Staff also alleges that FactorCorp failed to file with the Commission in accordance with OSC Rule 45-501 – Exempt Distributions[1] ("**Rule 45-501**"), and various documents used by the Companies to promote the Debentures, including a document entitled "FactSheet", a brochure, a Question and Answer Sheet, a document entitled "Investor Information" and quarterly reports issued by FactorCorp (collectively, the "**Promotional Materials**"), include statements that were materially misleading or untrue, contrary to subsections 122(1)(b) and 126.2(1) of the Act. For example, in the OMs and Promotional Materials provided to investors, the Companies were represented as being in the business of providing short-term financing to commercial clients through factoring and other secured asset-backed loans. It was also represented that the Companies would implement risk management practices to ensure acceptable risk levels in the use of investors' funds. According to Staff, however, these statements were materially misleading or untrue. Many of the loans made by FactorCorp were not short-term as represented. In addition, the loans were either not secured or were inadequately secured or had unenforceable security and the risk management practices implemented to ensure acceptable risk levels in the use of investors' funds were inadequate.

[4] Staff alleges that the materially misleading or untrue statements in the OMs and the Promotional Materials were the result of Twerdun's negligent and reckless disregard for ensuring that the representations made to investors were fulfilled. Staff submits that Twerdun was not duly diligent and thus cannot avail himself of the due diligence defence.

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[1] Following September 14, 2005, the requirement to file an offering memorandum, if one is used in connection with a distribution of securities in reliance on the accredited investor exemption, is set out in OSC Rule 45-501 – Ontario Prospectus and Registration Exemptions.

[5] Further, Staff alleges that the Companies improperly relied on the accredited investor exemption in the sale of the Debentures.

[6] Staff also alleges that FFI and Twerdun redeemed certain FFI securities in breach of an order issued by the Commission, contrary to subsection 122(1)(c) of the Act, and that Twerdun made materially misleading or untrue statements in evidence in a proceeding before the Commission, contrary to subsection 122(1)(a) of the Act.

[7] Staff alleges that Twerdun, as the sole director and officer of the Companies, was responsible for the breaches by the Companies of Ontario securities law pursuant to subsection 122(3) and section 129.2 of the Act.

[8] Finally, Staff alleges that the conduct of the Respondents compromised the integrity of Ontario's capital markets, was abusive and was contrary to the public interest.

B. History of Proceedings

1. Temporary Order

[9] On July 6, 2007, the Commission issued a temporary cease trade order against all of the Respondents (the "**Temporary Order**"). The Temporary Order was varied on July 27, 2007 and was further varied on October 26, 2007 to apply to Twerdun alone.

[10] The Temporary Order, as varied on October 26, 2007, was extended from time to time and, on May 12, 2009, the Commission ordered that the Temporary Order as varied on October 26, 2007 "be continued until the Proceeding is concluded and a decision of the Commission is rendered or until the Commission considers it appropriate".

2. Monitor, Receivership and Bankruptcy of the Companies

[11] The Temporary Order issued on July 6, 2007 and varied on July 27, 2007 required that, pursuant to subsection 127(1)1 of the Act, FactorCorp retain a monitor to review and oversee FactorCorp's business, operations and affairs as a term or condition of Twerdun and FactorCorp's registration. On August 1, 2007, KPMG Inc. ("**KPMG**") was appointed the monitor of the Companies (the "**Monitor**").

[12] By order of the Superior Court of Justice dated October 17, 2007, KPMG was appointed receiver and manager of the assets, undertakings and properties of the Companies (the "**Receiver**").

[13] By further order of the Superior Court of Justice dated March 25, 2008, the Companies were adjudged bankrupt on a consolidated basis and KPMG was appointed the trustee of the consolidated estate (the "**Trustee**").

3. Hearing on the Merits

[14] The hearing on the merits in this matter commenced on October 3, 2011. Twerdun did not appear on that day, however, Peter Carey ("**Carey**"), former counsel for Twerdun who had not been retained to act for Twerdun in connection with the hearing on the merits, appeared as a courtesy to the Commission and requested an adjournment on

behalf of Twerdun. I adjourned the hearing on the merits to October 5, 2011, and on October 5, 2011, I further adjourned the hearing to October 6, 2011.

[15] Evidence on the merits in this matter was heard on October 6, 7, 12, 13, 14 and 17, 2011. Twerdun was present on all of those days. James Grout ("**Grout**"), counsel for KPMG, appeared on October 3, 5, 6 and 7, 2011. On the morning of October 6, 2011, Grout advised the Commission that KPMG was not defending the allegations against the Companies and, accordingly, he would not be attending the remainder of the hearing except when Bradley Butcher ("**Butcher**"), a vice-president of KPMG, gave evidence on October 7, 2011. I proceeded in the absence of any representatives of the Companies on the remaining days of the hearing in accordance with subsection 7(1) of the *Statutory Powers Procedure Act*, R.S.O. 1990, c. S.22, as amended (the "**SPPA**").

[16] On November 24, 2011, Staff appeared and made closing submissions, supported by written submissions dated November 4, 2011. Twerdun filed written submissions dated November 21, 2011 and made closing submissions by telephone conference on November 24, 2011 pursuant to Rule 10.2 of the Ontario Securities Commission *Rules of Procedure* (2010), 33 O.S.C.B. 8017 (the "***Rules of Procedure***"). During the closing submissions, I asked Staff to provide further written submissions on the amounts raised by FFI pursuant to the various versions of the OMs that had been placed into evidence.

[17] Staff filed such submissions on January 12, 2012, consisting of a summary of "the total amounts raised by FactorCorp Financial Inc. through the various dealers: FactorCorp Inc., Farm Mutual Financial Services ("FMFS"), and Interglobe (Blonde & Little)" and three sub-summaries of the "amounts raised through each dealer…broken down by period in which the various versions (1 through 4) of the OM were in use" (collectively, "**Staff's Summaries**"). On January 13, 2012, I invited Twerdun to respond to Staff's submissions by February 6, 2012, however, he did not do so.

C. The Respondents

[18] FFI was incorporated in Ontario on May 26, 2003. There was no record that FFI had been registered under the Act or that it had been a reporting issuer in Ontario.

[19] FCI was incorporated in Ontario on August 13, 2002. FCI had been registered under the Act as a limited market dealer during the Material Time. There was no record that FCI had been a reporting issuer in Ontario.

[20] Twerdun was the sole officer, director and shareholder of FCI and the sole officer, director and controlling shareholder of FFI. Twerdun's wife and children owned, beneficially or otherwise, the remaining shares of FFI. Twerdun had been registered under the Act in various categories since May 1991, including as a salesperson from May 1991 to January 2002, as a trading officer[2] and director of another entity from October 2002 to January 2004 and as a trading officer and director of FCI during the Material Time.

[2] Defined in the section 139 certificate as the "president, secretary and compliance officer".

II. PRELIMINARY ISSUES

A. Twerdun's Adjournment Request

[21] At the commencement of the hearing on October 3, 2011, Twerdun, through his former counsel Carey, requested an adjournment of the hearing on the merits to October 10, 2011. Carey informed the Commission that Twerdun made an inadvertent mistake about the hearing dates and was out of the country for business reasons. According to Carey, Twerdun represented to him in a telephone conversation that he would be able to return to Toronto in the following week, and at the earliest, on October 5, 2011, although there was no guarantee that he would be able to return by the earlier date.

[22] Carey submitted that while it was Twerdun's "fault" that he was not able to attend and Twerdun had notice of the hearing dates six months prior to the hearing on the merits, it would be unfair to Twerdun, and it would not be in the public interest, if Twerdun was not given an opportunity to respond to the allegations against him (Hearing Transcript dated October 3, 2011 at p. 7). According to Carey, "there is nothing more inherently unfair than a hearing with one party who's being charged and not present" (Hearing Transcript dated October 3, 2011 at p. 16).

[23] Carey further submitted that Staff had previously been granted one adjournment. He observed that three weeks had been set aside for the hearing on the merits and submitted that, if Twerdun was not represented by counsel, the hearing would proceed quickly. It was his submission that, as such, the adjournment would not cause any delay to the proceeding or prejudice to Staff or the Commission.

[24] Carey took the position that, although the Commission has the authority to proceed in the absence of a respondent pursuant to section 7 of the SPPA, the issue was whether or not it ought to proceed. Carey submitted that the present case was unlike *Re Sunwide Finance Inc.* (2009), 32 O.S.C.B. 4671 ("***Sunwide***"), to which Staff referred, where neither respondents nor counsel appeared and no reason for their absence was provided.

[25] KPMG took no position with respect to Twerdun's adjournment request.

[26] Staff opposed Twerdun's adjournment request and referred to Rule 9.2 of the *Rules of Procedure* for the factors to be considered in determining whether to grant an adjournment. In particular, Staff submitted that an adjournment would not be in the public interest and was not necessary for a fair hearing. Twerdun was in fact requesting an adjournment of seven days. He was given notice of the proceeding as evidenced by Carey's attendance. Notice of the hearing was given when Staff requested an adjournment of the hearing on May 5, 2011 and hearing dates were set on consent of the parties on that day which was six months prior to the hearing on the merits. Staff submitted that, in light of the foregoing, there should not be any confusion about the hearing dates.

[27] Staff further submitted that as notice was provided in accordance with section 6 of the SPPA, the Commission was entitled to proceed in Twerdun's absence pursuant to section 7 of the SPPA and Twerdun was not entitled to further notice. In Staff's view, this

was also supported by the Commission's decision in *Sunwide*. Staff submitted that, if the Commission accepts the argument that it cannot proceed until a respondent attended because there cannot be a fair hearing in the absence of the respondent, the non-attendance of the respondent would delay the hearing indefinitely, which, according to Staff, cannot be the case.

[28] Staff submitted that there was no evidence of any reasonable efforts made to avoid the need for an adjournment. Twerdun simply decided not to attend for his own reasons. Further, the reasons provided to support the adjournment request were that Twerdun was confused about the hearing dates and left on a business trip. In Staff's view, these reasons were wholly without merit, particularly in an important matter such as the hearing on the merits. Staff pointed out that there was no information about where Twerdun went on business. Staff further submitted that Twerdun was represented by counsel and would have been advised about the hearing dates and the advisability of attending. If Twerdun wished to attend, he could have done so and should have attended the hearing on the merits on October 3, 2011. In response to Carey's argument about unfairness, Staff's submission was that "he who seeks justice should be present to request justice" (Hearing Transcript dated October 3, 2011 at p. 11). Accordingly, Staff submitted that there was no unfairness occasioned by proceeding in his absence.

[29] Staff submitted that an adjournment would cause Staff to incur additional costs, and the time set aside for the hearing would be lost. While Staff acknowledged that its case would require no more than five or six days of evidence, it was dependent on the length and extent of cross-examination of Staff witnesses. Further, it was unclear what amount of time Twerdun would require as he had provided no information in that regard. Carey's submission that there would be no delay lacked factual foundation.

[30] I made an oral ruling adjourning the hearing on the merits to October 5, 2011. In coming to this decision, I took into consideration the factors set out in Rule 9.2 of the *Rules of Procedure*, set out below:

> **9.2 Factors Considered –** In deciding whether to grant an adjournment, the Panel shall consider all relevant factors, including, but not restricted to, the following:
>
> (a) whether an adjournment would be in the public interest;
>
> (b) whether all parties consent to the request;
>
> (c) whether granting or denying the adjournment would prejudice any party;
>
> (d) the amount of notice of the hearing date that the requesting party received;
>
> (e) the number of any previous adjournment requests made and by whom;
>
> (f) the reasons provided to support the adjournment request;
>
> (g) the cost to the Commission and to the other parties for rescheduling the hearing;

(h) evidence that the party made reasonable efforts to avoid the need for the adjournment; and

(i) whether the adjournment is necessary to provide an opportunity for a fair hearing.

[31] Twerdun had notice of the hearing on the merits, which was to commence on October 3, 2011, since May 2011. Staff opposed the adjournment request and, in addition, I found Twerdun's explanation for his absence inadequate. While all of these factors supported Staff's position that an adjournment should not be granted, Staff indicated that it only required five or six days for its case. As a result, I concluded that it would be a reasonable accommodation to provide Twerdun with one final opportunity to appear without undue delay and without the other parties incurring substantial costs or suffering prejudice. I was not, however, prepared to grant an adjournment of one week as requested by Twerdun. In my view, an adjournment of two days would afford Twerdun sufficient time to return to Toronto if he elected to attend the hearing on the merits.

[32] When the hearing on the merits reconvened on October 5, 2011, I was advised by Carey that Twerdun was in Africa. Carey further advised that Twerdun had booked the first available flight to return to Toronto from Africa and was scheduled to arrive in Toronto at 3:00 p.m. on that day. Following discussions between Staff and Carey, I adjourned the hearing on the merits to the next day, October 6, 2011, on consent of the parties.

B. Amendments to the Statement of Allegations

[33] On October 6, 2011, following the parties' opening statements, Staff indicated that it intended to amend the Statement of Allegations. At that time, Staff informed me that some of the proposed amendments were merely to correct typographical errors while others were more substantive in nature, although in Staff's view the amendments would not change the nature of the allegations. Staff also advised that the proposed amendments had been provided to Carey, however, Staff did not receive any response from Carey or Twerdun and it was unclear to Staff whether Twerdun had been apprised of them. Staff indicated that it would provide the proposed amendments to Twerdun and discuss the proposed amendments with him.

[34] I expressed the concern that, should the amendments result in the expansion of the scope of the allegations, I would have to consider whether additional disclosure or time would be required to provide the Respondents with an opportunity to respond.

[35] On October 7, 2011, Staff presented its initial proposed amendments to the Statement of Allegations and made submissions in support of the proposed changes. The proposed amendments and Staff's submissions were as follows:

(a) Staff proposed to amend paragraph 5 by replacing the word "misrepresentations" with the clause "materially misleading or untrue statements" to reflect the language of section 122 of the Act. Staff submitted that there was no greater preparation required or prejudice suffered as a result of that proposed change.

(b) Staff proposed to amend paragraph 5 by adding to the text "the loans made by the Respondents to clients were" the clause "not for short terms, and were…". Staff also proposed to amend paragraph 17 and subparagraph 21(a) by adding the description that the secured lending or secured lending transactions were "short-term" in nature. Staff submitted that the Statement of Allegations already contained a reference to short-term financing in paragraph 5 and Staff simply did not carry forward this notion in subsequent paragraphs in the Statement of Allegations. Staff submitted that this change related to the report of Staff's proposed expert witness and further submitted that there was no issue with notice because the expert report was provided to Twerdun on August 8, 2011.

(c) Staff proposed to amend paragraphs 6 and 23 by removing the allegation that, in one instance, the Companies used funds for the purchase of shares, which purchase was not contemplated by the OMs. The following text in subparagraph 23(ii) of the Statement of Allegations would also be removed as a result of this proposed amendment: "on or about May 15, 2006, FFI purchased treasury shares in Activecore Technologies Inc. ("Activecore") a Toronto based technology company that trades in the U.S. over-the-counter market. This equity investment was not contemplated by the OMs".

(d) Staff proposed to amend paragraph 24 by removing the clause "Such statements would reasonably have had a significant effect on the market price or value of the security".

(e) Staff proposed to amend paragraphs 26 and 27 by replacing the reference to "paragraph 21" with a reference to "paragraph 20" and to amend paragraph 31 by replacing the reference to "paragraph 11" with a reference to "paragraph 10". Staff characterized these changes as the correction of typographical errors.

(f) Staff proposed to amend paragraph 29 by adding the following text: "FFI and Twerdun failed to exercise reasonable due diligence to ensure that the accredited investor exemption was applicable. In particular, Twerdun knew or ought to have known that many investors were not accredited because the Accredited Investor Certificates were *prima facie* incorrect". Staff proposed that the foregoing text replace the following text: "In many instances, Twerdun knew or ought to have known that the investors were not accredited and ought to have made further inquiries". Staff submitted that the notion of due diligence in the proposed amendments was already reflected in the language of "knew or ought to have known" in the existing paragraph 29.

(g) Staff proposed to amend paragraph 30 by adding the following text: "FFI and Twerdun breached s. 25 and s. 53 of the Act by distributing the Debentures without registration and for which no preliminary prospectus or prospectus was filed or receipted by the Director in circumstances where no exemption was available". Staff submitted that breaches of sections 25 and

53 of the Act were implied in the context and that it was not in dispute that no prospectus was filed and FFI was not registered under the Act.

(h) Staff proposed to amend paragraph 39, which includes a summary of Staff's allegations, to conform to the changes discussed above. The proposed additions were:

> …
>
> (b) the Respondents failed to file the OMs with the Commission pursuant to s. 4.3 of OSC Rule 45-501, subsequently amended to s. 6.4 of OSC Rule 45-501, in contravention of s. 122(1)(c) of the Act;
>
> …
>
> (d) FFI and Twerdun breached s. 25 and s. 53 of the Act by distributing the Debentures without registration and for which no preliminary prospectus or prospectus was filed or receipted by the Director in circumstances where no exemption was available.

According to Staff, the proposed amendments to subparagraph 39(b) did not create any surprise because they could already be found in the existing paragraph 19. The proposed amendments to subparagraph 39(d) would be made to conform to the proposed addition of allegations of breaches of sections 25 and 53 of the Act.

[36] Staff argued that the main concern with respect to amending the Statement of Allegations is notice to the Respondents. Staff submitted that many of the proposed amendments were first provided to the Respondents as part of the pre-hearing conference submissions in July 2011, and the proposed amendments in this form were provided to Carey by e-mail prior to the hearing on the merits on September 12, 2011. Staff received no response from Twerdun or his counsel with respect to its proposed amendments. It was Staff's submission that Twerdun was given notice of the amendments, and the fact that he did not deal with them was not the concern of the Panel.

[37] Further, Staff took the position that there were no concerns of surprise or unfairness arising from the proposed amendments and, because there was no issue of notice, prejudice or surprise, no additional disclosure or preparation was necessary.

[38] Twerdun did not object to the removal of an allegation and the proposed changes that dealt with typographical errors, set out in subparagraphs [35](c) and (e) above. He did object to the remaining proposed amendments on the grounds that he believed he would be prejudiced by the amendments.

[39] KPMG took no position with respect to the proposed amendments.

[40] I reserved my decision as to whether additional disclosure or time should be afforded to the Respondents to respond if Staff decided to amend its Statement of Allegations. On the following hearing day, namely, on October 12, 2011, I advised the parties that, while some of the proposed changes were non-substantive in nature and did not prejudice the Respondents, there were changes that I regarded as substantive. In particular, the proposed addition of the allegations of breaches of sections 25 and 53 of the Act to paragraphs 30 and 39 of the Statement of Allegations, set out in subparagraphs [35](g) and (h), as well as the proposed amendments to paragraph 29 of the Statement of Allegations which relates to the accredited investor exemption, set out in subparagraph [35](f) above, were more substantive in nature. Accordingly, if Staff intended to make these amendments, additional time would be afforded to the Respondents to respond.

