IIC Law Student Writing Awards Program

The Exception Should Prove the Rule:

Rethinking Corporate Attribution in Bankruptcy and Insolvency Law

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Introduction

It is reasonable to assert that a corporation should not be liable for the fraudulent acts of its directing mind, if those acts were committed entirely to defraud the corporation. Certainly, courts have recognized that "no social purpose is served by convicting a corporation whose directing mind has acted throughout in fraud of that corporation and its undertaking."[1] Similarly, where a "wrongful act is conceived and designed to benefit only the directing mind," without any benefit to the corporation, "no social purpose is served by convicting a corporation in such a circumstance."[2] Yet, when a corporation is defrauded by its directing mind, and that corporation becomes insolvent, attributing the intent of the directing mind to the corporation may be the only way to provide redress to creditors—one of the primary goals of the *Bankruptcy and Insolvency Act*.[3]

The following research examines the corporate attribution doctrine, particularly in the context of bankruptcy and insolvency law. Part I sets out the existing authoritative test for the corporate attribution doctrine. Part II examines the discretional nature of the doctrine, drawing insights from two recent bankruptcy and insolvency cases. Part III harmonizes patterns in judicial reasoning, critiques the recent reformulation of the doctrine in *Aquino*,[4] and advocates for the adoption of a contextual approach that considers the social purpose of the rule at issue before granting an exception.

I. The Corporate Attribution Doctrine

As articulated in *Canadian Dredge,*[5] and rearticulated in *Livent*,[6] the corporate attribution doctrine contends that if a wrongdoer acts as the "directing mind" of a corporation, and if the wrongful acts of the directing mind were done within the scope of their authority, those wrongful acts can be attributed to the corporation.[7] But there are "exceptions" or "defences" to the attribution doctrine. If the corporation does

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[1] *Canadian Dredge & Dock Co. v. The Queen*, [1985] 1 SCR 662 at para 50 [*Canadian Dredge*]
[2] *Ibid*.
[3] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3. [*BIA*]
[4] *Ernst & Young Inc. v. Aquino*, 2021 ONSC 527 [*Aquino*]
[5] *Canadian Dredge, supra* note 1.
[6] *Deloitte & Touche v. Livent Inc. (Receiver of)*, [2017] 2 SCR 855 [*Livent*]
[7] *Ibid* at para 100.

not receive a benefit from the wrongful acts, the actions of the directing mind will not be attributed to the corporation.[8] Accordingly, if the directing mind is acting entirely in fraud of the corporation, their actions will not be attributed to the corporation.[9] However, if the corporation receives a partial benefit, the "no benefit" defence will not apply, and the intent of the directing mind may still be attributed to the corporation.[10]

Canadian Dredge is regarded as the authoritative test for applying the corporate attribution doctrine,[11] though "courts retain the discretion to refrain from applying [the doctrine] where, in the circumstances of the case, it would not be in the public interest to do so."[12]

Deloitte & Touche v. Livent Inc.

In *Deloitte & Touche v. Livent Inc. (Receiver of),*[13] the Supreme Court of Canada reaffirmed the corporate attribution doctrine with an additional refinement—the principles set out in *Canadian Dredge* "provide a *sufficient* basis to find that the actions of a directing mind be attributed to a corporation, not a *necessary* one."[14]

Livent was a corporation that operated theatre shows in Canada and the United States. Livent was created by Mr. Drabinsky and Mr. Gottlieb, both of whom were involved in fraudulently manipulating the company's financial records. Deloitte was retained to conduct annual audits for Livent over five years, but Deloitte failed to uncover the fraudulent actions of Mr. Drabinsky and Mr. Gottlieb. After five years, Livent's significant financial irregularities were revealed, requiring the corporation to issue new financial statements and undergo restructuring. Mr. Drabinsky and Mr. Gottlieb were held accountable for their fraudulent actions.

