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Corporate identification: New uses for an old doctrine

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"For the sins of your fathers you, though guiltless, must suffer."

Horace, "Odes," III, 6, I.1

1 A well-established legal doctrine used to attribute knowledge to corporate defendants for the purpose of establishing their criminal and civil liability has recently taken on new relevance as a potential defence to claims brought by corporations and in determining priorities as between innocent victims. In December 2017, the Supreme Court of Canada released its decision in Deloitte & Touche v. Livent Inc. (Receiver of), *2017 SCC 63* (Livent), which considered an auditor's ability to invoke the corporate identification doctrine to defend claims brought against it by its corporate client. Although the auditor's defence was unsuccessful, the Supreme Court followed the Court of Appeal for Ontario and recognized that corporate identification could be invoked as a defence to actions by corporations.

2 In 2018, the Court of Appeal for Ontario heard DBDC Spadina Ltd. v. Walton, *2018 ONCA 60* (DBDC), in which corporate identification was invoked by one group of victims to recover in priority to a second group of victims. In December 2018, leave to appeal to the Supreme Court of Canada was granted in DBDC, on the question of when can corporate identification be invoked to support a claim for knowing assistance in a breach of fiduciary duty. At the time this article was written, the appeal was scheduled to be argued in May 2019.

3 With the Supreme Court set to articulate in greater detail the policy underlying the doctrine, the implication for claims brought by corporate plaintiffs may be significant. In many cases, such claims will succeed or fail where one can establish that the corporation was in the best position to prevent the harm that occurred and, therefore, on policy grounds should not be able to seek compensation from a third party for it.

4 Following a brief introduction to the emergence of the identification doctrine, this article reviews the policy behind the previous Supreme Court decision in Livent and will look ahead to the policy issue relevant in DBDC, the decision in which is likely to be released toward the end of the year.

5 Understanding the policy behind the use of the corporate identification doctrine will help counsel better understand and defend claims brought by corporate plaintiffs implicated in the very wrongdoing they are claiming for.

Some history

6 The use of corporate identification to establish the liability of corporate defendants is long- standing in both criminal and civil cases in Canada. The doctrine was first articulated by Viscount Haldane L.C. in Lennard's Carrying Co. Ltd. v. Asiatic Petroleum Co. Ltd., [1915] A.C. 705 (Lennard's Carrying). The case involved the

application of section 502 of the Merchant Shipping Act, which held shipowners free from liability where "loss or damage happened without [their] actual fault or privity." Given that most ships were owned through corporations, the question became, whose "fault or privity" could be attributed to the corporation for purposes of liability? It is in this context that Viscount Haldane stated, at 713:

> My Lords, a corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directing will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation.

7 In Lennard's Carrying, the corporation that owned the ship was managed by one Lennard. Since he was the "directing mind," his fault or privity was the corporation's fault or privity, and the company could not escape liability to owners of cargo which was damaged as a result of fire that occurred on the ship.

8 In the criminal context, the famous case of R. v. Canadian Dredge & Dock Co., *[1985] 1 SCR 662* (Canadian Dredge), established the general principle of corporate criminal liability in Canada based on the corporate identification doctrine. The case arose as the result of convictions of four corporations for fraud and conspiracy under the Criminal Code, RSC 1970, c. 34. In Canadian Dredge, certain of the defendants argued that a corporation could not be criminally liable, since a corporation could not form the necessary intent, or mens rea, required to establish criminal liability. In rejecting this argument, Estey J. wrote at para. 20:

> [The identification doctrine] produces the element of mens rea in the corporate entity, otherwise absent from the legal entity but present in the natural person, the directing mind. This establishes the "identity" between the directing mind and the corporation which results in the corporation being found guilty for the act of the natural person, the employee ...