[41] I invited the parties to make submissions on whether additional disclosure would be required, and the period of time necessary to allow the Respondents to respond to the allegations. The parties agreed that they would engage in discussions and advise me of the outcome of the discussions.

[42] On October 13, 2011, Staff advised me that, although Twerdun indicated to Staff that he would not require further disclosure or time to respond, Staff would not make any amendments that I regarded as being more substantive in nature. In other words, Staff proposed to amend the Statement of Allegations on the basis described in paragraph [35] above except that no changes would be made to paragraphs 29 and 30 of the Statement of Allegations.

[43] Twerdun consented to amending the Statement of Allegations as proposed in paragraph [42] above. I confirmed with Twerdun that he would not require additional time to respond and that he agreed to proceed without further delay. On October 13, 2011, Staff filed an Amended Statement of Allegations.

III. THE POSITIONS OF THE PARTIES

A. Staff

[44] In its written submissions, Staff requested that the following findings be made against the Respondents:

(a) The OMs distributed by FactorCorp contained misleading or untrue statements and/or failed to state facts which were required to be stated, contrary to subsection 122(1)(b) of the Act;

(b) FFI failed to file the OMs with the Commission pursuant to section 4.3 of Rule 45-501, subsequently amended to section 6.4 of Rule 45-501, contrary to subsection 122(1)(c) of the Act;

(c) The Promotional Materials distributed by FactorCorp to investors contained misleading or untrue statements and/or failed to state facts which were required to be stated, contrary to subsection 126.2(1) of the Act;

(d) FFI and Twerdun breached the Temporary Order by redeeming certain FFI securities on July 13, 2007, contrary to subsection 122(1)(c) of the Act;

(e) Twerdun, as the sole officer and director of FFI and FCI, authorized, permitted or acquiesced in the non-compliance with Ontario securities law described in subparagraphs (a) to (d) above and is therefore liable for FFI and FCI's breaches of the Act under section 129.2 and subsection 122(3) of the Act;

(f) Twerdun knowingly made statements and filed evidence and information with the Commission that were materially misleading or untrue and/or failed to state facts which were required to be stated, contrary to subsection 122(1)(a) of the Act; and

(g) The course of conduct engaged in by the Respondents compromised the integrity of Ontario's capital markets, was abusive to Ontario's capital markets and was contrary to the public interest.

[45] Staff also alleges that the failure of Twerdun and the Companies to conduct due diligence to ensure that Debenture holders were qualified as accredited investors was contrary to the public interest.

B. Twerdun

[46] Twerdun submits that it was never his intention to mislead investors. Twerdun takes the position that he contracted with and relied on others to conduct the necessary due diligence. For example, it is Twerdun's submission that he "relied upon [FactorCorp's] Sublenders to conduct themselves as they were contracted or engaged to manage specific portions of the [FactorCorp] portfolio…Twerdun relied on Sublenders to carry out due diligence as they had outlined in their documentation and lending practice". He submits that he contracted with dealers such as Farm Mutual Financial Services ("**Farm Mutual**") to ensure the accredited investor status of the Debenture holders. He further submits that he retained counsel to ensure that security was taken, that the OMs were filed and that he and the Companies were in compliance with Ontario securities law. He submits that he "did not act alone" and should not be held solely responsible for the failure of the Companies and that some of the borrowers to which FFI had made loans (the "**Borrowers**") and their principals were still operating their businesses and were not facing any regulatory proceedings.

[47] Twerdun also made submissions about the recovery of funds. He submits that he was not responsible for the "poor results in recovery efforts" because they were caused by "the lengthy delay in KPMG's poor efforts to secure and recover assets…, a harsh recession, a cookie cutter process that historically delivers poor recovery results…and Sublenders taking advantage of the bankruptcy to their own benefit". In particular, he submits that KPMG's delay in recovery caused "deliberate harm, in recovery efforts". Twerdun submits that KPMG engaged in "witch hunts", "accumulate[d] information not related to [FactorCorp] Debenture Holder's interests" and "over charged for their

services”, all of which amounted to a breach of its fiduciary duty to the Debenture holders.

C. The Companies

[48] KPMG indicated that it was not “defending the charges on behalf of the two corporate respondents” (Hearing Transcript dated October 6, 2011 at p. 49).

IV. ISSUES

[49] Staff’s allegations raise the following issues:

(a) Did FFI fail to file the OMs with the Commission in accordance with section 4.3 of Rule 45-501, subsequently amended on September 14, 2005 to section 6.4 of Rule 45-501, contrary to subsection 122(1)(c) of the Act?

(b) Did the Companies make materially misleading or untrue statements in the OMs which were documents required to be filed with the Commission, contrary to subsection 122(1)(b) of the Act?

(c) Did the Companies make materially misleading or untrue statements in the Promotional Materials, contrary to subsection 126.2(1) of the Act?

(d) Did FFI and Twerdun breach the Temporary Order by redeeming certain FFI securities on July 13, 2007, contrary to subsection 122(1)(c) of the Act?

(e) Did Twerdun, as the sole officer and director of the Companies, authorize, permit or acquiesce in the contraventions by the Companies of the Act and, if so, is Twerdun liable for such contraventions pursuant to subsection 122(3) or section 129.2 of the Act?

(f) Did Twerdun make materially misleading or untrue statements to the Commission, contrary to subsection 122(1)(a) of the Act?

(g) Did FFI and Twerdun fail to ensure that investors were entitled to rely on the accredited investor exemption, contrary to the public interest?

V. OVERVIEW OF THE EVIDENCE

A. Evidence Tendered at the Hearing

[50] Staff called five witnesses at the hearing on the merits, namely (i) Andre Moniz (“**Moniz**”); (ii) Butcher; (iii) Paul Zilkey (“**Zilkey**”); (iv) Frederick Paatz (“**Paatz**”); and (v) Lili Shain (“**Shain**”).

[51] Twerdun testified on his own behalf and was cross-examined. He called no other witnesses.

[52] Through the witnesses, 24 exhibits were introduced into evidence.

B. Witnesses

[53] Moniz, a senior investigation counsel with the Enforcement Branch of the Commission, testified about the investigation. Through Moniz, Staff introduced into evidence, among other things, section 139 certificates, corporation profile reports and documents provided by the Companies and Twerdun in the course of the Commission's compliance field review and Staff's investigation, including filings required under the Act to sell the Debentures pursuant to the accredited investor exemption.

[54] Staff also introduced into evidence, through Moniz, documents relating to the Companies that had been obtained from various persons or entities, including KPMG, Grant Buchan-Terrell, former counsel to the Companies and Twerdun ("**Buchan-Terrell**"), Farm Mutual and Fortress Investment Group LLC ("**Fortress**"), a U.S. investment management firm from which FactorCorp sought financing in or about June 2007. The documents included client files, security documents and transactional documents.

[55] Twerdun was interviewed by Staff on a voluntary basis on June 15, 2007. David Searle ("**Searle**"), the principal of an unincorporated business called Mohawk Business Solutions Group ("**MBSG**"), one of the Borrowers, was interviewed by Staff on April 1, 2009. As Searle had passed away by the time the hearing commenced, the transcript of his interview was introduced into evidence through Moniz.

[56] Staff then called Butcher, a Vice-President of KPMG who had been involved in this matter since mid-August 2010. Butcher testified about KPMG's roles as the Monitor, Receiver and Trustee and, through Butcher, various reports of KPMG, in its various capacities, were introduced into evidence.

[57] Butcher testified about the documents that KPMG obtained in its capacity as the Monitor, Receiver and Trustee at the office of the Companies. With the consent of Twerdun's counsel, KPMG also obtained the information stored on Twerdun's laptop computer and BlackBerry hand-held device. KPMG also obtained from Buchan-Terrell certain records of the Companies that were in his possession. Butcher testified that, in some instances, documents were directly obtained from the Borrowers.

[58] In its capacity as the Receiver, KPMG examined Twerdun on May 14, 2008 pursuant to sections 159 and 161 of the *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3, as amended (the "**BIA**"). In its capacity as the Trustee, KPMG examined Twerdun and representatives of certain of the Borrowers on July 10, 2008 pursuant to section 163 of the BIA.

[59] Staff called the principals of two of the Borrowers, namely, Zilkey, who was the principal of FCB Financial Inc. ("**FCB**"), and Paatz, who was the principal of Express Commercial Services Inc. ("**ECS**"). Zilkey and Paatz testified about the transactions between their respective companies and FFI.

[60] Finally, Staff called Shain, who was qualified at the hearing on the merits as an expert in commercial lending.

[61] As noted above, Twerdun testified on his own behalf. His evidence was similar to his submissions which are outlined in paragraphs [46] and [47] above.

C. Expert Evidence

[62] Shain was called by Staff as an expert witness. Her report, initially issued on August 8, 2011 and subsequently amended on September 26, 2011, stated that her evidence was to provide her opinion on the following issue:

> …did FactorCorp comply with the representations made in the FactorCorp Offering Memoranda (the "OMs") and in the FactorCorp "promotional" or reporting materials (the "Promotional Material") generally that:
>
> (a) Investor funds would only be used in factoring or short term secured lending transactions;
>
> (b) Loans would be backed by adequate collateral and secured; and
>
> (c) FactorCorp would conduct risk assessments and due diligence in relation to the quality of the borrower and the value of the security, and would implement risk management strategies to reduce risk and to monitor the value of the security.

[63] Shain's report does not address the adequacy or enforceability of security documents and registrations which the report states were the domain of the Receiver.

[64] Shain gave evidence that she had over 25 years of experience in commercial lending, which she described in her evidence as "lending money or adjudicating credit to commercial enterprises" (Hearing Transcript dated October 13, 2011 at p. 148). For example, she held various positions at the National Bank of Canada including Vice President, Specialized Lending and Vice President, Commercial and Specialized Lending. Shain testified that, in those roles, she was involved in the evaluation of secured loans of $50,000 to $50,000,000 made to medium-sized, privately held companies. She further testified that her responsibilities involved, among other things, assessing the due diligence conducted on prospective borrowers. According to Shain, when assessing whether FactorCorp conducted adequate due diligence, she did not base her assessment on the standards expected of a bank but relied on basic principles that applied to all lending transactions.

[65] Twerdun objected to the admissibility of Shain's evidence as expert evidence. Twerdun submits that Shain developed her expertise working for two Canadian chartered banks and that she had no experience working for or managing a small finance company. He submits that her report and testimony make reference to standards based on her experience in large banks which are not feasible or attainable in a small business. Accordingly, Twerdun submits that she was not qualified to provide expert evidence about the lending practices of "tier 2" or "tier 3" institutions such as FactorCorp.

[66] I qualified Shain as an expert in commercial lending on the basis that she had acquired specialized knowledge through her extensive experience as a senior lending officer for a major Canadian bank. Although Shain acknowledged that, while she had dealt with many "tier 2" or "tier 3" institutions, she had no experience working for one, I am satisfied that basic standards of due diligence, prudence and oversight apply to all commercial lending transactions regardless of the size of the lending institution. Shain's observations and opinions relating to lending standards are also entirely consistent with the written representations with respect to lending standards that were made by the Respondents to investors.

[67] Twerdun also argued that Shain's evidence should not be admitted because it was "biased and tainted". In Twerdun's submission, given the "derogatory remarks" outlined in the Statement of Allegations and KPMG reports which were provided to her, it would be impossible for her to provide an unbiased view.

[68] I do not accept Twerdun's assertion. Staff explained that Shain was provided with the Statement of Allegations in this matter to form the context of the analysis to be carried out. Shain testified that she "tried not to have any preconceived notions going into this process" and her expert opinion was formed based on FFI's lending procedures and documentation (Hearing Transcript dated October 14, 2011 at p. 83). In addition, in her expert report, Shain's statement of independence includes the following:

> I have no interest in the outcome of this matter, either directly or indirectly. My fee for this assignment is based solely on hours spent, and is in no way contingent upon the result of this analysis. I have no conflict of interest in this matter.

[69] Based on the foregoing, I find that Twerdun has not shown that Shain's evidence lacked impartiality or is biased.

[70] Twerdun further challenged Shain's evidence on the grounds that she only reviewed information that was made available to her by the Commission, which excluded information in the control of the Borrowers. According to Twerdun, it is important to note that Shain did not interview the Borrowers that he and the Companies relied on, or review their due diligence, management practices or security practices.

[71] While Shain acknowledged in her testimony that she only reviewed documents that were made available to her, which were primarily comprised of the files of the Companies in the possession of KPMG, I find that the issue raised by Twerdun as described in paragraph [70] above goes to the weight which I will ascribe to Shain's evidence and not to its admissibility. I am satisfied that Shain's descriptions and analyses of the transactions she reviewed were forthright and as thorough as the documentation to which she had access permitted.

D. Admissibility of Compelled Evidence under the *Bankruptcy and Insolvency Act*

[72] On the first day of the hearing, Staff sought to admit the transcript of the examination of Twerdun conducted on July 10, 2008 by KPMG in its capacity as the Trustee pursuant to section 163 of the BIA and the written record of the examination of Twerdun conducted on May 14, 2008 by KPMG in its capacity as the Receiver pursuant to sections 159 and 161 of the BIA.

[73] As Twerdun indicated his intention to testify on his own behalf, I determined that his direct testimony would provide the best evidence and that Staff would not be permitted to submit the transcripts and written record of prior examinations with the exception that Twerdun's prior evidence given under oath could be used in cross-examination to impeach his testimony. I also decided that, in the event that Twerdun chose not to testify, it would be open to Staff to submit the transcripts and written record of the prior examinations.

VI. EVIDENCE AND SUBMISSIONS

[74] The Companies were engaged in the business of providing financing to commercial businesses using funds that they raised from the sale of the Debentures. The following are the facts and submissions relating to the sale of the Debentures and the lending transactions in which the Companies were engaged.

A. Sale of Debentures

1. Debentures Offered for Sale

[75] Staff's Summaries, which are uncontested by the Respondents and which I accept as accurate, show that FFI offered the Debentures for sale and raised a total of approximately $50.4 million from more than 600 Ontario investors during the Material Time.[3]

[76] The Debentures had terms ranging from one year to five years and entitled investors to a rate of interest on which FFI and the investor would agree at the time of the investor's subscription. According to Shain's report, the rate of interest on the Debentures ranged from 6% to 8% per annum depending on the term. The OMs provided that interest would be paid to investors on a monthly basis.

[77] The Debentures could be redeemed by the investors at maturity with notice which was usually 120 days. If an investor did not request the repayment of the principal amount, the Debenture automatically renewed for an additional term. Twerdun testified that 98% of the investors renewed their investments on maturity.

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[3] Staff's Summaries show that FFI raised approximately $56.1 million from 2003 to 2007 and approximately $5.7 million was raised in 2003, which was not during the Material Time.

[78] All of the Debentures issued by FFI were sold pursuant to the accredited investor exemption under Rule 45-501 and, following September 14, 2005, National Instrument 45-106 – Prospectus and Registration Exemptions ("**NI 45-106**").

[79] The evidence shows that approximately $7.4 million was returned to investors by way of redemptions and approximately $17.4 million was returned to investors who purchased Debentures through Farm Mutual as a result of the settlement of a class action against certain directors and officers of entities related to Farm Mutual.[4]

2. Dealers Engaged by FFI for the Sale of the Debentures

[80] The Debentures were sold to investors primarily through three dealers registered as limited market dealers under the Act at the time, namely, Farm Mutual, Interglobe (Blonde & Little) and FCI. I accept as accurate, Staff's Summaries, which were not contested by the Respondents and which show that of the $50.4 million raised by FFI during the Material Time, approximately $46.1 million was raised by Farm Mutual, approximately $2.1 million was raised by Interglobe (Blonde & Little) and approximately $2.1 million was raised by FCI.

3. OMs

[81] Staff identified various versions of the OMs which were used to sell the Debentures to investors. In oral submissions, Staff noted that it was difficult to identify the period of time in which each version of the OMs was used to sell the Debentures as some of the OMs were undated.

[82] Again, as described in paragraphs [16] and [17] above, Staff subsequently filed summaries which include an approximation of the time period in which each version of the OMs was used to sell the Debentures. According to Staff, four versions of the OMs were used from 2003 to 2007 in the sale of the Debentures through Farm Mutual, one version of the OMs was used from 2005 to 2006 in the sale of Debentures through Interglobe (Blonde & Little) and another version was used from 2003 to 2007 in the sale of the Debentures through FCI. I accept these summaries, which were not contested by the Respondents, as accurate.

[83] There are minor differences between the various versions of the OMs. For example, two of the OMs identify FCI as the issuer of the Debentures while the remaining OMs identify FFI as the issuer. As Staff pointed out, despite the use of the names of both FFI and FCI as the issuer in the OMs, investors only received Debentures issued by FFI. I am satisfied that, subject to these minor differences, the OMs were substantially the same and the statements with which Staff takes issue were consistent in the various versions of the OMs and were made throughout the Material Time.

[84] The OMs describe FFI's business as follows:

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[4] Some portion of the funds returned to investors may have been raised in 2003, prior to the Material Time.

> FactorCorp Financial Inc.[5] (defined above as the "Corporation") was formed for the purpose of providing funding to; factoring, leasing and similar short-term secured asset-backed financing services to commercial clients. The Corporation generates revenue by way of investing capital with factoring commercial accounts receivable on a short-term basis. The Corporation will generate an investment pool of funds through this offering for deployment in its funding, and managing, of factoring and other asset-backed operations.

[85] The OMs identify and describe two types of lending transactions in which FFI engaged, namely, factoring and secured lending. They describe factoring as follows:

> Factoring is a process whereby the customer (the "**Borrower**" or "**Merchant**") pledges its receivables, or assets, (either general or specific pledges) deemed by the "factor" (i.e., the party assuming the collection risk, the "**Factor**") to be of acceptable credit quality in exchange for either a specific one-time advance or a secured revolving credit facility.

[86] Factoring transactions are described to be "short-term in nature" and used primarily for the following purposes:

> 1) as a bridge to establishing or increasing a bank credit facility; 2) as a means to manage a corporation's balance sheet (thus satisfying certain bank covenants or capital market expectations); 3) as a lower-cost alternative to the equity dilution accompanied by the issuance of additional equity, particularly on a venture capital basis; 4) to finance temporary bulges in receivables associated with seasonal or special orders; or 5) recover government receivables, such as; tax credits, GST rebates, or Scientific Research credits.

