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DECISION A CAUTIONARY TALE FOR UNREGISTERED SECURITIES DEALERS

"Undoubtedly, this decision will send a strong message to participants in the Ontario securities markets who have deprived unsuspecting investors of the benefits of dealing with persons registered to trade in securities..."

By Fraser McDonald
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The decision of the Ontario Superior Court in *Caldwell v. Baglione* 2018 ONSC 3208, released on June 7, 2018, confirms that the consequences for those who engage in the business of distributing securities without holding registration as a dealer or providing investors with a prospectus can be many and varied.

Winchester, an entity controlled by Baglione, and its affiliates (the Winchester Group) had engaged since 1999 in the business of distributing to the public investments in commercial real estate pursuant to a series of offering memoranda describing the investments, their structure and the associated risks. None of the members of the Winchester Group or Baglione had ever been registered to engage in the business of trading in securities in accordance with Ontario securities laws and no prospectus was ever filed in respect of any of the securities that they were distributing.

These activities came to the attention of staff of the Ontario Securities Commission which commenced an investigation in 2010, following which it entered into a settlement agreement with Baglione and the Winchester Group on March 27, 2013. The settlement was given effect to by an order issued by the OSC on March 28, 2013. The settlement agreement provided, among other things, that Baglione and the Winchester Group would:

- cease all trading activity;
- identify whether each investment for each unitholder qualified under an exemption from the prospectus requirement; and
- where an investment was determined not to qualify for a prospectus exemption, cause the relevant unitholder to be divested of its interest by purchasing or otherwise redeeming the investment on the basis of a report by an independent third party acceptable to staff of the OSC, ultimately determined to be Grant Thornton.

Brett Caldwell made investments in the securities of three real estate projects distributed by the Winchester Group at an aggregate purchase price of $1,505,000, being satisfied by the payment of $20,000 in cash, and the assumption of mortgage debt and the issuance of promissory notes for the balance. Between the dates of his investments and November 2015, Caldwell made monthly payments totalling approximately $618,000.

In a letter to Caldwell dated Nov. 23, 2015, the Winchester Group advised Caldwell that it had been determined that no prospectus exemption was available for the distribution of securities to him and, as a result "you are required to be divested of your units based on the principal (sic) that you be put back in the position that you would have been had you not invested."

Based on a formula devised by Grant Thornton, which essentially required repayment of amounts paid by Caldwell plus tax costs of the divestment, less assumed tax benefits received, Caldwell was advised that he would be divested of his first investment, which had a purchase price of $324,500 and in respect of which he had paid instalments totalling $209,630, for the amount of $32,958.86. No attempt was made to determine the value of the underlying real estate.

Expecting that he would be divested of his other two investments on a similar basis, Caldwell stopped making instalment payments. He was subsequently advised that he would be divested of a second investment, which had a purchase price of $360,000 and in respect of which he had paid instalments totalling $161,903, and that he would owe the Winchester Group $275.31. Again, no attempt was made to determine the value of the underlying real estate.

Caldwell never received any communication regarding the divestment of his third investment. However, in its court filings the Winchester Group suggested that, even though Caldwell had paid instalments totalling $256,710 in respect of the acquisition cost of $820,500, he owed it a further $80,431.16.

Caldwell commenced an action alleging that Winchester Group's actions in terminating the agreements he had with it in respect of his investments and unilaterally choosing the remedy of rescission and failing to pay him fair value for his investments were breaches of the agreements, entitling him to damages. He also relied on the oppression remedy under the *Business Corporations Act* (Ontario) and submitted that the bare trustees of the underlying real estate breached their fiduciary duties to him by not acting in his best interests.

Winchester Group submitted that the proper recourse for Caldwell was to petition the OSC for an order varying the terms of the order enforcing the settlement agreement, premised on the fact that the order required that Caldwell be returned to the position he would have been in had he never invested. It also submitted that the doctrine of frustration applied due to the "interference" of the OSC.

The court ruled that Caldwell had established a claim for breach of contract and oppression, and while it found it unnecessary to make a decision on breach of trust, stated that it would have held in favour of Caldwell on that point as well.

The court found that a variation order was not the proper recourse since there was nothing in the order supporting the principle that Caldwell was to be returned to the position he would have been in had he never invested. The only reference in the order to the divesting of units was the paragraph which provided that the Winchester Group was to "purchase or otherwise redeem the investment." The manner in which Caldwell's units were to be valued was not part of the order. The court held that, on the contrary, this was a matter between Caldwell and the Winchester Group.

In respect of the frustration argument, the court noted that this doctrine comes into play when a supervening event, beyond the control of the parties and not contemplated by them, results in a significant change in the obligation. The supervening event in this case was the OSC's involvement and the subsequent settlement which was caused entirely by the Winchester Group's failure to abide by Ontario securities law.

While determining that the agreements between Caldwell and the Winchester Group were illegal because they were not in compliance with Ontario securities law and that the general rule is that an action cannot be founded on an illegal act, the court noted that there is an exception where the illegality arises by statute and the person asking for relief is within the class for whose benefit the statute is intended to operate. The purpose of the provisions of the *Securities Act* (Ontario) concerning registration and the prospectus requirement are to protect members of the investing public, such as Caldwell. Accordingly, the court found that he is a person for whose benefit the securities law is intended to operate and is, therefore, able to avail himself of the above- noted exception and entitled to a remedy.

On the oppression remedy, the court relied on the decision of the Supreme Court of Canada in *BCE Inc. v. 1976 Debentureholders* [2008] 3 S.C.R. 560 and held that the actions taken by the Winchester Group were in breach of Caldwell's reasonable expectations at the time he entered into the investments and unfairly prejudicial to him. The court noted that Caldwell was never in breach under the agreements and found that the Winchester Group's actions in improperly terminating the agreements and paying Caldwell as if he'd never invested were clearly unfairly prejudicial to Caldwell.

The formula used by the Winchester Group not only denied Caldwell any capital appreciation, it also credited the Winchester Group with the tax savings that he obtained.

The court ordered a valuation of Caldwell's investments as at Nov. 23, 2015, the date on which Caldwell stopped paying the Winchester Group under the agreements, with Caldwell to be paid the amount determined to be the fair market value of his investments.

Undoubtedly, this decision will send a strong message to participants in the Ontario securities markets who have deprived unsuspecting investors of the benefits of dealing with persons registered to trade in securities and the information that a prospectus vetted by the regulator would provide, and have been reprimanded by the regulator for so doing, discouraging them from attempting to take further advantage of investors by interpreting the terms of a settlement entered into with the OSC in a fashion that further disadvantages those investors.

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