9 The resulting test is succinctly stated by Estey J. at para. 66:

> [I]n my view the identification doctrine only operates where the Crown demonstrates that the action taken by the directing mind (a) was within the field of operation assigned to him; (b) was not totally in fraud of the corporation; and (c) was by design or result partly for the benefit of the company.

10 The test laid out in Canadian Dredge has been found to be equally applicable in the civil context in Canada.[1] Thus, in both the criminal and civil context in Canada, the use of the corporate identification doctrine to establish the liability of a corporation for mens rea or knowledge-based claims has been well established for more than 30 years.

11 A final word about the operation of the doctrine is important. Corporate identification is not a cause of action; it is a doctrine of attribution: To whom is knowledge to be attributed for the purpose of establishing liability? The policy choice guiding the use of corporate identification is always informed by the particular cause of action it is being invoked in support of. It is the policy debate behind application of the doctrine to knowing assistance claims that led the DBDC litigation to the Supreme Court. And it was the policy debate behind its use in support of an illegality defence that led to the appeal in Livent.

Corporate identification as a "shield"

12 While there have been numerous cases in the insurance context that have considered the use of corporate identification as a shield, outside of the insurance area there are few cases considering the applicability of the doctrine in defending against claims brought by corporate plaintiffs.[2]

13 The use of corporate identification as a shield was considered in the trial and appeal decisions in Livent. In the 118-page trial decision (Livent v. Deloitte & Touche LLP, *2014 ONSC 2176*), Justice Gans found that Livent was a victim of a fraud carried out by its principals and senior management. But Livent, through those same principals,

was also a perpetrator of the fraud. Should Livent be permitted to advance a claim against its auditor for damages that it was itself complicit in causing? Could the auditor invoke corporate identification in aid of a defence of illegality?

14 Livent's principals had been criminally prosecuted and convicted of fraud. Livent claimed against its auditors, Deloitte & Touche, for breach of contract and negligence as a result of their failure to detect the fraud. Deloitte defended the claim, in part, by invoking corporate identification in support of an ex turpi causa defence, as well as limitation and contributory negligence arguments.

15 Justice Gans reviewed the authorities on corporate identification, starting with Lennard's Carrying through to Canadian Dredge, which, he concluded, was also applicable in the civil context. However, Justice Gans pointed out that neither case "dealt with a situation where the doctrine was sought to be applied in an action by an "aggrieved" company against a third party ..."; neither dealt with corporate identification as a shield. Ultimately, Justice Gans held at para. 261 that corporate identification could not be used as a shield:

> I am of the view ... that the corporate identification doctrine was not intended to and does not apply [as a defence] to an action commenced by an aggrieved company against a third party for negligence or breach of contract.

Defences based on corporate identification recognized at the Court of Appeal for Ontario

16 At the Court of Appeal for Ontario, Justice Blair considered the corporate identification doctrine, and Deloitte's argument that "the frauds were not committed against Livent; they were committed by Livent" (para. 68).

17 As did the trial judge, Justice Blair reviewed the authorities and found that none of them dealt with the issue of the use of corporate identification as a shield. Again, it must be borne in mind that corporate identification is only a precondition to the applicability of the defences raised. The applicability of the doctrine must be reviewed separately for each defence. In the case of Livent, those defences were defence of illegality, ex turpi causa, as well as a claim for contributory negligence. Justice Blair held that the defence of illegality was a policy-driven one, which depended on the defendant establishing that allowing the claim to proceed would undermine the integrity of the justice system.

18 Ultimately, the Court of Appeal declined to apply the doctrine on policy grounds. Allowing an auditor to shield itself behind the doctrine of corporate identification in support of an illegality defence would allow the auditor to avoid liability for the very task it was hired to carry out, being the review of the accuracy of a company's financial reporting. Failing to detect a fraud being carried out by management was said to go to the heart of the auditor's mandate.