[87] The OMs make the following representations about the advance rates in a factoring transaction:

> Funds advanced to the client are typically limited to a maximum of 80% to 85% of acceptable receivables, although higher advance rates may be considered in the case of short-term receivables of superior quality, such as government, government-insured receivables, or insured receivables.

[88] FactorCorp also represented in the OMs that it would consider secured lending transactions and described secured lending as follows:

> The Corporation will consider other temporary loans where there is alternative and strong tangible security such as collateral mortgages on principal residences, chattel mortgages on manufacturing equipment, etc…

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[5] Or FactorCorp. Inc. in two versions of the OMs.

…

> …Secured lending differs from factoring transactions in that alternative (or additional security) beyond accounts receivable is usually taken to secure the advances. Such additional security (and security over immovable assets) is typically provided as a means to induce the lender to remain relatively "transparent" (or of limited involvement) in the Borrower's operations and business relationships.

[89] The OMs represent the nature of secured lending transactions that FactorCorp proposed to engage in as follows:

> These secured, temporary loans will follow more traditional commercial loan structures and will generally have a risk profile similar to that involved in factoring transactions…Examples of security typically offered to support commercial loans include: 1) residential mortgages on primary residences or recreational property; 2) chattel mortgages on machinery and equipment; 3) general and specific security interests on inventory and other tangible assets; 4) assignment of contractual rights and obligations; 5) pledges of securities including stocks, bonds, mutual funds, bank deposits, term deposits and Guaranteed Investment certificates, etc.; 7)[*sic*] Collateral mortgages on commercial property; and/or 8) other security where in the discretion of the Manager[6] there exists a readily available secondary market.

…

> …Thus to the Corporation, such secured, temporary "bridge" loans represent additional sources of revenue with risk characteristics similar to those of factoring transactions and are consistent with the short-term commitment of the Corporation's funds.

[90] The OMs represent that "In all such cases, the temporary advances are limited to circumstances in which there are available independent valuations by conservative industry sources (e.g., real estate and equipment appraisers, tax valuations, etc.) based on either liquidation values or a conservative advance rate (e.g., 70%) of market value".

[91] The OMs include a list of 13 risks, identified as "specific to [FactorCorp]", and qualify the list as being "not exhaustive but illustrative" of the risks to which the Companies are subject. The list of risks includes the following:

…

> <u>Security Risk</u> – Management, from time to time, be [*sic*] unable to realize sufficient proceeds of exercise of its security to satisfy the Debenture holders' full entitlement under the Debentures;

[6] Defined in the OMs as FFI or FCI.

> <u>Credit Risk</u> – Credit losses among its Borrowers may result in operating losses to the Corporation, thereby impacting adversely upon the Corporation's ability to honour its obligations in respect of the Debentures;
>
> …
>
> <u>Operating Risk</u> – The is no assurance that the Manager will be able to find and negotiate profitable factoring/secured lending transactions at acceptable risk and there is no assurance that the Corporation's risk management practices will be effective in preventing risk in all circumstances;
>
> …
>
> <u>Collateral Risk</u> – Notwithstanding that the Corporation may have used what it believes to be conservative valuations of the pledged assets or security behind each factoring advance or secured loan, there can be no assurances that the Corporation or any other party can attain these values in the event of realization and liquidation of these assets. A potential failure to liquidate assets at values consistent with the expectations of the Corporation or the Manager may result in losses to the Corporation's debenture holders.

[92] Under the heading "Risk Management Practices", the OMs represent that the Companies will engage in the following practices to mitigate the risks identified above:

> Recognising the risks inherent in the factoring business, the Corporation will engaged [*sic*] several factoring operators whose expertise in commercial finance generally and factoring/secured lending in particular provides the Corporation with a level of assurance that the foregoing risks will be mitigated, and diversified, to the extent practicable in the operation of the business. Because the Manager will deploy capital into several factoring operations the risk will be significantly reduced.
>
> In addition to the reliance on the Manager's proprietary credit marketing and decisioning skills, the Corporation intends to diversify its assets by industry, client and end-debtor (trade debtor) to the extent practical given the Corporation's limited resources.
>
> The Manager will ensure that credit and asset quality will comply with the requirements to support its bank line of credit that serves as an additional monitoring source on the activities of the Corporation. Overseen by the Manager, the Corporation will utilize an assortment of proprietary financial structures, security, credit decisioning and administrative procedures to ensure that the Corporation's funds are used to build a profitable portfolio at acceptable risk.

[93] The foregoing section of the OMs also lists the security requirements as follows:

- General Security Agreement registered in the first position over the receivables financed;
- Acknowledgements/priority agreements from the current PPSA[7] registrants;
- Personal guarantees of the principal shareholders;
- Factoring Agreement, promissory notes and/or financing agreements incorporating repurchase agreements in the event that payment for the receivables is not received in the agreed timeframe;
- Other security specific to the transaction (i.e., collateral mortgages on residences, chattel mortgages on specific equipment, irrevocable letters of direction over other cash receipts such as tax receivables, etc.).
- Government or Insurance Company covenants or guarantees.

4. Promotional Materials

[94] At the hearing on the merits, Staff presented Promotional Materials which were used by the Companies to promote the Debentures.

(a) The FactSheet

[95] The FactSheet, which was undated, provides a description of the business of FactorCorp which is similar to that found in the OMs. The description of the types of transactions in which the Companies engaged as found in the FactSheet appears to also have been excerpted from the OMs. More specifically, the content of the FactSheet is similar to the excerpts from the OMs set out in paragraphs [84], [86], [88] and [89] above.

(b) FactorCorp Brochure

[96] A brochure of FactorCorp, also undated, sets out a list of FactorCorp's managing advisors, namely, Twerdun; Brian Vallesi; Zilkey; Cassels Brock Blackwell LLB; Buchan-Terrell; and Farnham and Company, Charter Accountants. As in the case of the FactSheet, the brochure includes what appear to be excerpts from the OMs. The parts of the brochure relating to the business of the Companies, the types of transactions in which the Companies engaged and the Companies' risk management practices are similar to the excerpts from the OMs set out in paragraphs [84], [86], [89] and the first paragraph of the excerpt in paragraph [92] above.

[7] PPSA means the *Personal Property Security Act (Ontario)*, R.S.O. 1990, c. P.10, as amended

(c) Question and Answer Sheets

[97] As the name of the document suggests, the Question and Answer Sheets, one dated April 2004 and the other undated, provide a list of questions and answers concerning FactorCorp's business. The following are some of the questions and answers in the April 2004 version:

> Q2 – The rate of return seems too good to be true. How is FactorCorp Financial able to offer this type of return?
>
> A2 – The Corporation is currently actively involved in funding the asset based lending, leasing and accounts receivable factoring business, emphasizing both government and insured receivables. <u>Asset based lending involves the securing of a loan with pristine assets</u>. For example a home worth $500,000 could be used to secure a $200,000 loan and in addition, personal guarantees would be obtained as well.…<u>By being more efficient than the large banks and having seasoned and experienced senior bankers on staff</u>, the Manager is able to avoid the costs, mistakes and training issues incurred by the Bank's business models.
>
> …
>
> Q8 – The business presents an opportunity to earn equity rates of return with bond or covered call type risk. This sounds too good to be true – What's the catch??
>
> A8 – There is no catch…Like a commercial bank, <u>the Corporation obtains all appropriate security to minimize any losses</u> and the Managers will defer associated Management fees to further minimize any downside. <u>Essentially, the risk profile is similar to a "covered call" on a secured short-term corporate bond</u>.
>
> …
>
> …<u>Like a commercial bank, the Corporation obtains all appropriate security to minimize any losses and the Managers will defer associated Management fees to further minimize any downside</u>…
>
> Q11 – What controls are in place to ensure that the funds are retained by the business and invested in quality receivables? How would this prevent management from misappropriating company monies?
>
> A11 – The Manager and the Corporation has [*sic*] many internal and external controls <u>to ensure that the funds are invested in quality accounts receivable</u> and divested into many different factoring style companies.
>
> …

- …Bank staff will be monitoring account activity and receivable quality in the traditionally conservative way while will further ensure that funds are used in a manner consistent with the business plan.

...

- External auditors will be performing a formal audit on the Corporation on an annual basis;

…

Q. 12 – Who is the "Advisory" group and how does it function?

A. 12 – A brief profile of the Advisory Group is a seasoned team of professionals with extensive experience managing large sums of funds on behalf of individuals, banks and institutions. Each brings to the Advisory Group a different perspective on operational and financial risk which is incorporated in the decision making process. Advisory Group meetings are held on a regular basis to discuss and assess both new and existing transactions. Normally the Group holds meetings on at least a weekly (sometimes daily) basis depending upon the volume of transactions being presented. Exact details of how the Group functions and the process used to make decisions is proprietary however a majority of members must agree prior to the authorization of any transactions.

[Emphasis added.]

[98] Although Twerdun testified that the Question and Answer Sheets were used until December 2005 and then "retracted", Staff introduced into evidence an internal e-mail from a branch manager of Farm Mutual dated December 9, 2005 with which he circulated what he described as:

> …the new revised Offering Memorandum and Subscription Agreements in electronic form. I have also once again included the other documents that have not changed.
>
> [Emphasis added.]

The documents attached to the e-mail and the revised Offering Memorandum included the Question and Answer Sheet dated April 2004.

[99] Although it would have been preferable to hear evidence directly from a representative of Farm Mutual regarding the use of the Question and Answer Sheets after December 2005, I accept that the e-mail above shows that the Question and Answer Sheets remained in use after December 2005 and reject Twerdun's testimony, which is not supported by any documentary evidence.

(d) Information Provided to Investors

[100] A document entitled Investor Information described FactorCorp as follows:

- "A pooled fund of funds".
- "A 'Secured' lender to 'Secured' lenders".
- "Successful and has never missed a payment or lost a penny in assets".
- "100% secured by assets such as cash, SRED Government receivables, Federal and Provincial Government receivables, EDC Government Program, mutual funds, GICs, property, machinery, general security agreements, personal guarantees, contracts, etc.".

[101] The Investor Information purported to provide a number of examples of how the business of FactorCorp worked:

> <u>A Typical Example of how it works</u>:
>
> A client requires a $600,000 loan to produce 2000 electrical components for a Walmart contract. One of our factoring lenders evaluates the company, the contracts, and <u>completes a credit and background check on the client</u>.
>
> If all is acceptable they lend against the contract ($600,000), <u>take the clients [*sic*] personal residence as security ($700,000), and a General Security Agreement (GSA) against the entire company ($350,000) giving them control over the clients [*sic*] company and assets</u>.
>
> Then they file with FactorCorp and request to borrow the $600,000 and provide a total of $1,650,000 in security that is registered in FactorCorp's favour. FactorCorp then goes to its capital pool of investors and issues the $600,000 to the lender and provides the $1,650,000 in security to the pool of investors.
>
> <u>The "Secured Debenture Holders" (pool of investors) is now covered almost 3:1 (security to investment dollars)</u>.
>
> <u>Another Example:</u>
>
> Client is referred to our SRED lending experts for a loan to cover an approved Federal Government Tax receivable from an accredited and major accounting firm for $250,000.
>
> The SRED team discovers they have filed several times successfully for the (SRED) Scientific Research and Development Tax Credit. All their paperwork is in order and background checks and credit checks are favourable. They agree to lend only $125,000 against the receivable and

> notify the Government that they are to take assignment of the entire $250,000 payment. Once the Government confirms the assignment the lender contacts FactorCorp.
>
> The SRED lender assigns the security of the $250,000 Government payment to the "Secured Debenture Holders" (pool of investors) in FactorCorp with security 2:1 (Government security to investment dollars). FactorCorp lends the $125,000 to the SRED lender.
>
> Final Example:
>
> Client requires a mortgage for $175,000 against his $200,000 residence. Our mortgage specialists do a property search and background check on the client. The appraisal comes in at $200,000 and the real estate sales are moderate in that location. The residence itself is in a desirable location. The mortgage lender registers a lean [*sic*] against the property, which is assigned to FactorCorp, which is then assigned to the "Secured Debenture Holders". The $175,000 is issued from the pool and the security is pledged to the FactorCorp investors.
>
> [Emphasis added.]

(e) Quarterly Reports

[102] A number of FactorCorp's reports to its investors were introduced into evidence. Each report sets out the value, at the time of the report, of the security held for every investor dollar which, from 2004 to 2007, ranged from $1.44 to $2.03. In other words, the reports represent that the investments were secured by assets having a value of 144% to 203% the value of the related investment. Each report also provides a breakdown of security held by FactorCorp and the "Position of Security and Payments" at the time. All of the reports from 2004 to 2007 state that over 97% of the loans were "current", that is, were not in default.

B. Lending Transactions

[103] It is not in dispute that FactorCorp engaged in 13 transactions during the Material Time. Staff provided a summary of these transactions and Twerdun indicated in oral submissions that he did not dispute the accuracy of the information in the summary. I accept this summary, which is reproduced below, as accurate:

Client Name	**Date(s) of Agreements**	**Loan Amount**	**Name of Principal(s)**	**Type of Borrower**	**Purpose of Loan**
Express Commercial Services Inc. ("**ECS**")	July 2003 – September 2006	$19,718,300 (preferred shares investment)	Fred Paatz	Direct Borrower/Sub Lender	Mainly to finance Royal Reef Resort development, factoring
Breken	July 2003 and	$1,800,000	Paul Zilkey	Sub Lender	To lend to a

Financial Inc. ("**Breken**")	February 2004				single company operating as "The Monitoring Center"
FCB Financial Inc. ("**FCB**")	September 2003 – February 2005 and October 2005	$8,759,102	Paul Zilkey	Sub Lender	SRED lending, tax credit lending, factoring
Mohawk Business Solutions Group ("**MBSG**")	February 2004	$1,744,476	David Searle, Ron Cooke	Direct Borrower	To finance construction of 2 gas stations on Indian reserve
Romco Capital Partners ("**Romco**")/ Capmor Financial Services Corp. ("**Capmor**")	May 2004 – April 2005 (originally with One World)	$1,774,666	Bob McAllister, Steve Vooro	Sub Lender	To finance leases to multiple clients
Integra Investment Services Ltd. ("**Integra**")	June 2004	$700,000	Roy Jennix	Sub Lender	To finance undeveloped land in BC
W3 Connex ("**W3**")	September 2004	$1,630,536	Brian Walters	Direct Borrower, also an Indirect Borrower through LC3	To finance several rural broadband communication networks
Forbes Hutton Financial Inc. ("**Forbes Hutton**")	November 2004	$9,310,000	Arnold Milan	Sub Lender through One World (Brian Vallesi)	To finance gaming machines in US jurisdictions
Lease Capital Corporation of Canada ("**LC3**")	July 2005	$2,552,500	Steve Vooro, Gerry Makahonen	Sub Lender	To finance leases to multiple clients
CanFactor Inc. ("**CanFactor**")	October 2005	$630,000	Mike Rundle	Sub Lender	To finance factored receivables for three clients

Sydcom Wireless Corp. ("**Sydcom**")	August 2006, "repapered" February 2007	$796,500	Randy Aquino, Geraldine Borromeo	Direct Borrower	To refinance second and third mortgages that could not be repaid
Ice Planet (1) Ltd. ("**Ice Planet**")	December 2006 and February 2007	$250,000, $50,000	Philip Jackson	Direct Borrower, Also an Indirect Borrower through FCB for $4,550,000	To finance preproduction costs for potential TV series

[104] Staff did not lead evidence with respect to all of the transactions listed in paragraph [103] above and indicated that it does not take issue with certain transactions, such as the transactions with Breken Financial Inc. and CanFactor Inc. I will similarly limit my review of the evidence to those transactions and, in particular, FFI's transactions with ECS, FCB and MBSG, which amply demonstrate the basis on which FFI purported to discharge the responsibilities that it undertook pursuant to the Debentures.

1. Express Commercial Services Inc. (ECS)

(a) Paatz's Evidence

[105] Paatz testified that he founded ECS, a company based in Burlington, Ontario, in 2001. Paatz described ECS as being in the business of factoring and providing other types of financing such as asset-based lending. Paatz gave evidence regarding ECS's business relationship with Twerdun which commenced in or about April 2003.

(i) ECS's Articles of Incorporation and Preferred Shares

[106] Paatz testified that ECS's Articles of Incorporation were amended on December 9, 2002 for the purpose of creating an unlimited number of Class A, B, C and D preferred shares. The rights attaching to these classes of shares are identical except that each class carries a different rate on its fixed preferential cumulative cash dividends. Class C preferred shares have a fixed dividend of 14%.

[107] ECS's Articles of Incorporation provide that common shareholders of ECS are not entitled to dividend payments until dividends have been paid on the preferred shares. On the liquidation, dissolution or winding-up of ECS, the preferred shareholders are entitled to a fixed payment of $1.00 per share in addition to accrued and unpaid fixed dividends before any payment is made to the holders of common shares. If the assets available for distribution are insufficient, the amounts owing to preferred shareholders are reduced on a *pro rata* basis.

[108] The preferred shares are subject to ECS's right of redemption at $1.00 per share. They also carry a right of retraction, exercisable at $1.00 per share following the first anniversary of the issuance of the preferred shares.

(ii) Loans to ECS

[109] At the outset of ECS's business relationship with Twerdun, in or about April 2003, Twerdun agreed to provide $280,000 to ECS by way of a loan in the amount of $80,000 made by his spouse and another loan in the amount of $200,000 made by 1504622 Ontario Inc., a company that Paatz believed was owned by Twerdun, for the purpose of funding ECS's factoring business.

[110] According to Paatz, prior to making these advances, Twerdun visited ECS's offices, reviewed ECS's financial statements and asked a number of questions about how ECS operated. He did not think that Twerdun asked ECS to complete an application form, nor did he recall providing his consent to a personal information search. Paatz testified that ECS subsequently sent reports to FFI on a monthly basis.

[111] The evidence presented at the hearing indicated that the loans were repaid in full with interest.

(iii) Purchase of Preferred Shares

[112] Subsequently, in or about July 2003, Paatz contacted Twerdun to obtain further financing. According to Paatz, Twerdun communicated to Paatz that he had established a new company, FFI, and that he would be funding ECS through FFI in the future. Following discussions, FFI agreed to purchase Class C preferred shares from ECS that paid a 14% annual dividend. FFI and ECS subsequently entered into a number of Preferred Class "C" Share Agreements (the "**ECS Preferred Share Agreements**") pursuant to which FFI purchased Class C preferred shares from ECS. Paatz testified that share certificates evidencing FFI's ownership of ECS preferred shares were issued as a result.

[113] Paatz explained during cross-examination that ECS's normal course of business was initially factoring and the evidence suggests that the funds were initially received from FactorCorp for that purpose. The initial ECS Preferred Share Agreements, dated July 10, 2003, provided that "Whereas ECS is in the business of factoring, which is the purchase of receivables for which it is paid a fee". ECS Preferred Share Agreements made following May 4, 2004 state that ECS was in the business of factoring and "secured asset based lending".