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[8] *Ibid.*
[9] *Ibid.*
[10] *Ibid* at para 73.
[11] *Livent*, *supra* note 1 at para 103.
[12] *Ibid* at para 104.
[13] *Ibid.*
[14] *Ibid.*

Livent was placed under receivership, and the receiver initiated legal action against Deloitte for negligently preparing the corporation's annual audits. However, Deloitte argued the defence of illegality should bar Livent's claim.[15] The defence of illegality "bars an otherwise valid action in tort on the basis that the plaintiff has engaged in illegal or immoral conduct and, therefore, should not recover."[16] However, the defence of illegality could only be invoked if the fraudulent actions of Mr. Drabinsky and Mr. Gottlieb were attributed to Livent, necessitating an application of the corporate attribution doctrine.

At the Supreme Court of Canada, Justice Gascon, writing for the majority, clarified that the corporate attribution doctrine is "not a standalone principle; rather, it is a means by which acts may be attributed to a corporation for the particular purpose or defence at issue."[17] Deloitte was hired to detect fraud and irregularities in the company financials, and it failed to do so. Allowing Deloitte to use the defence of company fraud to dismiss a claim for failing to detect that same fraud is illogical. Fraud was the very action that Deloitte "was enlisting against," and thus, permitting the defence of illegality "would render the statutory audit meaningless."[18] Thus, Justice Gascon declined to apply the corporate attribution doctrine on the basis of public policy, and the actions of Mr. Drabinsky and Mr. Gottlieb were not attributed to Livent.[19]

II. Implications in Bankruptcy & Insolvency Law

Livent demonstrates that the corporate attribution doctrine is one of judicial necessity,[20] and thus, a court may decline to apply the doctrine if doing so would counter public policy.[21] *Livent* also demonstrates that context is central in determining when to apply the corporate attribution doctrine.[22] Yet, recent challenges have emerged in applying the doctrine within the framework of bankruptcy and insolvency law,

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[15] *Ibid* at para 98.
[16] *Ibid*.
[17] *Ibid* at para 97.
[18] *Ibid* at para 103.
[19] *Ibid* at para 104.
[20] *Ibid* at para 103.
[21] *Ibid* at para 104.
[22] *Ibid* at para 103.

as evidenced in *Ernst & Young Inc. v. Aquino* (*Aquino*)[23]—a case that was recently heard by the court of last resort.

Ernst & Young Inc. v. Aquino

John Aquino ("Mr. Aquino") was the president of two companies, Bondfield Construction Company Limited ("BCCL") and Forma-Con Construction ("Forma-Con"). In 2008, BCCL and Forma-Con ran into serious financial difficulties. BCCL underwent restructuring, and Forma-Con filed for bankruptcy.[24]

The court appointed Ernst & Young as the monitor for BCCL and its affiliates while appointing a trustee for Forma-Con's bankruptcy proceedings. The trustee became aware of a fraudulent invoicing scheme orchestrated by Mr. Aquino through BCCL and Forma-Con. The scheme resulted in millions of dollars being transferred out of BCCL and Forma-Con to non-arm's length parties prior to BCCL's restructuring and Forma-Con's bankruptcy.[25] Accordingly, the monitor and trustee sought declarations that the transfers were transfers at undervalue under s.96 of *BIA*.[26] The monitor and the trustee also pursued declarations holding Mr. Aquino and the others who profited from the scheme ("Aquino et al.") jointly and severally liable for the transferred amounts.[27]

Section 96 of the *BIA* enables a court to void a transfer at undervalue under specific conditions.[28] Here, Mr. Aquino had unlawfully transferred funds to non-arm's length parties more than a year before the initial bankruptcy event. Consequently, the application of s. 96 of the *BIA* also necessitated a finding that Mr. Aquino *intended* to defeat the interests of creditors at the time of the transfers. [29] Once established, Mr. Aquino's intent would then need to be attributed to BCCL and Forma-Con.