19 Crucially, however, the Court of Appeal did not agree with the trial judge that corporate identification could never be used as a shield. According to Justice Blair, at para.125:

> However, to the extent that the trial judge in this case was suggesting that the corporate identification doctrine could never be used to attribute thoughts or actions to a corporation for the purposes of allowing a third party to rely on a defence such as ex turpi causa, I should not be taken as agreeing with that general proposition. The application of the attribution rule is contextual and will depend on the circumstances of the case.

Livent at the Supreme Court of Canada

20 The Supreme Court of Canada released its decision in Livent in December 2017, granting Deloitte's appeal in part by reducing the damage award from $84,750,000 to $40,425,000, but affirming the trial judge's findings of liability.

21 The Court also affirmed that Canadian Dredge remained the "authoritative test" for application of the corporate identification doctrine. The Court reaffirmed that the doctrine was grounded in policy, and that the Court must take into account the public interest that would or would not be served by its application in a particular case:

> [W]here, as here, its application would render meaningless the very purpose for which a duty of care was recognized, such application will rarely be in the public interest. If a professional undertakes to provide a service to detect wrongdoing, the existence of that wrongdoing will not normally weigh in favour of barring civil liability for negligence through the corporate identification doctrine."

22 The Court held that in certain circumstances public policy and judicial necessity would support imputing the corporation with the knowledge of its directing minds. However, in the case of a statutory audit, shielding the auditor from liability for negligence for the very wrongdoing it was tasked with protecting the corporation from would "render the statutory audit meaningless" [para. 104].

23 What remained unaddressed, however, was what circumstances or public policy considerations would support the availability of the corporate identification doctrine as a shield in cases not involving liability of auditors.

Next stop: The Supreme Court of Canada - DBDC Spadina Ltd. v. Walton

24 The decision by the Court of Appeal for Ontario in DBDC Spadina v. Walton was released in early 2018. Unlike Livent, DBDC involved a more conventional use of corporate identification to attribute liability to a corporation, rather than being invoked in aid of a defence to a corporate claim.

25 However, DBDC is novel in that it was being invoked in a claim between two apparently innocent corporate victims of a fraudster. DBDC highlights the importance of policy considerations in the application of corporate identification and how these policy considerations involve a difficult balancing of competing interests.

26 DBDC was a fraud action brought by corporations owned by Dr. Stanley K. Bernstein, owner of a chain of diet clinics, against Norma Jean Walton and her husband, Ronauld Walton, both Ontario lawyers, for fraud involving over $100 million in investments in a real estate scheme orchestrated by the Waltons.

27 The application judge in the case found the Waltons liable for damages of some $66 million. However, the application judge dismissed the claim for joint and several damages against certain corporations, the "Schedule C Companies," controlled by the Waltons and used to facilitate the fraud, on the grounds that Norma Jean Walton was not the controlling mind of the Schedule C Companies and that those companies could therefore not be liable for knowing assistance and knowing receipt arising out of her breach of fiduciary duty.

28 The DBDC plaintiffs appealed that decision, and the Court of Appeal granted the appeal, finding that corporate identification applied, that Norma Jean Walton was the directing mind of the Schedule C Companies and that they knowingly assisted her in the breach of trust. Her sins were their sins.

29 A notable feature of the case was that the investors in the Schedule C Companies were themselves victims of the Waltons' fraud. The Schedule C Companies were owned 50/50 by the Waltons along with innocent investors who had invested in their scheme. Ultimately, the Court of Appeal's decision was a priorities dispute: Which of two groups of victims would be entitled to the remaining assets of the Schedule C Companies?

30 Justice Blair recognized that the investors in the Schedule C Companies were victims of the fraud, but concluded that this did not have "much bearing" on the application of the Canadian Dredge criteria. In fact, Justice Blair held that policy considerations in the context of a complex, multi-corporation, multi-party fraud supported a more flexible and "less demanding" approach to the corporate identification criteria than would be the case in a mens rea criminal offence. Ultimately, Justice Blair found that Norma Jean Walton was the directing mind of the

Schedule C Companies and that the companies could be attributed with knowledge of and participation in the fraudulent breaches of fiduciary duty and the resulting claim for knowing assistance in that breach. The Schedule C Companies' investors were left without any recourse against the assets of the companies once those became exigible to satisfy the judgment obtained by the DBDC plaintiffs.