[114] The ECS Preferred Share Agreements had the following terms:

> ECS shall pay to [FFI] a 14% per annum dividend in twelve equal payments from the date this Agreement is accepted. The dividend will be treated as 'dividend' income as outlined under the CCRA tax act. Payments will continue until the term of this Agreement expires or at such a time as ECS repurchases the 14% Class "C" Preferred Shares.
>
> This Agreement shall remain in effect for a period of __ year(s) and shall automatically renew for identical periods, upon the same conditions herein set forth, until [FFI] furnishes ECS with 90 days advanced written notice

> of it's [*sic*] intention not to renew the agreement at the expiration of the current term. At which time ECS agrees to return the Principal and pro-rated interest is received.[8]

[115] Initially, the ECS Preferred Share Agreement stipulated a term of one year. In or about May 2004, the term of the Agreement became two years because, according to Paatz, "FactorCorp and ECS were getting comfortable in doing business with each other" and they wanted a longer term relationship (Hearing Transcript dated October 13, 2011 at p. 28).

[116] The ECS Preferred Share Agreement also initially provided that ECS "agrees to secure the Class 'C' Preferred Shares by a corporate guarantee". The ECS Preferred Share Agreements entered into after June 9, 2004 also include the following: "assignment of all security, and via GSA." [9] In addition, ECS agreed that all receivables purchased would be over-collateralized by a minimum of 20% and that ECS would obtain a GSA from all of its clients.

[117] Paatz testified that, in 2003, he and Mark Hall ("**Hall**"), who, together with Paatz, was a founding director of ECS, came up with the idea of buying a property in the Turks and Caicos Islands following speculation by certain Canadian politicians that the Turks and Caicos could become a Canadian province. While Paatz acknowledged that neither he nor Hall had any resort construction experience, they decided to develop a resort and found a property for sale while on a trip to the Turks and Caicos Islands. Paatz acknowledged in his evidence that there was no independent third-party analysis to support his initial view about the viability of such a development, and no valuation or appraisal of the property was conducted until 2006.

[118] Paatz testified that, in or about May 2004, he proposed the project to be known as the Royal Reef Resort to Twerdun and provided him with a "breakdown of what was going on on the islands as far as the types of resorts that were being built there, the prices that they were selling for, the condo prices, and just a very good idea of what we expected to do. We didn't have a business plan as such at that point, like a completed business plan, but we had a draft of what we were proposing to do" (Hearing Transcript dated October 13, 2011 at p. 34). Paatz testified that he requested $3.0 million for the initial purchase of the property and $7.0 million for the future development of the project.

[119] According to Paatz, Twerdun was "very keen" about the project, agreed to provide funding for the initial purchase of the property and also orally committed to providing further financing of $7.0 million (Hearing Transcript dated October 13, 2011 at p. 32). Shortly after Paatz made the proposal, on May 4, 2004, Twerdun provided ECS with a cheque in the amount of $2.0 million and provided a further cheque in the amount of $2.2 million on June 1, 2004. These funds were advanced to ECS pursuant to various ECS Preferred Share Agreements.

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[8] ECS Preferred Share Agreements made following May 4, 2004 stated that "…ECS agrees to return the Principal and pro-rated interest in exchange of the Class 'C' Shares".

[9] The term GSA means a general security agreement.

[120] During the period from July 2003 to March 2007, FFI purchased shares of ECS having a total value of approximately $19.7 million. Paatz testified that, of the $19.7 million, approximately $15.0 million was ultimately used to fund the development of the Royal Reef Resort and the balance was used to fund ECS's factoring business. Dividends were paid by ECS to FFI on a monthly basis using funds received from the sale of condominiums at the resort, ECS's factoring business or from loan advances by third parties.

[121] Paatz testified that he and Hall established an entity called Royal Reef Resort Ltd. in the Turks and Caicos Islands in order to purchase the underlying property and develop the resort. According to Paatz, Twerdun requested that ECS establish another company in order to provide funding for the construction of the Royal Reef Resort. As a result, Paatz and Hall established a new corporation in Canada called Estates International Inc. ("**EII**"). The purpose of EII, which did not have any assets, was to receive funds from ECS and, in turn, advance the funds to Royal Reef Resort Ltd., which owned the underlying property of the proposed resort.

[122] Paatz testified that there were various loan agreements pertaining to the flow of funds from ECS to EII and from EII to Royal Reef Resort Ltd. At the hearing, Paatz described a Facility Agreement between ECS and EII dated April 30, 2004 pursuant to which ECS made available to EII a loan facility with a maximum limit of $10.0 million. EII then advanced the same amount to Royal Reef Resort Ltd. under a separate Facility Agreement dated May 10, 2004 pursuant to which EII made available to Royal Reef Resort Ltd. a loan facility with a maximum limit of $10.0 million.

[123] Paatz testified that, although the ECS Preferred Share Agreements make reference to a corporate guarantee, no such guarantee was executed. He also testified that Twerdun later insisted on an "assignment of all security, and via GSA". As a result, a GSA was entered into between ECS and FFI on May 5, 2004.

[124] In addition, Paatz testified that there were GSAs between ECS and EII and between EII and Royal Reef Resort Ltd. He testified that, while he was able to file the former GSA, he was not able to file the latter because "there wasn't any system available to do it" (Hearing Transcript dated October 13, 2011 at p. 39). Paatz testified that ECS continued to provide reports to FFI and Twerdun on a monthly or quarterly basis, and he believed that either he or Hall notified Twerdun that the GSA between EII and Royal Reef Resort Ltd. could not be filed, which meant that the loan was unsecured.

[125] Paatz confirmed in his testimony that no charge or other security interest was registered against the Royal Reef Resort property on behalf of ECS, EII or FactorCorp to secure FFI's loan advances. Meridian Trust, a local trust fund in the Turks and Caicos Islands that provided funding for the project, and TDMG Concordia, the construction company that was retained to develop the property, were provided with security interests in the property. More specifically, Meridian Trust was subsequently provided with a first mortgage in the amount of $7.0 million in 2006 or 2007 and TDMG Concordia with a second mortgage in the amount of $6.3 million.

[126] Paatz testified that, following the commencement of construction, he began marketing the Royal Reef Resort. Advance sales in the amount of $32.0 million were made and deposits of $15.0 million were received. Paatz testified that, in or about September 2006, construction of the Royal Reef Resort was halted due to the lack of funding by FFI. He testified that, by that time, the project was "about a third complete as far as the first phase is concerned" (Hearing Transcript dated October 13, 2011 at p. 87). By April 2007, ECS had difficulty making dividend payments to FFI.

[127] Paatz confirmed that, at the time of the hearing, no further progress had been made to develop the project and he was looking for a buyer for the property.

[128] In his cross-examination, Paatz acknowledged that the preferred shares were convertible to cash.

(b) Expert Evidence

[129] Based on the documents and information provided to her, it was Shain's opinion that FFI's investment in ECS was not a loan.

[130] Shain opined that ECS failed to take tangible security from its borrowers, including EII and Royal Reef Resort Ltd. Approximately $10.0 million of the funds received from Debenture holders was loaned through an ECS single purpose subsidiary, EII, to finance the construction of a resort condominium project in the Turks and Caicos Islands. Although a GSA was received from Royal Reef Resort Ltd., no specific mortgage security was registered against the property. As there were several mortgages and other claims totaling over $30.0 million already either registered against the resort or which otherwise had priority, the GSA was effectively unsecured.

[131] ECS's financial statements for 2005 and 2006 show negative net worth of $1.2 million and $3.7 million, respectively. According to Shain, this fact turns FactorCorp's preferred share advance into an indefinite commitment. In her review, Shain did not see any documented follow-up with respect to ECS's delinquencies or its potential insolvency.

[132] Shain reported that there were no security schedules, appraisals or external confirmation of collateral values in the client files. She observed that appraisals were only requested in response to an audit and were never received.

[133] Twerdun valued the Royal Reef Resort at $30.0 million and treated it as encumbered only by the $14.0 million that was owed to FactorCorp. Shain opined that FactorCorp's clients (ECS or EII) did not have a specific charge on the property and the property was already indebted for more than its value. Shain saw little evidence of any ongoing valuation of tangible collateral security against loan value.

(c) The Position of Staff

[134] Staff submits that FFI's investment in ECS was not a loan and not properly secured. Staff further submits that FFI failed to conduct due diligence with respect to its loan to ECS. Each of these arguments will be discussed in further detail below.

(i) FFI's investment was not a loan

[135] Staff refers to the Supreme Court's decision in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558 ("***CDIC***") at paras. 51 and 52 as authority for the proposition that the proper characterization of the ECS Preferred Share Agreements depends on the intention of the parties as expressed in the words chosen by them in the agreement. Staff submits that if the words of the agreements themselves are not determinative, the surrounding circumstances may be analyzed. According to Staff's reading of *Royal Bank of Canada v. Central Capital Corp.*, [1996] O.J. No. 359 (O.C.A.) ("***Central Capital***") at paras. 79 and 131, the surrounding circumstances include the articles of incorporation, the company's books and records and the conduct of the parties.

The language in the agreement

[136] Staff submits that, on their face, the ECS Preferred Share Agreements were evidently not loans. Staff argues that the second recital as well as clauses 1 and 2 of the ECS Preferred Share Agreements provide the substance of the transaction. The second recital of the Preferred Share Agreements states:

> Whereas "The Investor" desires to purchase a 14% Class "C" Preferred Shares in ECS for which it will receive a monthly paid dividend on said money, before the last business day of each month.

[137] Clauses 1 and 2 of the ECS Preferred Share Agreements state:

> "The Investor" shall deliver to ECS a sum of $_____CAD, upon the execution of this agreement, in exchange for ______ ECS 14% Class "C" Preferred Shares from its treasury.
>
> ECS shall pay to "The Investor" a 14% per annum dividend in twelve equal payments from the date this Agreement is accepted. The dividend will be treated as 'dividend' income as outlined under the CCRA tax act. Payments will continue until the term of this Agreement expires or at such a time as ECS repurchases the 14% Class "C" Preferred Shares.

[138] Staff submits that the express words used in these provisions, such as "Investor", "purchase", "preferred shares", "dividend" and "treasury", are all part of the language of corporate investment and not debt. Staff's view of the substance of the transaction based on the foregoing is that FactorCorp purchased preferred shares of ECS and ECS guaranteed a 14% dividend on the purchased shares.

[139] While Staff recognizes that debt language and concepts are present in the ECS Preferred Share Agreements, they are, in Staff's submission, secondary to the Class C preferred share acquisition by FactorCorp. According to Staff, when one is searching for the substance of a particular transaction, one should not be too easily distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement (*CDIC*, *supra*, at para. 55).

Surrounding circumstances

[140] Staff submits that the ECS Preferred Share Agreements, ECS's Articles of Incorporation and the surrounding circumstances all suggest that the heart of the transaction was an investment by FactorCorp in the preferred shares of ECS.

Staff's legal submissions

[141] Staff argues that the proper characterization of the ECS Preferred Share Agreements engages corporate law and the corporation's Articles of Incorporation. This is because the *Business Corporations Act* (Ontario), R.S.O. 1990, c. B.16, as amended (the "**OBCA**") and the common law relating to corporations, which apply to ECS, govern the priority of claims and place restrictions on the ability of a corporation to issue and redeem shares and to declare and redeem dividends.

[142] As a starting point, Staff submits that one of the foundations of corporate law is that a corporation's creditors should have priority over the corporation's shareholders (Kevin McGuinness, *Canadian Business Corporations Law*, 2nd Edition (Markham: LexisNexis, 2007) ("**McGuinness**") at pp. 359 and 360).

[143] Staff refers to subsection 22(4)(a) of the OBCA for the proposition that a corporation may create classes of shares and the rights, privileges, restrictions and conditions attaching to a class of shares must be stated in the corporation's articles of incorporation.

[144] Staff then refers to subsection 23(3) of the OBCA for the proposition that a share is not validly issued by a corporation until consideration for the share is fully paid. According to Staff, pursuant to subsection 28(1)(a) of the OBCA, a corporation may not hold shares in itself (subject to statutory exceptions).

[145] Staff further submits that, pursuant to section 38 of the OBCA, the directors of a corporation may declare a cash dividend if the corporation can satisfy statutory solvency tests.

[146] Citing McGuinness, *supra*, at pp. 512 and 513, Staff submits that a director's power to declare dividends is discretionary. A shareholder may only sue for undeclared dividends in limited circumstances and a court will be unlikely to interfere with a director's exercise of discretion regarding the declaration of dividends. Once a dividend is declared, it is a debt to all shareholders entitled to payment and enforceable by the courts (McGuinness, *supra*, at p. 520).

[147] In Staff's submission, subsection 127(3)(d) of the OBCA provides that a director may not delegate the discretion to declare dividends to a committee of the board of directors or an officer. Staff submits that, by extension, a director may not delegate the authority to declare dividends by contract. A corporation cannot contract to guarantee dividends or pay interest on shares. According to Staff, such a contract is void.

[148] Staff submits that section 32 of the OBCA provides that a corporation, if authorized by its articles of incorporation, may repurchase its shares so long as it satisfies statutory solvency tests. The redemption price must be stated in the articles of incorporation either expressly or by formula.

Articles of ECS

[149] In Staff's submission, the terms of ECS's Articles of Incorporation are similar to those found in *Central Capital*, including retraction and redemption rights at a fixed price per share, fixed dividend entitlements, fixed per share entitlements on liquidation and dissolution in priority to other classes of shares, continuing shareholder rights if the corporation does not honour the retraction rights and limited voting rights. The Articles of Incorporation do not guarantee dividends but provide that dividends are payable "when, as and if" declared by the board of directors. Staff submits that the Articles of Incorporation unambiguously point to the creation of an equity relationship.

Debt features of the ECS Preferred Share Agreements inconsistent with Articles

[150] Staff submits that a review of the debt features of the ECS Preferred Share Agreements reveals an attempt to guarantee dividends within an equity relationship rather than the creation of a debtor-creditor relationship.

[151] Staff submits that clauses 3 and 4 of the ECS Preferred Share Agreements deal with the repurchase of the preferred shares at the option of FactorCorp or ECS, respectively. They provide that:

> This Agreement shall remain in effect for a period of __ year(s) and shall automatically renew for identical periods, upon the same conditions herein set forth, until The Investor furnishes ECS with 90 days advanced written notice of it's [*sic*] intention not to renew the agreement at the expiration of the current term. At which time ECS agrees to return the Principal and pro-rated interest in exchange for the Class "C" Shares.
>
> It is agreed that ECS will provide 60 days written notice if it is their intention to pay out the principal and pro-rated interest to The Investor. The Investor agrees to return the Class "C" Shares once the principal and pro-rated interest is received.

[152] Staff submits that both clauses state that, once the repurchase rights are exercised, FactorCorp will return the Class C preferred shares. According to Staff, however, instead of stating the price per share on repurchase, both clauses refer to "the Principal and pro-rated interest". "Principal" is not a defined term in the ECS Preferred Share Agreement

and neither "Principal" nor "interest" appears in any other part of the ECS Preferred Share Agreements.

[153] It is Staff's submission that clauses 3 and 4 also provide that, if either ECS or FactorCorp exercises its repurchase rights, FactorCorp will return the preferred shares to ECS. Staff submits that this is significant because if clauses 3 and 4 were repayment of debt provisions, the lender would have no cause to give anything of value to the debtor in return for repayment. Staff submits that the fact that the preferred shares must be returned under the ECS Preferred Share Agreements meant that ECS was buying back the shares it sold to FactorCorp under the ECS Preferred Share Agreements.

[154] Staff argues that clauses 3 and 4 should be interpreted as contractual versions of the redemption and retraction rights in subsections 5(K) and (L) of ECS's Articles of Incorporation. Subsection 5(K) of the Articles of Incorporation includes the redemption rights attaching to the Class C preferred shares. It states that:

> The corporation may, upon giving notice as hereinafter provided, redeem the whole or any part of the Class C shares upon payment of the sum of $1.00 for each share to be redeemed, together with all accrued and unpaid fixed preferential cumulative cash dividends thereon.

[155] According to Staff, subsection 5(K) of the Articles of Incorporation addresses redemptions and dividends but is the functional equivalent of clause 4 of the ECS Preferred Share Agreements. Instead of "Principal and pro-rated interest", subsection 5(K) of the Articles of Incorporation refers to "price per share" and "unpaid fixed preferential cumulative cash dividends".

Security features of the ECS Preferred Share Agreements are void

[156] Clause 5 of the ECS Preferred Share Agreements provided that "ECS agrees to secure the Class 'C' Preferred Shares by a corporate guarantee, assignment of all security and via GSA".[10] Staff submits that this clause suggests a debtor-creditor relationship, however, the security obligations in clause 5 are contrary to the OBCA with the result that the GSA registered under the PPSA was unenforceable against ECS. Staff submits that, instead of evidencing a debt, clauses 2 and 5 of the ECS Preferred Share Agreements suggest that the parties were attempting to secure a promise to pay continuous dividends in the ECS Preferred Share Agreements in the context of an equity relationship.

[157] Staff argues that the preferred shares of a corporation cannot be used as security for a loan by the issuing corporation under the OBCA. Subsection 23(3) of the OBCA provides that shares of a corporation are not lawfully issued until consideration for the share is fully paid. Staff submits that, based on subsection 23(3) of the OBCA, a corporation cannot issue shares without first receiving funds. If the money paid for the preferred shares was in substance a loan and not a purchase of shares, the preferred shares

[10] See also paragraph [116].

were not validly created. Staff argues that none of the documents reviewed suggests that the preferred shares were not validly created.

[158] Staff further argues that if the intent of clause 5 was to secure the obligation to pay dividends in clause 2, this represented an attempt to guarantee the Class C preferred share dividends in contravention of both ECS's Articles of Incorporation and corporate law. Subsection 22(4)(a) of the OBCA provides that the rights attaching to different classes of shares must be set out in the articles of incorporation. ECS's Articles of Incorporation provide that Class C preferred shareholders have a right to a fixed dividend "when, as and if declared by the board of directors of the corporation…". Staff takes the position that ECS could not, therefore, have validly guaranteed the future payment of dividends. In Staff's submission, clause 2 of the ECS Preferred Share Agreements is void.

[159] Staff submits that ECS could not contract out of the obligations of directors under the OBCA. According to Staff, subsection 127(3)(d) of the OBCA prevents directors of a corporation from delegating the authority to declare dividends.