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[23] *Aquino*, *supra* note 4.
[24] *Ibid* at para 5.
[25] *Ibid* at paras 4-10.
[26] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3, s. 96.
[27] *Aquino*, supra note 4 at para 8.
[28] *Bankruptcy and Insolvency Act*, R.S.C., 1985, c. B-3, s. 96.
[29] *Aquino*, supra note 4 at para 205.

The application judge, Justice Dietrich, held that Mr. Aquino did intend to defeat creditors at the time of the transfers.[30] Justice Dietrich also had no issues determining that Mr. Aquino was the directing mind of BCCL and Forma-Con in his capacity as president of both corporations and was acting in such when he orchestrated the fraudulent payment scheme. The only issue left then, is whether Mr. Aquino's intent could be attributed to BCCL and Forma-Con.

Mr. Aquino argued his fault could not be attributed to BCCL and Forma-Con because neither corporation received a benefit from his fraudulent actions. It is true that the corporate attribution doctrine, as it stands, would not attribute the wrongful acts of a directing mind to the corporation if the corporation did not receive a partial benefit and its directing mind was acting wholly in fraud of it.[31] Justice Dietrich determined that "the actions of John Aquino were not intended to benefit BCCL and Forma-Con and they did not do so."[32] And so, it would seem that Mr. Aquino's intent to defeat a creditor could not be attributed to BCCL and Forma-Con.

But it would be unjust to allow Mr. Aquino to rely on a "defence" to the corporate attribution doctrine because it would undermine the remedial purpose of s. 96 of the *BIA,* which is to provide proper redress to creditors.[33] Instead, Justice Dietrich held that the *Canadian Dredge* principles (including the exceptions that would otherwise shield corporate liability) ought not to apply. Mr. Aquino's intent was still attributed to BCCL and Forma-Con, absent any benefit conferred to the corporations. Aquino et al. appealed the decision, contending that Justice Dietrich did not adhere to the binding authority set out in *Canadian Dredge.*

At the Ontario Court of Appeal, Justice Lauwers, writing for the court, examined the text and purpose of s. 96 of the *BIA*, stating that an "[a]n approach that would favour the interests of fraudsters over

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[30] *Ibid* at para 202.
[31] *Livent, supra* note 6 at para 100.
[32] *Aquino,* supra note 4 at para 217.
[33] *Ibid* at para 230.

those of creditors seems counterintuitive and should not be quickly adopted."[34] Justice Lauwers reframed the corporate attribution test in the context of bankruptcy and insolvency:

> The underlying question here is who should bear responsibility for the fraudulent acts of a company's directing mind that are done within the scope of his or her authority – the fraudsters or the creditors?[35]

The reformulation was articulated with reference to the "social purpose of providing proper redress to creditors, which is the core aim of s. 96 of the *BIA*."[36]

Golden Oaks Enterprises Inc. v. Scott

Following *Aquino*, the decision in *Golden Oaks* was rendered. Golden Oaks Enterprises Inc. ("Golden Oaks") was a one-man corporation, run by Mr. Lacasse.[37] Mr. Lacasse began raising money through Golden Oaks; he used funds from new investors to repay previous investors, culminating in a Ponzi scheme.[38] When the scheme unraveled, the Ontario Superior Court appointed a trustee for Golden Oaks. The trustee initiated 80 actions against repaid investors, alleging that they had been unjustly enriched.[39]

The corporate attribution doctrine is important here, as it raises the question of whether Mr. Lacasse's awareness of the fraud could be attributed to Golden Oaks. If attribution were established, it would mean that Golden Oaks possessed knowledge of Mr. Lacasse's fraudulent activities, thereby triggering the commencement of the limitation period for filing a claim for unjust enrichment.