[160] Staff submits that a corporation cannot create "secured" corporate shares and refers to the following passage in *Central Capital* to support its submission:

> Holders of preferred stock of a corporation, in the absence of express provision to the contrary, are stockholders and not creditors of the corporation, except for dividends declared. They have no lien upon, and are not entitled to, any of the assets of the corporation when it becomes insolvent, until all debts are paid. <u>Furthermore, there is authority that the status of a preferred stockholder is not changed to that of creditor, even though a dividend is guaranteed. Indeed it is beyond the power of a corporation to issue a class of stock, the holders of which are entitled to preference over general creditors.</u>
>
> …
>
> Even where preferred stock has a fixed redemption date, arrival of that date does not change the status of a preferred stockholder to that of a creditor.
>
> [Emphasis added.]
>
> (*Central Capital*, *supra*, at para. 143 citing Bjor and Reinholtz, Fletcher Cyclopedia of the Law of Private Corporations (1990), revised, vol. 15A.)

[161] Staff further submits that it was impossible for Paatz and Hall to have had reasonable grounds to guarantee the solvency of ECS in the future because section 101 of the BIA provides for the liability of directors who authorize dividends paid or shares redeemed by a corporation within a year of an initial bankruptcy event in certain circumstances, including where "the directors did not have reasonable grounds to believe that the transaction was occurring at a time when the corporation was not insolvent or the

transaction would not render the corporation insolvent". It follows in Staff's submission that the purported guarantee of future dividends is illegal.

[162] Staff submits that, in any event, the ECS financial statements provided to FactorCorp for 2005 and 2006 show negative net worth of $1.2 million and $3.7 million, respectively. Staff submits that all purchases of preferred shares in 2006 and 2007 (totaling $2.2 million) were made in the face of ECS's insolvency and concomitant inability to redeem the preference shares.

ECS financial statements show Class C shares as "capital stock"

[163] Staff notes that, in ECS's financial statements, ECS lists its preferred classes of shares as liabilities, but not as debt or shareholder equity. According to Staff, the fact that ECS recorded the preferred shares as a liability in the amount of the retraction price demonstrates that it acknowledged that the preferred shares would have to be redeemed at a certain date.

[164] Staff argues that the 2004 and 2006 financial statements demonstrate that ECS was rolling-over the amounts owed on un-retracted preferred shares into future years.

[165] Staff points out that, despite the fact that ECS recorded its preferred shares of all classes as liabilities, it also listed these shares in the "capital stock" section of its financial statements along with the common shares. Staff argues that, ultimately, the fact that the preferred shares are listed as capital stock of the corporation should outweigh the fact that ECS recorded the retraction price as a liability. In Staff's submission, the preferred shares were part of the authorized capital of ECS and not some other debt instrument.

Paatz and Twerdun treated the transaction as an equity investment

[166] In Staff's submission, the evidence of Paatz is that Twerdun agreed to advance funds by way of equity instead of continuing his previous practice of using debt instruments such as term notes. Staff argues that, as the entity providing the funds, FFI had the leverage to determine the transactional structure but, ultimately, FFI agreed to the ECS Preferred Share Agreements.

[167] It is Staff's position that Twerdun confirmed, by his conduct, that he viewed FactorCorp's involvement in ECS as an investor in two letters confirming FactorCorp's ECS shareholdings. According to Staff, in two letters signed back to ECS's auditor by Twerdun, FFI was asked whether it agreed it was a preferred shareholder of ECS and was provided with the opportunity to dispute or clarify the nature of FFI's transaction with ECS as follows:

> Do you agree with the above? If you do, would you please sign this letter in the space below. However, if you do not, would you please note at the foot of this letter or on the reverse side, the details of any differences.

In Staff's submission, Twerdun acknowledged that FFI was a shareholder of ECS and did not disagree or dispute the nature of the transaction for any reason.

[168] Staff further argues that the series of attempted restructurings of the transactions into loans further indicate that Twerdun acknowledged the equity relationship between FactorCorp and ECS by his stated desire to convert FactorCorp's equity position into debt.

Staff's concluding submissions

[169] Staff submits that the purchase of preferred shares in a corporation presumptively creates an equity relationship between the purchaser and the corporation. According to Staff, any express language in the relevant documents, including the articles of incorporation and the purchase agreements, that the preferred share purchase creates a creditor-debtor relationship is inconsistent with the articles and void at law.

[170] Staff takes the position that the true legal substance of the transaction is the acquisition by FFI of the preferred shares of ECS. Staff submits that the parties' attempt to guarantee and secure dividend payments and the retraction rights associated with the preferred shares by contract is in violation of laws governing the corporation.

(ii) ECS investment was not properly secured

[171] Staff submits that FFI's investment in ECS was not properly secured. First, Staff submits that the obligation to pay dividends is unenforceable. Staff submits that clause 2 of the ECS Preferred Share Agreements, which purports to guarantee the future payment of dividends, is unenforceable due to statutory illegality. According to Staff, it follows that the GSA between FFI and ECS becomes unenforceable with respect to any contractual promise to pay uninterrupted dividends. Staff submits that, in any event, the GSA was only adopted nearly a year after the purchases began.

[172] Staff further submits that subsection 9(1) of the PPSA establishes freedom of contract between parties to a security agreement, subject to the provisions of any other legislation. It is Staff's position that, since the OBCA invalidates clause 2 of the ECS Preferred Share Agreements, that obligation cannot be recognized under subsection 9(1) of the PPSA. Staff submits that, if clause 2 is not recognized as a securable obligation under the PPSA, the GSA is unenforceable in that regard and FFI has no right to realize on the collateral under the GSA for a breach of clause 2 of the ECS Preferred Share Agreements.

[173] Staff submits that this was exactly the situation that FFI found itself in by April 2007. That is, ECS advised FFI that it could no longer pay dividends and FFI had no ability to enforce ECS's obligation to do so.

[174] Staff also takes the position that the ECS investment was not properly secured because the priority of any security validly granted was not ensured. In Staff's submission, apart from the fact that the ECS transaction's true substance is that of an equity investment, the underlying security, even if valid, was suspect. FFI had a GSA relating to ECS's assets. In turn, ECS had a GSA relating to EII's assets and EII had a GSA relating to Royal Reef Resort's assets. However, Staff submits that the latter security agreement could not be registered in Ontario and was not registered in the Turks

and Caicos Islands. Accordingly, none of FFI, ECS and EII had a registered security interest in the property. According to Staff, Royal Reef Resort Ltd. could have granted, and did in fact grant, security on the lands to others with priority over any claim by EII, ECS or FFI. Staff argues that, as a result, any security interest granted indirectly in favour of FFI was subordinated to the secured creditors.

[175] Finally, Staff submits that the ECS investment was not properly secured because the value of the collateral was in doubt. Staff submits that the only asset of any value that FFI could have looked to was the property in the Turks and Caicos Islands, which was of unknown value. It was purchased for $2.7 million in 2004 and, between that time and 2007, approximately $15.0 million of FFI funds were spent to build a third of the first phase of the project. There was never any committed source of funding that would have ensured the completion of the project. In Staff's submission, absent a completed project, the value of a partially completed project is in doubt for obvious reasons. Staff submits that the inability of Royal Reef Resort Ltd. to sell the project to date further underscores the risk to which FFI exposed itself.

(iii) Failure to conduct due diligence

[176] In Staff's submission, Twerdun advanced approximately $15.0 million for the construction of the Royal Reef Resort notwithstanding the fact that ECS was not in the resort development business, neither of its two principals had any relevant experience, there was no independent market analysis to support the development's viability, the proposed development was located in a foreign jurisdiction in which none of them had any experience and for which there was no committed and reliable source of funding to complete the project. As a result, only one third of the first phase had been completed. Further, Staff submits that FFI advanced nearly $2.2 million to ECS notwithstanding financial statements that showed that ECS was insolvent. Accordingly, Staff submits that the Respondents failed to conduct due diligence and employ appropriate risk management practices to ensure acceptable risk.

(d) The Position of Twerdun

[177] Twerdun submits that he and FactorCorp relied on counsel in connection with its transaction with ECS. He submits that Buchan-Terrell, FactorCorp's counsel at the time, generated or reviewed all of the documentation, and FactorCorp relied on its counsel to structure the documentation to secure FactorCorp's position in the transaction. Twerdun emphasizes Buchan-Terrell's involvement by submitting that the funds provided to ECS were initially transferred through Buchan-Terrell's trust account.

[178] Twerdun argues that the ECS Preferred Share Agreements were a "specialized convertible debt instrument" and not a "straight share purchase". In support of his argument, Twerdun submits that the agreements had a "term" like a loan. In addition, Twerdun points to the language of the agreements that suggests a loan transaction, including that ECS agrees to "*secure* the Class 'C' Preferred Shares", that ECS agrees to "secure the Class 'C' Preferred Shares by…*GSA*" and that "all receivables purchased shall be *over collateralized*" [emphasis added]. Twerdun also refers to Paatz's testimony

as support for the proposition that the preferred shares were callable and convertible into cash or into a loan.

[179] Twerdun submits that he relied on ECS to govern itself in accordance with the terms agreed to by both parties. In addition, Twerdun submits that he relied on ECS's reports to FactorCorp about FactorCorp's assets within ECS's control. In Twerdun's submission, it was ECS, and not Twerdun or FactorCorp, that misrepresented its security and position, including a misrepresentation to FactorCorp that it was holding real estate as security with a loan to value ratio of 68%. Twerdun submits that ECS "mismanaged, deceived, manipulated and misrepresented the portfolio status".

[180] Twerdun submits that, while ECS provided its "credit policies and procedures" which outlined its "security", "risk management policy", "evaluation process" and "security" process, ECS did not adhere to its own policies. Twerdun submits that, despite this failure to adhere to its own policies, KPMG took no action against ECS to recover FactorCorp's assets from ECS which, in his submission, had a value of $44.0 million, and those assets to date remain in the control of ECS.

(e) Findings

[181] I find that FFI's purported investment in ECS was not a loan and that the amounts advanced were not secured. The Respondents were also negligent in permitting prior ranking security to be taken by third parties on the property in the Turks and Caicos Islands thereby negating any prospect of recovery. In addition, the amounts advanced to ECS represented, according to Shain, 38% of FactorCorp's portfolio, contrary to representations to investors that FactorCorp would ensure that the use of their funds would be diversified to reduce the risk of loss. The Respondents clearly failed to (i) undertake even a minimal standard of enquiry; (ii) impose minimal lending standards; or (iii) ensure adequate oversight with respect to the use of investor funds.

[182] Twerdun's attempts to ascribe the blame to his counsel and ECS ignores a number of undertaking provided by FactorCorp including the undertakings described at (i) paragraph [92] above to ensure that "[FFI] will utilize an assortment of proprietary financial structures, security, credit decisioning and administrative procedures to ensure that [FFI's] funds are used to build a profitable portfolio at acceptable risk"; and (ii) at paragraph [97] above that "Like a commercial bank, [FFI] obtains all appropriate security to minimize any losses" and that "Bank staff will be monitoring account activity and receivable quality in the traditionally conservative way".

2. FCB Financial Inc. (FCB)

(a) Zilkey's Evidence

[183] Zilkey testified that he was the principal of FCB, a corporation incorporated in or about September 2003. In his evidence, Zilkey described the business of FCB as funding "private loan transactions to commercial businesses in Ontario and in asset-backed lending receivables or research and development type tax credits" (Hearing Transcript

dated October 12, 2011 at p. 37). Zilkey testified that the loans made by FCB were higher risk and were subject to a rate of interest exceeding 18% per annum.

[184] In his testimony, Zilkey explained that the arrangement between FCB and FFI was one in which FFI advanced money to FCB which would, in turn, advance those funds to commercial businesses. He testified that, from September 15, 2003 to February 1, 2005, FCB entered into a number of agreements with FFI pursuant to which FFI advanced funds to FCB. On October 3, 2005, FCB and FFI entered into an Amending Agreement which replaced the numerous agreements made during the initial period from September 15, 2003 to February 1, 2005. Pursuant to the Amending Agreement, FFI made a revolving term loan to FCB in the principal amount of $8.0 million.

[185] According to Zilkey, FFI and FCB entered into GSAs pursuant to which FFI held security over the assets of FCB. At the hearing, Zilkey identified three such GSAs which were dated December 1, 2003, February 16, 2004 and October 3, 2005, respectively.

[186] Zilkey testified that, when FFI initially advanced funds to FCB, FCB was a start-up company which had no assets or operating history. As a result, no financial statements were provided to FFI at that time. It was agreed, however, that FCB would provide monthly reports to FFI. Zilkey did not recall completing a credit application or consenting to a background check until June 20, 2007. He testified that he did not remember having credit policies and procedures prior to 2005, and only provided copies to FFI in September 2005 in connection with some further amendments in October 2005 to the GSA dated February 16, 2004.

[187] Zilkey testified that, other than a line of credit provided to FCB by The Toronto-Dominion Bank in the principal amount of $200,000, FCB only received funding from FFI. FCB's use of the funds will be discussed in more detail below.

(i) Spaceworks and Ice Planet

[188] Zilkey testified that Spaceworks Entertainment Inc. ("**Spaceworks**") was in the business of film production and was engaged with Ice Planet Canada Ltd. ("**Ice Planet**") in the development of a science fiction television program called "Ice Planet". Zilkey identified the "primary principal, operating principal" of Spaceworks to be Phillip Jackson ("**Jackson**")(Hearing Transcript dated October 12, 2011 at p. 46).

[189] Zilkey testified that FCB used the funding provided to it by FFI to provide financing to Spaceworks and Ice Planet in the amount of approximately $4.0 million or $5.0 million.

[190] Zilkey testified that, at the time of FCB's loans to Spaceworks and Ice Planet, the TV program was at the "preproduction" stage. According to Zilkey, preproduction involved "items such as…putting together a cast, a crew, having a stage or a set built…the legal side of the funding,…looking for end buyers, negotiating rights, agreements and sales with buyers…typically would lead up to what's called the first day of principal photography, which is, as it states, the first day of shooting" (Hearing Transcript dated October 12, 2011 at p. 46).

[191] The collateral and security provided by Spaceworks and Ice Planet to FCB in connection with FCB's financing included:

(a) A GSA;

(b) A guarantee by an entity described in evidence as "Aurora" and as holding "a library of productions, completed productions/rights to complete a production" (Hearing Transcript dated October 12, 2011 at p. 57). The guarantee was secured by a GSA;

(c) A personal guarantee of Jackson not supported by any collateral;

(d) Personal guarantees of the other principals of Spaceworks supported by a pledge of their shares of Spaceworks; and

(e) A pledge of Ice Planet shares owned by Spaceworks.

[192] According to Zilkey, although no independent valuation had been undertaken in connection with Aurora's delivery of a guarantee and GSA, Jackson valued the film library owned by Aurora at $2.0 million. However, a lender in the United Kingdom referred to in evidence as "Freewheel" had prior ranking security over $600,000 to $700,000 of Aurora's assets.

[193] Zilkey testified that the assets of Spaceworks would have included, for example, a film library, tax credits in the amount of $100,000 (unrelated to Ice Planet) and GST rebates related to Spaceworks or Ice Planet. Based on the information provided by Spaceworks, Zilkey estimated that the value of the three items to be $650,000 in the aggregate.

[194] He also testified that the set for the production of Ice Planet would have been one of Spaceworks's assets. To Zilkey's knowledge, "there was significant money spent on the set and certainly seven figures" and could have been approximately $3.0 million (Hearing Transcript dated October 12, 2011 at p. 84). He testified that he was not aware that an appraisal had been undertaken with respect to the set.

[195] In Zilkey's evidence, Spaceworks's assets would also have included a potential tax credit for 25% to 35% of eligible production costs. According to Zilkey, the tax credits would have been "in and around sort of mid to high six figures to low seven figures" (Hearing Transcript dated October 12, 2011 at p. 66). Zilkey testified that no application for these potential tax credits was filed, nor were the credits supported by the typical tax specialist's estimate or accounting work required to make an application to obtain the tax credits.

[196] Zilkey testified that, although significant amounts of money were expended on pre-production costs, including approximately $3.0 million on the construction of the set, Spaceworks never commenced "the first day of principal photography" which, according to Zilkey, was required in order to apply for the tax credits. In the FCB monthly report to FFI dated February 28, 2006, Spaceworks is identified as being "delinquent" and having

an outstanding balance due of approximately $500,000. Zilkey testified that FCB made further advances to Spaceworks following that report. In the report dated October 31, 2006, Spaceworks is again identified as being "delinquent" and having an outstanding balance due of approximately $2.4 million.

[197] In his evidence, Zilkey recounted that there was no activity with respect to the Ice Planet production in late 2006 and early 2007. In early 2007, Spaceworks and Ice Planet were unable to pay rent on the property in which the set had been constructed and there had been discussions about the landlord possibly exercising its right to "foreclose…on the assets, being the set" (Hearing Transcript dated October 12, 2011 at p. 90). Zilkey confirmed that no further funding was provided to continue production and that the production of Ice Planet had never been completed.

(ii) Other sub-loans

[198] At the hearing, Zilkey also provided evidence about the status of other loans made by FCB to its borrowers including the following:

(a) FCB advanced $116,991 to 1131003 Ontario Ltd. carrying on business as MD Products. MD Products closed its plastics plant in Belleville in 2006 and FCB sued its principals under their guarantees to recover the shortfall.

(b) FCB advanced $293,501 to Yo Inc. FCB also sued the principals and guarantors of Yo Inc. under their guarantees in an attempt to recover the amount of the loan.

(c) FCB advanced $399,493 to Marathon Graphics Supply. The company was petitioned into bankruptcy by FCB in early 2007 after it was found to have engaged in what appeared to be fraudulent activity.

(d) FCB advanced $470,800 to Quality Flooring. The company was petitioned into bankruptcy by FCB in 2005.

[199] Zilkey testified the foregoing details would have been communicated to FFI as part of its monthly reporting.

(b) Expert Evidence

[200] Shain reported that FCB financed $4,550,000 of pre-production costs for a proposed science fiction television series that never went into production and failed to obtain tangible security from Spaceworks and Ice Planet. While FCB listed a government tax credit as security, film tax credits can only be obtained when a production has been completed. Accordingly, it is her opinion that it was inaccurate to consider the tax credits as security for a series that had not commenced production and had no committed means of doing so.

[201] In Shain's opinion, although Zilkey testified that several of the principals of Spaceworks and Ice Planet had given personal guarantees, some supported by a pledge of

shares and others not supported by any security, none of them were tangibly secured. Shain explained that, even if a guarantor has significant net worth outside his business, a personal guarantee is not considered to be tangible security unless it is supported by a specific assignment of security such as a collateral mortgage on a residence with an appraised value well in excess of the proposed loan, or a pledge of other assets such as marketable securities. According to Shain, personal guarantees that are supported by a pledge of shares of the guarantor's company (the borrower) are not considered as tangibly secured because (i) equity in private companies cannot be readily valued; and (ii) more importantly, personal guarantees are only called upon if the borrowing company cannot honour its debts, at which point, by definition, the equity is worthless. Accordingly, Shain opined that none of the guarantees given by the principals had any value from a security perspective.

[202] While FCB promised to and did provide status reports, Shain's evidence was that there was no documented follow-up with respect to delinquencies or the potential insolvency of FCB. A report from FCB dated February 28, 2006 clearly indicates that out of its 18 loans, nine were delinquent. One firm had voluntarily filed for bankruptcy and another was about to be petitioned into bankruptcy by FCB. Shain expected this to cause some alarm on the part of FFI given that it was FCB's primary funder, however, Shain saw no evidence of such concerns.

[203] It is not clear to Shain that FCB's reports were reviewed properly. The FCB report dated February 28, 2006 showed that half of FCB's loans were delinquent which fact would, according to Shain, cause most lenders to remove such loans from any value calculation.

[204] Shain noted that FCB's loans were all shown as current and their receivables were given full value despite the fact that many of them were delinquent and that the largest loan, namely, the loan to Ice Planet and Spaceworks, was effectively unsecured and repayment was doubtful. In Shain's opinion, it was not correct to give value to receivables the payment of which was in doubt.

(c) The Position of Staff

[205] Staff submits that Twerdun failed to obtain "independent valuations by conservative industry sources (e.g., real estate and equipment appraisers, tax valuations, etc.) based on either liquidation values or a conservative advance rate (e.g., 70%) of market value" as represented in the OMs and that there were serious problems with the value of the collateral for FCB. It is Staff's position that the value of the collateral in respect of the FCB advances to Spaceworks of $4.55 million was never ascertained.

[206] Staff further submits that FactorCorp failed to conduct due diligence with respect to FCB and that there was no committed, reliable source of funding to complete the Ice Planet series. According to Staff, the whole venture was speculative because it depended on the ability of Spaceworks and Ice Planet to complete and sell the television program, neither of which was reasonably probable when FFI advanced its loan. In addition, FFI

advanced nearly $1.5 million to FCB from February 2008 to October 2008 in the face of a "stunning portion of delinquencies in the FCB portfolio".

(d) The Position of Twerdun

[207] Twerdun submits that Zilkey was an experienced lender with over 12 years of experience working at The Toronto-Dominion Bank in commercial and corporate lending.

[208] Twerdun takes the position that he trusted Zilkey and relied on him to adhere to the lending practices outlined in the materials provided by FCB to FactorCorp. However, Zilkey failed to secure his portfolio as agreed to in his materials and documentation. Twerdun emphasizes that FCB provided FactorCorp with a Credit Policies and Procedures document, and, in Twerdun's submission, he should not be held completely responsible for FCB's violation of its own process.

[209] Twerdun further submits that he relied on the reports provided to him by FCB. According to Twerdun, Zilkey acknowledged in cross-examination that, when he provided the reports about the state of FCB's portfolio to FactorCorp, he believed that FCB's assets were not at risk. Twerdun submits that this was the same sentiment that was relayed to him in several reviews in 2006 and 2007. Twerdun submits that he discussed FCB's delinquency with Zilkey and Zilkey dismissed it as typical small business delays and of no consequence.

[210] Twerdun submits that the loan documents were reviewed by counsel, and that he was entitled to rely on his counsel's advice.

(e) Findings

[211] I find that the Respondents failed to (i) properly assess the risks entailed in FCB's loans to Spaceworks and Ice Planet which were reliant, in part, on tax credits which could only be obtained when film production had been completed; (ii) ensure that an independent valuation was obtained; (iii) ensure that appropriate security was obtained with respect to the approximately $3.0 million expended on the construction of the set in a building that was not owned by Spaceworks or Ice Planet; (iv) exercise appropriate oversight with respect to FCB's activities; and (v) take prompt remedial action in the light of the significant number of delinquencies in FCB's loan portfolio.

3. Mohawk Business Solutions Group (MBSG)

(a) Searle's Evidence

[212] The evidence obtained during the voluntary interview of Searle on April 1, 2009, disclosed that MBSG was an unincorporated business owned by Searle and was registered with the Mohawk Council of Akwesasne on September 24, 2001. MBSG's business registration describes its business as "operating in the area of business consulting and financial management". It appears that Twerdun engaged MBSG as an intermediary to facilitate the enforcement of security for the loans.

[213] The evidence also disclosed that FFI made loans to MBSG in the aggregate amount of approximately $1.7 million.

[214] The transcript of the voluntary interview of Searle shows that FFI made loans to MBSG to fund the construction of two gas stations and to assist Four Directions Petroleum (First Nation) Inc. (“**Four Directions**”), a company owned by Ronald Cook (“**Cook**”), in its business of distributing fuel to gas stations located on reserves in Canada and the State of New York.

(i) Loans for the construction of two gas stations

[215] The evidence of Searle indicated that FFI funds were loaned by MBSG to Cook doing business under the name “Trade Zone” to finance the construction of a gas station located on the New York side of the Akwesasne Mohawk reserve. Additional funds were provided to an unknown entity controlled by Cook’s family for the construction of the second gas station in Salamanca, New York.

[216] The loans were secured by a GSA provided by MBSG to FFI dated January 16, 2004. Searle testified in his voluntary interview that MBSG, in turn, obtained GSAs from Trade Zone and the owner of the Salamanca gas station, however, these documents were never found. According to Searle, Twerdun engaged Searle in connection with the transaction on the basis of his understanding that, as an Indian, Searle could enforce security on assets located on an Indian reserve.

[217] Searle indicated that, while he attempted to register the GSA provided by Trade Zone in the State of New York about a year after the loan advances were made, he was not successful because the gas station was located on the reserve and the reserve did not have a registry system in place. He also learned that any security agreement with respect to the Trade Zone gas station could not be enforced without the permission of the New York Akwesasne Mohawk tribe.

(ii) Loan to assist Four Directions in continuing operations

[218] In his voluntary interview, Searle identified a demand note dated March 13, 2004 evidencing a 180-day term loan in the principal amount of $250,000 made by FFI to MBSG and Four Directions.

[219] The demand note described that the purpose of the loan was “[t]o provide investment for distribution of petroleum products to First Nations fuel stations on reserves in Canada and United States of America”. In his voluntary interview, Searle clarified that this loan was not related to the construction of the two gas stations. He gave evidence that Four Directions was involved in litigation and a monitor was appointed. As a result, “there was no further money coming in” and Cook approached Twerdun for assistance (Transcript of the Voluntary Interview of Searle dated April 1, 2009 at p. 62). Searle believed that the funds advanced by FFI were being used for the “purchase of fuel and company bills during the fight that they were having” or for legal fees incurred in connection with the litigation (Transcript of the Voluntary Interview of Searle dated April 1, 2009 at p. 58).

[220] Searle provided evidence in the voluntary interview that the funds advanced were provided directly to Cook. Searle was only involved in the transaction for "reputational purpose" or as a "safeguard" (Transcript of the Voluntary Interview of Searle dated April 1, 2009 at p. 65).

[221] On March 14, 2004, Searle and Cook provided written personal guarantees, each limited to the sum of $250,000, as security for the loan.

[222] Searle gave evidence that, while some interest payments were made, the principal of the loan was not repaid.

(b) Expert Evidence

[223] In Shain's report, she characterized the loan as being made through an Indian business entity to fund the construction of two gas stations on a cross-border reserve. MBSG was the borrower and executed a GSA, however, it does not appear that MBSG owned the gas stations. One of the stations was owned by Cook and the other by someone else. Although it appears that the use of MBSG as an intermediary was meant to provide assurance that collateral security could be enforced, FactorCorp did not appear to have investigated the practical and legal uncertainty relating to the seizure of collateral on a reserve, nor was it clear that MBSG had the ability to pledge its assets. According to Shain, personal guarantees limited to $250,000 were obtained from Searle and Cook, the principals of MBSG and Four Directions, respectively, however, the guarantees were not secured and had no value from a security perspective for the reasons discussed in paragraph [201] above.

[224] Shain reported that there was no evidence of pre-funding due diligence relating to MBSG. While there were some sketches of the proposed gas stations and some invoices or estimates for the cost of the work, there were no forecasts, business plan, references or analysis of the risks associated with lending to a business on a First Nation reserve.

[225] Shain reported that FFI's advances to MBSG were for 100% of the costs of MBSG's projects.

(c) The Position of Staff

[226] Staff submits that the MBSG loan was unenforceable and was not secured. Staff's arguments will be discussed in further detail below.

(i) MBSG loan was unenforceable

[227] Staff submits that FFI's loan to MBSG was unenforceable because the personal property of an Indian located on a reservation cannot be used as collateral in a transaction with a non-Indian, nor can a judgment creditor garnish or execute against the assets of a judgment debtor who is a status Indian holding the property in question on reservation lands.

[228] In support of its position, Staff refers to section 88 of the *Indian Act*, R.S.C. 1985, c. I-5, as amended (the "**Indian Act**"), for the proposition that provincial laws of general application apply to Indians in the province to the extent that these laws do not conflict with the Indian Act, in which case the Indian Act prevails.

[229] Staff also refers to subsection 89(1) of the Indian Act which, according to Staff, operates as an exception to the application of provincial personal property security laws by shielding the personal property of status Indians situated on reserve lands from seizure, attachment, distress or garnishment in favour or at the instance of a non-Indian (*McDiarmid Lumber Ltd. v. God's Lake First Nation*, [2006] 2 S.C.R 846, at paras. 5 and 38). In Staff's submission, the elements of subsection 89(1) of the Indian Act must be fully satisfied to protect a status Indian's reserve-based property from civil process. They are (i) the Indian or band must have status under the Indian Act; (ii) the property must be situated on a reserve; and (iii) the security interest, attachment, levy, seizure and distress or execution must not be in favour of or at the instance of a non-Indian (*Alberta (Workers' Compensation Board) v. Enoch Band*, [1993] A.J. No. 576 (Alta. C.A.) at paras. 14 to 18). Staff also submits that transactions structured to avoid the provisions of subsection 89(1) of the Indian Act are unenforceable (*Benedict v. Ohwistha Capital Corp*., [2011] O.J. No. 31 at para. 22).

[230] Staff submits that FFI's GSA with Searle, carrying on business as MBSG, is unenforceable under subsection 89(1) of the Indian Act, as Searle was a status Indian, all of his property or property in the name of MBSG secured by the GSA was on the reservation, and the GSA was in favour of FactorCorp which is not a status Indian.

[231] As to tangible property, it is Staff's submission that Searle acknowledged that neither he nor MBSG had any property that would be subject to seizure under the GSA. Furthermore, Staff submits that there is no suggestion that any tangible property Searle held was held or stored off reserve lands.

[232] Staff submits that the only assets held by MBSG were forms of intangible property, debts secured by the pledges and GSAs relating to the gas station entities as well as MBSG's bank account. Staff submits that any debts due to MBSG would have been payable to MBSG's bank account on the reservation.

[233] Staff takes the position that, regardless of any other shortcomings under provincial personal property security regimes, the GSA between FFI and MBSG was evidently rendered unenforceable by subsection 89(1) of the Indian Act.

[234] Staff submits that, as a practical matter, the transaction structure agreed to by FFI to "secure" repayment could have easily and legally been defeated. By way of example, Staff submits that Searle could have refused to repay FFI while enforcing his security against the entities owning the gas stations. FFI could have successfully sued MBSG, but it would not have been able to execute the judgment because of subsection 89(1) of the Indian Act. It is Staff's submission that FFI was completely reliant on Searle's goodwill and had no legal security.

(ii) MBSG loan was not properly registered

[235] Staff further submits that the MBSG loan was not properly secured or registered. Assuming that FFI's security interest "attached" to MBSG's collateral, which assumes that the mere listing of the project numbers without actual addresses was sufficient to describe the gas station collateral, it is Staff's position that FFI did not perfect its interest by registering it under the PPSA in Ontario or the relevant statute in the State of New York. In addition, MBSG's GSAs with the gas station entities were never registered.

[236] Staff submits that the effect of perfection under the PPSA is that the secured party's interest in the debtor's collateral takes priority over other creditors, including unperfected secured creditors and the debtor's trustee in bankruptcy.

[237] Staff submits that had either of the gas station owners declared bankruptcy, MBSG would have ranked behind perfected secured creditors. Staff also submits that, had MBSG declared bankruptcy, FFI would have ranked behind perfected secured creditors and, furthermore, it would have been unable to directly enforce MBSG's security interest as a result of the provisions in the Indian Act.

(d) The Position of Twerdun

[238] According to Twerdun, Searle explained in his voluntary interview that his role for the last two decades was to act a "go between", to enforce security in Indian-related transactions and to collect debt and even assume control of debtors if necessary.

[239] Twerdun submits that Staff made reference to unrelated, out of context, case law that did not apply because Searle was able to collect from Indians. Twerdun submits that Searle acted for other parties in the same capacity as that for which FactorCorp had engaged him from 2007 to 2010.

[240] Twerdun submits that the funds FFI loaned to MBSG were guaranteed by Searle and Cook. Twerdun argues that both gas stations were built and are currently in operation. In Twerdun's submission, the gas stations, not including the land, were valued at approximately $1.7 to $2.1 million. Twerdun submits that, when Searle realized that KPMG was on a "witch hunt" and FactorCorp was bankrupt as a result of the actions of Farm Mutual, Searle looked for a means to take advantage of the situation. It is Twerdun's position that, if the Companies had been left in his control without the influence of KPMG or the Commission, the recovery outcome would have been optimized instead of minimized.

[241] Twerdun acknowledges that a GSA was signed but not registered as a result of the provisions of the Indian Act. According to Twerdun, FactorCorp would be able to enforce its security through MBSG and the guarantee provided by Searle. Twerdun points out that Searle also co-signed the promissory and demand notes which Twerdun submits were utilized to ensure that, if Searle did not act when required to enforce the security, FactorCorp could affect his credit rating as well as his ability to obtain corporate and personal financing.

(e) Findings

[242] I find that the loan transactions involving MBSG reflected what can only be described as a shocking dereliction by the Respondents of their duties to the investors. FFI made loans to MBSG aggregating approximately $1.7 million, the proceeds of which were used to finance the construction of two gas stations, at least one of which was to be located on the U.S. side of the Akwesasne Mohawk reserve, and to fund a fuel distribution service to gas stations located on reserves in Canada and the U.S. MBSG used the services of an intermediary, purportedly to assist in obtaining security on an Indian reserve. In fact, the loans were (i) entirely inappropriate, given the loan criteria represented to investors; (ii) totally unsecured and largely undocumented; and (iii) for the full amount of the expenses to be incurred, contrary to the representations of the Respondents to investors.

4. FFI's Loan Transactions

(a) Staff's Submissions

[243] Staff made submissions with respect to the following three additional loan transactions:

(a) The loan of $700,000 by FFI to Integra Investment Services Ltd. ("**Integra**") in June 2004 in connection with a larger loan in the amount of $2,500,000, the proceeds of which were used to discharge certain mortgages and the development of a property in British Columbia;

(b) The establishment by FFI of a revolving loan in favour of Sydcom Wireless Corp. ("**Sydcom**") in the principal amount of approximately $675,000 on February 14, 2007 which was intended to refinance a previous loan in the principal amount of $600,000 to Randy Aquino and Geraldine Borromeo, the principals of Sydcom; and

(c) The loan of approximately $9.3 million by FFI to Forbes Hutton Financial Inc. ("**Forbes Hutton**") in November 2004.

[244] Staff submits that the evidence demonstrates that none of the loan transactions described in paragraph [243] above was secured and that both Integra and Sydcom ceased operations when they became insolvent.

(b) Twerdun's Submissions

[245] Twerdun's submissions regarding the three loans transactions can be summarized as follows:

(a) With respect to the loan by FFI to Integra, Twerdun submits that FactorCorp received a "fully secured first mortgage" of the property, however, this mortgage "failed due to bankruptcy". He also submits that the low recovery of only $300,000 in this case was due to the fees of over $300,000 incurred by the Trustee and the "typical bankruptcy discounting by so called professional Trustees";

(b) With respect to the loan by FFI to Sydcom, Twerdun submits that it was always FactorCorp's intention to secure itself. He submits that this is evidenced by, for example, the GSAs between FFI and Sydcom dated December 5, 2005 and February 14, 2007 and the assignment of security dated February 14, 2007 in evidence; and

(c) With respect to the loan by FFI to Forbes Hutton, Twerdun submits that it was not his intention to enforce securities on sweepstake machines in the U.S. but to focus on the guarantee provided by Arnold Milan who is in Twerdun's submission a "multi millionaire who still resides in a multimillion dollar home, drives several exotic automobiles, and controls several business domestically and internationally".

(c) Expert Evidence

[246] Shain provided the opinion that, in general, FactorCorp operated without basic prudent lending practices, and without due regard to the statements that it made in the OMs and Promotional Materials as to the nature of the loans, the adequacy of the collateral and security and risk management practices.

[247] Shain reported that, notwithstanding the fact that the OMs and Promotional Materials represented that the investors' funds would be invested in short-term loans, i.e. loans having a term of one year or less, three of FactorCorp's 12 loans were for three years and represented 21.9% of the dollar volume of the loan portfolio. FactorCorp also made two loans representing 11.7% of the loan portfolio to two leasing companies whose underlying assets were leases with terms from three to seven years. Although the loans were technically payable on 90 days' notice, in reality this could not have been achieved given the length of the terms of the leases.

[248] Shain also reported that there was no tangible security for several direct loans made by FFI including the loans to Sydcom, MBSG/Four Directions and Ice Planet. Further, she opined that FactorCorp failed to ensure that certain Borrowers who were sub-lenders tangibly secured their loans in the manner described in the OMs and Promotional Materials. According to Shain, there was no evidence of any loan granted by FactorCorp or its Borrowers that was over-collateralized with a collateral mortgage on residential real estate. Shain also observed that FactorCorp did not require the Borrowers to place their own capital (or any capital) behind its advances, funding in effect 100% of the underlying loans that would be available to repay advances. It was therefore vulnerable to sub-lender credit error.

[249] In her report, Shain stated that the due diligence undertaken with respect to prospective borrowers "ranged from incomplete in some cases to virtually nil in others". There was "no evidence of a Credit Application, standard due diligence, stress testing, analysis or Credit Committee/Advisory board meetings or minutes in any of the files".

She further stated that FFI did not obtain or review regular reports to ensure that collateral coverage remained adequate and that underlying loans were current, nor did FFI monitor the reports received or follow-up on end-client delinquencies. FactorCorp did not maintain basic credit files and failed to have real estate collateral independently valued before advancing funds.