At the Ontario Superior Court, Justice Gomery held that the defences to the corporate attribution doctrine were inapplicable because Mr. Lacasse's actions conferred a partial benefit to the company. Accordingly, the corporate attribution doctrine was applied to attribute the knowledge of Mr. Lacasse to Golden Oaks. However, the case was not dismissed as the court held that, since Golden Oaks was a one-

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[34] *Ernst & Young Inc. v. Aquino*, 2022 ONCA 202 at para 77.
[35] *Ibid* at para 78.
[36] *Ibid* at para 79.
[37] *Golden Oaks Enterprises Inc. v. Scott*, 2022 ONCA 509 [*Golden Oaks*]
[38] *Ibid* at para 55.
[39] *Ibid* at para 10.

person company and no one else knew of the fraud, the claim was not discoverable, and the limitation period had not expired.

At the Ontario Court of Appeal, Justice Sossin held there were "strong public policy grounds to resist permitting those who benefited from the usurious interest scheme perpetrated by Lacasse from avoiding liability...through the application of the corporate attribution doctrine."[40] Justice Sossin refused to apply the corporate attribution doctrine based on public policy. Thus, the action brought by the trustee was not barred by the *Limitations Act*, and the unjust enrichment claims could proceed.[41]

The appellate decisions rendered in *Aquino* and *Golden Oaks* were both appealed to, and heard by, the Supreme Court of Canada. At the time of this research, the decisions have not yet been released.

III. Advocating for a Different Approach

It is tempting to draw distinctions between the analyses in *Livent*, *Golden Oaks* and *Aquino*. Certainly, in *Livent* and *Golden Oaks*, the court chose not to attribute liability to the corporation, where the doctrine would otherwise support a finding of corporate liability. On the other hand, the court in *Aquino* seems to adopt the opposite approach, by insisting on attributing liability to the corporation, where the doctrine (or exceptions to the doctrine, rather) would otherwise preclude a finding of corporate liability. But the cases bear more similarities than one may initially think.

In *Livent*, the court declined to apply the corporate attribution doctrine to find Livent liable, it is also true that the court denied Deloitte's defence of illegality. The court, in effect, says, *we will not allow you to rely on this defence because the defence would not be available but for your own wrongdoing.* This is because Deloitte's defence hinged on the existence of illegal fraud—the very fraud that Deloitte was being sued for failing to detect. While the defence of illegality may otherwise apply to bar a civil claim, the court rightfully reasoned that it would be "perverse to deny auditor's liability for negligently failing to detect fraud where the harm [to the corporation] is likely to occur and likely to be most serious."[42] And

[40] *Ibid* at para 51.
[41] *Ibid* at para 59.
[42] *Livent,* supra note 6 at para 103.

"denying liability on the basis that an individual within the corporation has engaged in the very action that the auditor was enlisted to protect against would render the statutory audit meaningless."[43]

Similarly, in *Golden Oaks,* the court declined to apply the corporate attribution doctrine to find Golden Oaks had the requisite knowledge of the fraudulent actions of Mr. Lacasse, because such a finding would time-bar the action through the *Limitations Act*. And it is clearly nonsensical to allow a fraudster's awareness of their own fraud to bar a claim brought against those unjustly enriched by that very fraud. It would lead to a perverse outcome—depriving the trustee of a civil remedy.[44]

Aquino is no different. In *Aquino*, Mr. Aquino's "defence" was only available due to his own wrongdoing. The defence hinged on finding that the corporation received no benefit—but the lack of benefit received by the corporation flowed from the nature of the transfer itself; the corporation received no benefit because Mr. Aquino transferred the funds undervalue. The defence of "no benefit" both gives rise to the problem and is a consequence of it. And depriving creditors of a remedy for a transfer undervalue on the basis that the corporation received no benefit from those transfers would render s. 96 of the *BIA* meaningless. Indeed, despite Aquino et al. appealing on the grounds of the deviation from *Canadian Dredge*, the decision in *Aquino* is entirely consistent with the court's discretion to deny a defence when it undermines the purpose of the provision or legal rule at issue. While the underlying reasoning is similar, all three decisions appear disjointed; they beg for a uniform approach.