[250] Shain observed that, with the exception of ECS, there were no financial statements that pre-dated the initial loans to any clients. She recognized that FCB, MBSG, Ice Planet and four other companies were start-ups and had no history. These companies contributed to the heavy weighting in favour of unproven businesses which was in itself a significant risk factor.

[251] Shain also reported that, of the sub-lenders reviewed, only Lease Capital Corporation of Canada, Romco Capital Partners ("**Romco**")/Capmor Financial Services Group ("**Capmor**") and CanFactor Inc. appeared to have used advance rates for their respective borrowers that were consistent with industry standards, however, they were outside the 70% loan to value ratio described in the OMs. It was impossible for her to determine what advance rates, if any, were used by ECS, Forbes Hutton and FCB for their respective borrowers.

(d) Findings

[252] I find that the loans to Integra, Sydcom and Forbes Hutton were unsecured and both Integra and Sydcom became insolvent thereby precluding any recovery given the absence of security.

VII. ANALYSIS

A. Did FFI fail to file the OMs with the Commission in accordance with section 4.3 of Rule 45-501, subsequently amended on September 14, 2005 to section 6.4 of Rule 45-501, contrary to subsection 122(1)(c) of the Act?

1. The Law

[253] In Ontario, there is no obligation to prepare an offering memorandum for use in connection with a trade or distribution made in reliance on the accredited investor exemption. However, if an offering memorandum is delivered to a prospective investor in connection with a trade or distribution made in reliance on the accredited investor exemption, a copy must be filed with the Commission. During the Material Time, this requirement was set out in section 4.3 of Rule 45-501 and, following the amendment to Rule 45-501 on September 14, 2005, in section 6.4 of Rule 45-501 (see also Part 4 of the Companion Policy 45-501CP – To OSC Rule 45-501 ("**45-501CP**") prior to September 14, 2005 and Part 5 of 45-501CP following September 14, 2005).

[254] From January 1, 2004 to September 13, 2005, section 4.3 of Rule 45-501 provided as follows:

> **4.3 Delivery of Offering Memorandum to Commission** – If an offering memorandum is provided to a purchaser of securities in respect of a trade made in reliance upon an exemption from the prospectus requirement in section 2.1, 2.3 [the accredited investor exemption], 2.12 or 2.13, the seller shall deliver to the Commission a copy of the offering memorandum or any amendment to a previously filed offering memorandum on or before 10 days of the date of the trade.

[255] Following the amendment on September 14, 2005, Part 6 of Rule 45-501 governs the use of offering memoranda in distributions made in reliance on the accredited investor exemption from the prospectus requirement set out in section 2.3 of NI 45-106. Section 6.4 of Rule 45-501 requires that an offering memorandum be filed with the Commission as follows:

> **6.4 Delivery of offering memorandum** – If an offering memorandum is provided to a prospective purchaser, the seller must deliver to the Commission a copy of the offering memorandum or any amendment to a previously delivered offering memorandum within 10 days of the date of the distribution.

[256] Staff alleges that FFI's failure to file the OMs was a contravention of Ontario securities law under subsection 122(1)(c) of the Act. Subsection 122(1)(c) of the Act states that "Every person or company that,…contravenes Ontario securities law, is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both".

2. Analysis

[257] No issue was raised with respect to the provision of the OMs to investors by FFI in connection with its sale and distribution of the Debentures in reliance on the accredited investor exemption from the prospectus requirement. Accordingly, pursuant to section 4.3 of Rule 45-501, and subsequently section 6.4 of Rule 45-501 following the amendment on September 14, 2005, FFI was required to file copies of the OMs with the Commission.

[258] Based on the section 139 certificates introduced into evidence by Staff, I find that FFI failed to file any offering memorandum with the Commission during the Material Time in accordance with section 4.3 of Rule 45-501, subsequently amended to section 6.4 of Rule 45-501 on September 14, 2005, contrary to subsection 122(1)(c) of the Act and contrary to the public interest.

B. Did the Companies make materially misleading or untrue statements in the OMs which are documents required to be filed or furnished under Ontario securities law, contrary to subsection 122(1)(b) of the Act?

1. The Law

[259] Subsection 122(1)(b) of the Act relates to the making of materially misleading or untrue statements in documents required to be filed with the Commission under the Act. It provides that:

> **122. (1) Offences, general** – Every person or company that,
>
> …
>
> (b) makes a statement in any application, release, report, preliminary prospectus, prospectus, return, financial statement, information circular, take-over bid circular, issuer bid circular or other document required to be filed or furnished under Ontario securities law that, in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading;…
>
> …
>
> is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both.

[260] The Act does not define the words "in a material respect". Commission case law has established that the words "in a material respect" impose a standard of materiality against which an impugned statement is to be judged (*Re Biovail Corp.* (2010), 33 O.S.C.B. 8914 ("***Biovail***") at para. 63). According to the Commission in *Biovail*:

> … the assessment of the materiality of a statement is a question of mixed fact and law that requires a contextual determination that takes into account all of the circumstances including the size and nature of the issuer and its business, the nature of the statement and the specific circumstances in which the statement was made.
>
> (*Biovail*, *supra*, at para. 69)

[261] In *Biovail*, the Commission held that it is appropriate to apply the reasonable investor standard to assess whether statements made in a news release, which was a disclosure document relied on by investors in making investment decisions, were misleading or untrue in a material respect. The Commission noted that the reasonable investor standard is "an objective test and applying it is ultimately a matter of judgment to be exercised in light of all of the relevant circumstances" (*Biovail*, *supra*, at para. 80). The reasonable investor standard has been articulated by the Commission as follows:

> … we will treat a statement as material if there is a substantial likelihood that a reasonable investor would consider the statement to be important in making an investment decision. By an investment decision, we mean a decision to buy, sell or hold shares. That will require us to determine whether the statement or omission would have assumed actual significance to a reasonable investor.
>
> (*Biovail*, *supra*, at para. 74)

[262] Staff submits that a due diligence defence under subsection 122(2) is not available to the Respondents. The subsection states that:

> **122(2) Defence** – Without limiting the availability of other defences, no person or company is guilty of an offence under clause (1)(a) or (b) if the person or company did not know and in the exercise of reasonable diligence could not have known that the statement was misleading or untrue or that it omitted to state a fact that was required to be stated or that was necessary to make the statement not misleading in light of the circumstances in which it was made.

2. Analysis

[263] In paragraphs [257] and [258] above, I found that the OMs were documents that were required to be filed under Ontario securities law. Accordingly, the making of materially misleading or untrue statements in the OMs would contravene subsection 122(1)(b) of the Act.

[264] As described in paragraph [82] above, some of the OMs were used in 2003, which was prior to the Material Time. However, as found in paragraph [83], I am satisfied that there were only minor differences between the various versions of the OMs and there is no evidence of any substantive amendments having been made to the form or forms in use during the Material Time. The statements with which Staff takes issue were consistent throughout the OMs and were made throughout the Material Time.

[265] The Respondents represented in the OMs throughout the Material Time that the proceeds derived from the sale of the Debentures would be used in factoring, asset-backed lending and leasing or similarly secured short-term loan transactions with tangible securities. The following are paraphrased summaries of other key representations by FFI in the OMs:

(a) Temporary loan transactions would be limited to circumstances in which there are independent valuations by conservative industry sources (e.g., real estate and equipment appraisers, tax valuations, etc.) based on either liquidation value or a conservative advance rate (e.g. 70%) of market value.

(b) FFI would utilize an assortment of proprietary financial structures, security, credit determinations and administrative procedures to ensure that its funds are used to build a profitable portfolio at acceptable risk.

(c) Specific security requirements will generally consist of elements of (i) GSAs registered in the first position over the receivables financed; (ii) acknowledgement/priority agreements from the current PPSA registrants; (iii) personal guarantees of the principal shareholders; (iv) collateral mortgages on residences, chattel mortgages on specific equipment, irrevocable letters of direction over cash receipts such as tax receivables; and (v) government or insurance company covenants or guarantees.

[266] As stated in the OMs, FFI's business was established to provide an investment opportunity primarily for "high net worth clients looking for a means of substantially increasing return on investment that has negligible stock market correlation". When addressing risk management practices, the OMs also stated the following:

> Recognising the risks inherent in the factoring business, the Corporation will engaged [*sic*] several factoring operators whose expertise in commercial finance generally and factoring/secured lending in particular provides the Corporation with a level of assurance that <u>the foregoing risks will be mitigated, and diversified</u>, to the extent practicable in the operation of the business. Because the Manager will deploy capital into several factoring operations <u>the risk will be significantly reduced</u>.
>
> …
>
> Overseen by the Manager [FFI], the Corporation will utilize an assortment of proprietary financial structures, security, credit decisioning and administrative procedures to ensure that the Corporation's funds are used to <u>build a profitable portfolio at acceptable risk.</u>
>
> [Emphasis added.]

[267] As exemplified by my findings in paragraphs [181], [182], [211], [242] and [252] above relating to the transactions between FactorCorp and its Borrowers, including ECS, FCB and MBSG, the evidence in fact disclosed that most of the loans made by FFI (i) were not short-term; (ii) substantially exceeded any advance rate that would be considered prudential for the level of risk represented to the investors, including the 70% advance rate that FFI represented in the OMs that it would use; (iii) were routinely unsecured or inadequately secured by unenforceable or unperfected security instruments; and (iv) failed to meet the majority of the lending standards which FFI represented to investors would be employed and maintained. It is also clear that neither Twerdun nor FactorCorp took any meaningful steps to preserve or protect the assets that had been purportedly secured when it became evident that the Borrowers or the sub-lenders were in financial difficulty.

[268] Twerdun argues that he relied on counsel to ensure that security was taken, that the OMs were filed and that generally he and the Companies were compliant with Ontario securities law. Other than Twerdun's testimony, the documents that were placed into evidence show that Buchan-Terrell expressly disclaimed any advice in respect of the GSA taken by FFI from ECS and its legal effect. I was not presented with any further evidence about the precise nature of the advice that Twerdun might have received.

[269] Twerdun also argues that he relied on the Borrowers to (i) conduct the necessary due diligence in respect of the loans which they would make to their respective borrowers; (ii) obtain proper security; and (iii) engage in risk management. Twerdun's justification for his inadequate stewardship clearly does not apply to the direct loans made by FFI and clearly would not warrant the failure of oversight when he engaged sub-lenders to disburse the funds that were received from investors.

[270] There is no evidence before me that (i) the Companies generally undertook any meaningful due diligence to ensure the creditworthiness and reliability of the Borrowers; (ii) the Companies followed even minimal industry standards in documenting and securing FFI's loans; or (iii) the Companies exercised appropriate oversight to ensure that the Borrowers complied with the undertakings relating to loans and security that they provided to Twerdun and the Companies. Most of the loans, including the loans to FCB, MBSG, Integra, Sydcom and Forbes Hutton, were effectively unsecured as illustrated by the evidence notwithstanding FFI's representations to investors about the quality of the assets against which it would lend and the nature of the security and advance rates that it would employ.

[271] The Companies also failed, as represented in the OMs, to oversee the loans and the financial condition of the Borrowers and ensure the maintenance of the value and enforceability of its security. The financing by ECS of approximately $15.0 million to finance the development of the Royal Reef Resort is an example of the failures by the Companies to oversee the use of funds advanced to its Borrowers and ensure that its Borrowers fulfilled their obligations to ensure the maintenance of the value and enforceability of their security.

[272] Given the nature of FactorCorp's business and the fact that sales of the Debentures appear to have been largely made on the basis of the contents of the OMs, reasonable investors would almost certainly have based their decisions to purchase Debentures, at least in substantial part, on the representations concerning security, oversight and risk set out in the OMs and, as a result, such statements were material at the time and in light of the circumstances under which they were made.

[273] Having concluded above that FFI failed to file the OMs as required under the Act and that the OMs were replete with statements that were misleading or untrue, I find that FFI made statements in documents required to be filed or furnished under Ontario securities law that, in a material respect and at the time and in the light of the circumstances under which they were made, were misleading or untrue, contrary to subsection 122(1)(b) of the Act and contrary to the public interest.

[274] With respect to the due diligence defence, I find that the defence is not available to the Companies. Twerdun's attempts to rebut Staff's allegations relating to the conduct by the Companies of their business including, in particular, the loan transactions between FFI and the Borrowers and the loan transactions between certain of the Borrowers and the sub-lenders, are totally without merit. In reality, Twerdun and FFI knew and in the exercise of reasonable diligence would have known that the statements repeatedly made to investors were untrue in a material respect at the time and in the circumstances made. As a result, I find that FFI is not entitled to the benefit of a due diligence defence.

C. Did the Companies make materially misleading or untrue statements in the Promotional Materials, contrary to subsection 126.2(1) of the Act?

1. The Law

[275] Subsection 126.2(1) of the Act provides that:

> **126.2 (1) Misleading or untrue statements** – A person or company shall not make a statement that the person or company knows or reasonably ought to know,
>
> (a) in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading; and
>
> (b) would reasonably be expected to have a significant effect on the market price or value of a security.

2. Analysis

[276] Subsection 126.2(1) of the Act did not come into force until December 31, 2005 and, accordingly, does not apply to any statements made by the Companies in the Promotional Materials prior to that date. Notwithstanding the foregoing, the evidence indicates that the Promotional Materials were used during, and prior to, the Material Time.

[277] The Promotional Materials include statements that were clearly intended to induce prospective investors to purchase Debentures by representing that FactorCorp would employ what can only be described as exemplary standards of diligence, documentation and security. The following extracts from the Promotional Materials cited by Staff in their written submissions and by Shain in her report are examples:

> "Asset based lending involves the securing of a loan with pristine assets. For example a home worth $500,000 could be used to secure a $200,000 loan and in addition, personal guarantees would be obtained as well."
>
> "For every investor dollar we manage we hold $1.63 in security."

> "The Corporation will consider other temporary loans where there is alternative and strong tangible security such as collateral mortgages on principal residences, chattel mortgages on manufacturing equipment, etc. In all such cases, the temporary advances are limited to circumstances in which there are available independent valuations by conservative industry sources (e.g., real estate and equipment appraisers, tax valuations, etc.) based on either liquidation values or a conservative advance rate (e.g., 70%) of market value."
>
> "FactorCorp is 100% secured by assets such as cash, SRED Government receivables, Federal and Provincial Government receivables, EDC Government Program, mutual funds, GICs, property, machinery, general security agreements, personal guarantees, contracts, etc."

[278] It is quite clear from the evidence summarized above that the Companies were not diligent and did not follow even minimal industry standards in documenting and securing the loans made to the Borrowers and ensuring that the same standards were followed in connection with the loans made by the Borrowers to the sub-lenders. For essentially the same reasons as are described in paragraphs [267] to [273] above, I find that the statements made by the Companies in the Promotional Materials were material to investors and that, from the outset, the Companies knew or reasonably ought to have known that many of their statements were, in a material respect and at the time and in the light of the circumstances under which they were made, misleading or untrue.

[279] As the statements made by the Companies in the Promotional Materials were designed to induce the investors to purchase Debentures and given my finding above that many of the statements were, in a material respect and at the time and in the light of the circumstances under which they were made, misleading or untrue, it follows that, had the investors known that such statements were untrue in a number of material respects, the Debentures would have had no value. As a result, the statements described in paragraph [277] above and many others of a similar nature in the Promotional Materials breached subsection 126.2(1) of the Act, contrary to the public interest.

D. Did FFI or Twerdun breach the Temporary Order, contrary to subsection 122(1)(c) of the Act?

1. The Law

[280] As set out in paragraph [256] above, subsection 122(1)(c) of the Act provides that:

> **122. (1) Offences, general** – Every person or company that,
>
> …
>
> (c) contravenes Ontario securities law,

> is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both.

[281] In *Re Limelight Entertainment Inc.* (2008), 31 O.S.C.B. 1727 ("***Limelight***"), the Commission held that a breach of a temporary cease trade order is contrary to subsection 122(1)(c) of the Act. In that case, the Commission stated that:

> "Ontario securities law" is defined in subsection 1(1) of the Act to include "… in respect of a person or company, a decision of the Commission or a Director to which the person or company is subject." The First Temporary Order and the Amended Temporary Order constitute decisions of the Commission under section 127 of the Act. Accordingly, any breach by the Respondents of the First Temporary Order or the Amended Temporary Order contravenes Ontario securities law.
>
> (*Limelight*, *supra*, at para. 200)

2. Analysis

[282] Staff alleges that, on July 13, 2007, FFI and Twerdun breached the Temporary Order by redeeming certain FFI securities. The relevant terms of the Temporary Order that was in force on that day, which was the initial Temporary Order issued by the Commission on July 6, 2007 pursuant to section 127 of the Act and would remain in force, unless extended, for 15 days after its making, were as follows:

> **IT IS HEREBY ORDERED** that, pursuant to subsection 127(5) of the Act that:
>
> …
>
> (c) pursuant to paragraph 127(1)1 of the Act, the following terms and conditions are imposed on the registration of FactorCorp and Twerdun, effective immediately:
>
> (i) Twerdun, FactorCorp and any company controlled, directly or indirectly, by Twerdun, and FactorCorp including but not limited to FactorCorp Financial, are prohibited from making redemptions and participating in or acquiescing to any act, directly or indirectly, in furtherance of a redemption of securities of FactorCorp and FactorCorp Financial;
>
> …

[283] At the hearing on the merits, Twerdun admitted in his evidence to causing FFI to make an electronic funds transfer on or about July 12, 2007 to repay certain investors the aggregate amount of $724,287.53. Twerdun's admission is consistent with banking statements and records introduced into evidence by Staff which show that 10 investors were paid an aggregate amount of $724,287.53 on July 13, 2007.

[284] Twerdun explained in his evidence that the foregoing repayment related to the redemption of "cash-backed securities" issued by FactorCorp. He takes the position, however, that the "cash-backed securities" were distinct from the Debentures and their redemption did not constitute a breach of the Temporary Order. More specifically, he testified that:

> The repayment of the cash-backed securities, or CBSes, on July 12th, 2007 I do not feel is a breach of the order. The monies were distributed to the rightful investors. CBSes were an investment distinct from the other assets of FFI. It had its own OM, had its own subscription, had its own security and was distinct and had quarterly interest payment frequency as opposed to the monthly that the main fund had. This issue was discussed with counsel before processing. It had no impact or relevance to the general FFI debenture holders.
>
> (Hearing Transcript dated October 17, 2011 at pp. 22 and 23)

[285] The terms of the Temporary Order made on July 6, 2007, which was in force on July 12 and 13, 2007 when Twerdun caused FFI to redeem the "cash-backed securities", prohibited Twerdun and FFI from "making redemptions and participating in or acquiescing to any act, directly or indirectly, in furtherance of a redemption of <u>securities of FactorCorp and FactorCorp Financial</u>" [emphasis added]. In other words, the Temporary Order prohibited Twerdun and FFI from redeeming any of the securities that had been issued by FFI, including the "cash-backed securities".