If the Social Purpose is Fulfilled, No Defense Should Prevail

On the facts of *Aquino*, it is hard to dispute that Mr. Aquino's intent ought to be imputed to BCCL and Forma-Con. Any other outcome would be unjust and counter to the purposes of s. 96 of the *BIA*. Yet, the restatement of the corporate doctrine by Justice Lauwers' is not immune from criticism. As the adage goes, hard cases make bad law. And bad law makes harder cases. The question should not, or rather cannot, be whether the fraudsters or the creditors should bear the responsibility in all bankruptcy and insolvency

[43] *Ibid*.
[44] *Golden Oaks*, *supra* note 37 at para 57.

cases.[45] Justice Lauwers' articulation works well within the context of s. 96. However, as argued by the Insolvency Institute of Canada ("IIC"), the question of who should bear responsibility between fraudsters or creditors, if adopted, would create implications for other provisions within the *BIA*. For instance, consider provisions that simply authorize the trustee to "[stand] in the shoes of the debtor."[46] In such instances, the trustee's entitlement to the debtor's property is no greater than that of the debtor.[47] Consequently, adopting a one-size-fits-all approach would lead to unpredictable outcomes and may undermine the legislative intent of *BIA* provisions that are not aimed solely at maximizing creditor recovery.

Indeed, a strict importation of the *Canadian Dredge* principles into bankruptcy and insolvency attempts to force a square peg into a round hole. The IIC proposes a better solution—the question should be whether the normal rule of attribution would achieve the social purpose of the provision or legal rule.[48] Only when the answer is no, would an exception be warranted.[49]

Apply this formulation to *Livent*, for example. The regular rule of attribution (attributing fault to Livent) would make the defence of illegality available to Deloitte. Accordingly, its application would not achieve the social purpose of the statutory audit requirement.[50] Thus, an exception to the attribution doctrine is warranted, and the same outcome is reached—Deloitte is denied the defence of illegality, and the wrongful actions of Mr. Drabinsky and Mr. Gottlieb are not attributed to Livent.

The same conclusion would be reached in *Golden Oaks.* The regular rule of attribution (attributing knowledge to Golden Oaks) would have the effect of commencing the two-year limitation period, and thus, would "undermine a fundamental tenet of insolvency law, the policy of ensuring equitable distribution of the assets between creditors."[51] Then, an exception to the attribution doctrine is warranted, and the same

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[45] Roderick Wood, "Ernst & Young Inc v Aquino: Attributing Fraudulent Intent to a Defrauded Corporation" (April 1, 2022). Canadian Business Law Journal, (2022) Vol. 66 at 251.
[46] *Ibid* at para 29.
[47] *Ibid*.
[48] IIC Factum, *supra* note 47 at para 32 (emphasis added).
[49] *Ibid.*
[50] *Livent*, *supra* note 6 at para 104.
[51] *Golden Oaks*, *supra* note 37 at para 57.

outcome is reached—the knowledge of Mr. Lacasse is not attributed to Golden Oaks, and the limitation period does not bar the trustee's claim from being brought.

In *Aquino*, attributing Mr. Aquino's intent to BCCL and Forma-Con would allow creditors to recover the improperly transferred funds by permitting the court to void the undervalue transfers. It is easy to see, then— the regular attribution rule (attributing fault to BCCL and Forma-Con) would satisfy the social purpose of s. 96 of the *BIA* by providing proper redress to creditors. Thus, an exception or defence to the attribution doctrine is not warranted, and the same outcome is reached—Mr. Aquino's intent is attributed to BCCL and Forma-Con, and the court need not consider the defence of "no benefit" at all.

It is unclear whether Justice Lauwers' articulation of the corporate attribution doctrine will be affirmed at the Supreme Court of Canada, or if it will be substituted for a new articulation entirely. Though, allowing an exception to the doctrine only when the social purpose of the provision or legal rule is unfulfilled is a practical solution worth considering. The exception should prove the rule, after all.