[286] One of the purposes of the Temporary Order issued in this case, as Twerdun acknowledged in an affidavit that he swore on July 16, 2007 in support of his application to vary or set aside the Temporary Order pursuant to sections 144 and 127 of the Act, was to "create a better opportunity to achieve a fair and orderly repayment to the holders of all Repayment Debentures and to protect the interests of all other Debentureholders" (Affidavit of Twerdun sworn July 16, 2007 at para. 26). I accept Staff's submission that FFI's redemption of the "cash-backed securities", which was caused by Twerdun, violated the Temporary Order.

[287] Twerdun also asserted in his evidence that he discussed the issue of redeeming the "cash-backed securities" with his counsel, however, I was not provided with further evidence in support of this assertion, including the nature of such discussions. Accordingly, I am not satisfied that Twerdun can avail himself of this defence.

[288] For the foregoing reasons, I find that Twerdun breached the Temporary Order, which breach was contrary to subsection 122(1)(c) of the Act and was contrary to the public interest.

E. Did Twerdun, as the sole officer and director of the Companies, authorize, permit or acquiesce in the Companies' contraventions of Ontario securities law and is he therefore responsible for such contraventions pursuant to subsection 122(3) or section 129.2 of the Act?

1. The Law

[289] Pursuant to subsection 122(3) and section 129.2 of the Act, a director or officer is deemed to be liable for a breach of Ontario securities law by an issuer when the director or officer authorizes, permits or acquiesces in the issuer's non-compliance with the Act.

[290] A "director" is defined in subsection 1(1) of the Act to include "a person acting in a capacity similar to that of a director of a company".

[291] An "officer" is defined in the same section of the Act to mean "the chair, any vice-chair of the board of directors, the president, any vice president, the secretary, the assistant secretary, the treasurer, the assistant treasurer, and the general manager of a company, and any other person designated an officer of a company by by-law or similar authority, or any individual acting in a similar capacity on behalf of an issuer or registrant".

[292] Subsection 122(3) of the Act, which applies to directors or officers of a company that contravened subsection 122(1) of the Act, provides that:

> **122(3) Directors and officers** – Every director or officer of a company or of a person other than an individual who authorizes, permits or acquiesces in the commission of an offence under subsection (1) by the company or person, whether or not a charge has been laid or a finding of guilt has been made against the company or person in respect of the offence under subsection (1), is guilty of an offence and is liable on conviction to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both.

[293] Section 129.2 of the Act, which applies to directors or officers of a company that fail to comply with Ontario securities law, states that:

> **129.2 Directors and officers** – For the purposes of this Act, if a company or a person other than an individual has not complied with Ontario securities law, a director or officer of the company or person who authorized, permitted or acquiesced in the non-compliance shall be deemed to also have not complied with Ontario securities law, whether or not any proceeding has been commenced against the company or person under Ontario securities law or any order has been made against the company or person under section 127.

[294] In *Re Momentas Corp.* (2006), 29 O.S.C.B. 7408 ("***Momentas***"), the Commission discussed the meaning of the terms "authorize", "permit" and "acquiesce" and the threshold for liability as follows:

> Although these terms have been interpreted to include some form of knowledge or intention, the threshold for liability under section 122 and 129.2 is a low one, as merely acquiescing [in] the conduct or activity in question will satisfy the requirement of liability. The degree of knowledge of intention found in each of the terms "authorize", "permit" and "acquiesce" varies significantly. "Acquiesce" means to agree or consent quietly without protest. "Permit" means to allow, consent, tolerate, give permission, particularly in writing. "Authorize" means to give official approval or permission, to give power or authority or to give justification.
>
> (*Momentas*, *supra*, at para. 118)

2. Analysis

[295] Twerdun was the sole director and officer of the Companies. He was responsible for ensuring that the OMs were filed with the Commission in accordance with Rule 45-501 and failed to do so. He further failed to ensure that the statements made in the OMs and Promotional Materials were not materially untrue or misleading despite the fact that, as Shain indicated in her report, Twerdun, as the sole director and officer, both sourced and adjudicated his own lending opportunities and knew or should have known that the statements made in the OMs and the Promotional Materials did not reflect the true state of his loan portfolio. In addition, Twerdun authorized FFI's breach of the Temporary Order by directing the redemption of securities issued by FFI.

[296] For the foregoing reasons, I find that Twerdun authorized, permitted or acquiesced in the Companies' contraventions of subsections 122(1)(b), 122(1)(c) and 126.2(1) of the Act and therefore contravened subsection 122(3) of the Act and is deemed to have failed to comply with Ontario securities law under section 129.2 of the Act.

F. Did Twerdun make materially misleading or untrue statements to the Commission, contrary to subsection 122(1)(a) of the Act?

[297] Subsection 122(1)(a) provides that:

> **122. (1) Offences, general** – Every person or company that,
>
> (a) makes a statement in any material, evidence or information submitted to the Commission, a Director, any person acting under the authority of the Commission or the Executive Director or any person appointed to make an investigation or examination under this Act that, in a material respect and at the time and in the light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or that is necessary to make the statement not misleading;
>
> is guilty of an offence and on conviction is liable to a fine of not more than $5 million or to imprisonment for a term of not more than five years less a day, or to both.

[298] I did not receive submissions from the parties regarding the application of subsection 122(1)(a) of the Act to misleading or untrue statements made during a hearing before the Commission. In the absence of such submissions and given my findings on the other issues, I do not find it necessary to make findings under subsection 122(1)(a) of the Act.

G. Did FFI and Twerdun fail to ensure that investors were entitled to rely on the accredited investor exemption, contrary to the public interest?

1. The Law

[299] Prior to September 14, 2005, the accredited investor exemption, which was set out in section 2.3 of Rule 45-501, stated that:

> **2.3 Exemption for a Trade to an Accredited Investor** – Sections 25 and 53 of the Act do not apply to a trade in a security if the purchaser is an accredited investor and purchases as principal.

[300] The term "accredited investor" was defined in section 1.1 of Rule 45-501 to include:

> (p) a promoter of the issuer or an affiliated entity of a promoter of the issuer;
>
> (q) a spouse, parent, brother, sister, grandparent or child of an officer, director or promoter of the issuer;
>
> (r) a person or company that, in relation to the issuer, is an affiliated entity or a person or company referred to in clause (c) of the definition of distribution in subsection 1(1) of the Act;
>
> (s) an issuer that is acquiring securities of its own issue;
>
> …
>
> (aa) a person or company in respect of which all of the owners of interests, direct or indirect, legal or beneficial, are persons or companies that are accredited investors;

[301] Several categories of accredited investors set out in section 2.3 of Rule 45-501 made reference to the term "promoter" and "distribution". These terms were defined in subsection 1(1) of the Act as follows:

> "distribution", where used in relation to trading in securities, means,
>
> …
>
> (c) a trade in previously issued securities of an issuer from the holdings of any person, company or combination of persons or companies holding a sufficient number of any securities of that issuer to affect materially the control of that issuer, but any holding of any person,

company or combination of persons or companies holding more than 20 per cent of the outstanding voting securities of an issuer shall, in the absence of evidence to the contrary, be deemed to affect materially the control of that issuer.

"promoter" means,

(a) a person or company who, acting alone or in conjunction with one or more other persons, companies or a combination thereof, directly or indirectly, takes the initiative in founding, organizing or substantially reorganizing the business of an issuer, or

(b) a person or company who, in connection with the founding, organizing or substantial reorganizing of the business of an issuer, directly or indirectly, receives in consideration of services or property, or both services and property, 10 per cent or more of any class of securities of the issuer or 10 per cent or more of the proceeds from the sale of any class of securities of a particular issue, but a person or company who receives such securities or proceeds either solely as underwriting commissions or solely in consideration of property shall not be deemed a promoter within the meaning of this definition if such person or company does not otherwise take part in founding, organizing, or substantially reorganizing the business;

[302] The term "affiliated entity" was defined in section 1.2 of Rule 45-501 as follows:

1.2 Interpretation — (1) In this Rule a person or company is considered to be an affiliated entity of another person or company if one is a subsidiary entity of the other, or if both are subsidiary entities of the same person or company, or if each of them is controlled by the same person or company.

(2) In this Rule a person or company is considered to be controlled by a person or company if

(a) in the case of a person or company,

(i) voting securities of the first-mentioned person or company carrying more than 50 percent of the votes for the election of directors are held, otherwise than by way of security only, by or for the benefit of the other person or company, and

(ii) the votes carried by the securities are entitled, if exercised, to elect a majority of the directors of the first-mentioned person or company;

…

(3) In this Rule a person or company is considered to be a subsidiary entity of another person or company if

(a) it is controlled by,

(i) that other, or

(ii) that other and one or more persons or companies each of which is controlled by that other, or

(iii) two or more persons or companies, each of which is controlled by that other; or

(b) it is a subsidiary entity of a person or company that is the other's subsidiary entity.

[303] Section 3.1 of 45-501 CP provided guidance regarding the due diligence that must be exercised by the seller to satisfy its obligations when relying on the accredited investor exemption:

> **3.1 Seller's Due Diligence** — It is the seller's responsibility to ensure that its trades in securities are made in compliance with applicable securities laws. In the case of a seller's reliance upon exemptions from the prospectus and registration requirements, the Commission expects that the <u>seller will exercise reasonable diligence for the purposes of determining the availability of the exemption used in any particular circumstances</u>. The Commission will normally be satisfied that a seller has exercised reasonable diligence in relying upon a particular exemption if the seller has obtained statutory declarations or written certifications from the purchasers, <u>unless the seller has knowledge that any facts set out in the declarations or certifications are incorrect</u>. In circumstances where a seller has recently obtained a statutory declaration or a written certification from a purchaser with whom a further trade is being made on an exempt basis, the seller may continue to rely upon the recently obtained statutory declaration or certification unless the seller has reason to believe that the statutory declaration or certification is no longer valid in the circumstances.
>
> [Emphasis added.]

[304] After September 14, 2005, the accredited investor exemption was set out in section 2.3 of NI 45-106 which provides that:

> **2.3 Accredited investor** – (1) The dealer registration requirement does not apply in respect of a trade in a security if the purchaser purchases the security as principal and is an accredited investor.
>
> (2) The prospectus requirement does not apply to a distribution of a security in the circumstances referred to in subsection (1).

[305] The definition of "accredited investor" set out in section 1.1 of NI 45-106 following September 14, 2005 no longer makes reference to "promoter" or "affiliated entity" of an issuer. However, it does include:

(t) a person in respect of which all of the owners of interests, direct, indirect or beneficial, except the voting securities required by law to be owned by directors, are persons that are accredited investors

2. Analysis

[306] The evidence shows that the Debentures were sold to investors pursuant to the accredited investor exemption.

[307] Staff introduced into evidence Accredited Investor Certificates which included a certification by the Debenture holders that they qualified as accredited investors based on certain criteria. Staff also provided a "Summary Sheet of Accredited Investor Due Diligence", supported by the Accredited Investor Certificates, which shows the number of Debentures holders who selected one or more of the criteria. In particular, the summary shows that:

(a) Thirty five investors whose investments totaled $1,974,286 represented that they were accredited investors within the meaning of criterion (p) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates as "a promoter of [FFI] or an affiliated entity of a promoter of [FFI]";

(b) Two investors whose investments totaled $100,000 represented that they were accredited investors within the meaning of criterion (q) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates as "a spouse, parent, grandparent or child of an officer, director or promoter of [FFI]";

(c) Two investors whose investments totaled $125,000 represented that they were accredited investors within the meaning of criteria (p) and (q) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates in the manner set out in subparagraphs (a) and (b) above;

(d) Twelve investors whose investments totaled $685,000 represented that they were accredited investors within the meaning of criterion (r) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates as "a person or company that, in relation to [FFI], is an affiliated entity or a person or company referred to in clause (c) of the definition of distribution in subsection 1(1) of the [Act]";

(e) Two investors whose investments totaled $100,000 represented that they were accredited investors within the meaning of criterion (s) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates as "[FFI], where it is acquiring securities of its own issue";

(f) One investor whose investment totaled $50,000 represented that he or she was an accredited investor within the meaning of criteria (r) and (s) of the accredited investor definition in the pre-amended Rule 45-501, described in the Accredited Investor Certificates in the manner set out in subparagraphs (d) and (e) above; and

(g) Five investors whose investments totaled $250,000 represented that they were accredited investors within the meaning of criterion (aa) of the accredited investor definition in the pre-amended Rule 45-501, and one investor whose investment totaled $35,000 represented that he or she was an accredited investor within the meaning of criterion (t) of the accredited investor definition in NI 45-106 following the amendment, described in the Accredited Investor Certificates as "a person or company in respect of which all of the owners of interests, direct or indirect, legal or beneficial, are persons or companies that are accredited investors".

[308] Although Twerdun testified that he reviewed the Accredited Investor Certificates, he admitted that he only reviewed them for "completion, not for content" (Hearing Transcript dated October 17, 2011 at p. 49). More specifically, he testified that:

> Only reviewed for completeness in terms of, you know, name, address, signatures, phone numbers, accredited investor certificate, the category had been selected, and that page A4 had a signature and a witness signature of the dealer who had recommended this and accepted it.
>
> (Hearing Transcript dated October 17, 2011 at p. 52)

[309] Twerdun also submits that he relied on Farm Mutual to ensure that the Debenture holders qualified as accredited investors and points to the following sections of the Distribution Agreement between FFI and Farm Mutual as support for his submission:

> 2.0 **Solicitations** During the term of this agreement, the Dealer[11] shall permit appointed Associates, who have met the Dealers criteria, to solicit or otherwise cause sales of the Suppliers'[12]product to the Dealers' clients, who meet the accredited investor criteria, as defined by the Commission, the commissions laws of regulations.
>
> …
>
> 2.2 **Compliance**. The Dealer agrees to take all steps necessary to ensure that products of the Supplier are sold by the Dealers' Associates in accordance with the terms of this agreement and further agree that each will cooperate in all actions and measures, including any disciplinary procedures, undertaken by the Dealer to ensure compliance with the same.

[11] The Dealer is defined in the Distribution Agreement as Farm Mutual.
[12] The Supplier is defined in the Distribution Agreement as FFI.

[310] In my view, it should have been obvious to Twerdun, a registrant for more than 12 years, that the criteria selected by certain investors were clearly inappropriate. Twerdun was the sole founder and the majority shareholder of FFI. As Staff submits, Twerdun was the "only person that could have possibly qualified as a 'promoter'". As Twerdun was also the sole director and officer of FFI, it should have been readily apparent to him that:

(a) Where an investor relied on criterion (p), the investor was not Twerdun or an affiliated entity of Twerdun;

(b) Where an investor relied on criterion (q), the investor was not Twerdun's spouse, parent, brother, sister, grandparent or child;

(c) Where an investor relied on criterion (r), the investor was not an affiliated entity of FFI, nor did he or she hold a sufficient number of securities of FFI to affect materially the control of FFI;

(d) Where an investor relied on criterion (s), the investor was not FFI acquiring securities of its own issue; and

(e) Where an investor who was a natural person relied on criterion (aa) (or criterion (t) after September 14, 2005), this criterion only applied to non-natural person as it contemplated ownership of the person.

[311] Pursuant to section 3.1 of 45-501CP, where the basis of an investor's qualification as an accredited investor was on its face incorrect and warranted further investigation, Twerdun was not entitled to continue to rely on the certification by the investor.

[312] During cross-examination, Staff put to Twerdun the summary and subscription documents of a number of investors and asked Twerdun whether those investors qualified as accredited investors based on the criterion or criteria that they selected. In all instances, Twerdun acknowledged that the investors did not fall within the category or categories of accredited investors that they selected.

[313] I accept Staff's submission that FFI and Twerdun could not contract out of their responsibilities to ensure the applicability of the exemption. In *Re White* (2010), 33 O.S.C.B. 1569 ("***White***"), WNBC The World Network Business Club Ltd. ("**WNBC**"), one of the corporate respondents, was the issuer of the securities at issue. Capital Investments of America ("**Capital Investments**"), another corporate respondent, contracted with WNBC to invest money in foreign exchange markets and other markets using money raised by WNBC. In an agreement between WNBC and Capital Investments, WBNC represented to Capital Investments and its sole owner Naveed Qureshi ("**Qureshi**") that investors were "qualified, sophisticated and knowledgeable investors". The Commission held that Qureshi was not entitled to rely on the accredited investor exemption because:

> The responsibility for ensuring that the requirements of an exemption are met is the responsibility of the person seeking to rely on the exemption.

> Therefore, Qureshi cannot rely on his assumption about investors nor the agreement between Capital Investments and WNBC that he thought the investors were accredited investors.
>
> (*White*, *supra*, at para. 161)

[314] I find that the principle articulated in *White* is applicable to the present case and that Twerdun's reliance on the Distribution Agreement with Farm Mutual was not sufficient to satisfy the responsibility to ensure that the accredited investor exemption was available to the Debenture holders.

[315] For the reasons above, I find that FFI and Twerdun's failure to ensure that the investors were entitled to rely on the accredited investor exemption was contrary to the public interest.

VIII. CONCLUSION

[316] For the reasons stated above, I find as follows:

(a) FFI used the OMs in connection with the sale and distribution of FFI securities and accordingly was required to file them with the Commission in accordance with section 4.3 of Rule 45-501, subsequently amended on September 14, 2005 to section 6.4 of Rule 45-501. FFI failed to file the OMs with the Commission, contrary to subsection 122(1)(c) of the Act and contrary to the public interest.

(b) The Companies made materially misleading or untrue statements in the OMs which were used in connection with the sale and distribution of FFI's securities and were therefore documents required to be filed with the Commission, contrary to subsection 122(1)(b) of the Act and contrary to the public interest.

(c) The Companies made materially misleading or untrue statements in the Promotional Materials, contrary to subsection 126.2(1) of the Act and contrary to the public interest.

(d) FFI and Twerdun breached the Temporary Order by redeeming certain FFI securities on July 13, 2007, contrary to subsection 122(1)(c) of the Act and contrary to the public interest.

(e) Twerdun, as the sole director and officer of the Companies, authorized, permitted or acquiesced in their contraventions of subsections 122(1)(c), 122(1)(b) and 126.2(1) of the Act, and is therefore liable for these contraventions pursuant to subsection 122(3) and section 129.2 of the Act.

(f) Twerdun failed to ensure that investors were entitled to rely on the accredited investor exemption, contrary to the public interest.

[317] I will also issue an order dated February 22, 2013 which sets down the dates for the hearing with respect to sanctions and costs in this matter.

Dated at Toronto this 22nd day of February, 2013.

"*Christopher Portner*"

Christopher Portner