31 Justice van Rensburg dissented, holding that it was unfair that the claims of the Schedule C Companies' investors would be "obliterated" by the claims of the DBDC investors, especially when there was no evidence of the DBDC investors' funds flowing directly into many of the Schedule C Companies.

32 In addition, Justice van Rensburg disagreed that there should be a "less demanding application" of the second and third criteria of the Canadian Dredge test in the context of a complex multi- party investment fraud. A claim for knowing assistance in breach of fiduciary duty constituted a "serious wrong that requires actual knowledge and not constructive knowledge by the participant." By finding that the Schedule C Companies had knowingly participated in a breach of fiduciary duty simply because Norma Jean Walton had used them as conduits for funds, the majority decision risked unmooring the cause of action in knowing assistance from the need to establish the morally culpable level of participation on which the tort is grounded.

33 Justice van Rensburg held that there was no policy reason supporting the use of corporate identification to impose liability on the Schedule C Companies for the wrongs committed by Norma Jean Walton. While Justice Blair recognized the need to consider the policy grounds for application of the corporate identification doctrine, he did not discuss these policy grounds explicitly. What can be gleaned from his decision, however, is that the application of corporate identification to establish the participation element of a knowing assistance claim is supported on policy grounds where the use of multiple corporations to transfer funds in a fraud case could have the effect of shielding such corporations from liability if the actions of their principals were not attributed to them. Relaxing the test for corporate identification in such circumstances was justified on these policy grounds. The Supreme Court disagreed with Justice Blair and adopted Justice van Rensburg's dissent.

34 According to Justice Blair, even though attribution worked an injustice against innocent investors and victims, this unfairness did not trump the policy consideration of preventing a corporate shell game that used the Schedule C Companies as part of an overall fraudulent design. The loss to innocent victims was outweighed by the policy of preventing the abuse of corporate arrangements.

Conclusion: Policy reasons supporting use of corporate identification as a shield

35 What emerges from these recent cases on the corporate identification doctrine is that policy choices behind application of the doctrine can result in liability or losses for innocent victims. In Livent, the policy of strengthening the statutory audit took precedence over the rights of an auditor defendant who was arguably as much of a victim of a management fraud as were the company's creditors and shareholders.

36 In DBDC, the choice between winners and losers was even more stark: The policy of preventing the use of multiple corporations to carry out a fraud trumped the rights of victims, who stood to lose everything.

37 In light of the potential unfairness in application of corporate identification, what policy should guide the Court when applying the doctrine, especially when the doctrine is invoked in defence to corporate claims? In the case of using the doctrine as a shield, the question guiding policy should be the same as it is when it is used to establish corporate liability: "Who was in the best position to prevent the wrongdoing?"

38 In auditor cases, arguably the auditor was in the best position to prevent the fraud occurring. In Livent, Deloitte was almost as much of a victim of the fraud as the firm's creditors and shareholders. Nevertheless, Deloitte had the means to discover the fraud at some point in its audit mandate. Justice Gans found at trial that Deloitte had been too content to trust the fraudsters inside Livent, in part to preserve the lucrative business it generated, and thus failed to carry out its duties and prevent the extent of the fraud that occurred.

39 However, in non-auditor cases, following DBDC, arguably in cases of the simple use of a corporation as a conduit in knowing assistance cases, the party normally in the best position to prevent the fraud is the corporation itself, through its officers and board of directors. Corporate identification should be applied on policy grounds to prevent plaintiff corporations whose directing minds are involved in wrongdoing from seeking damages against third parties for actions they were in the best position to prevent.

40 This approach suggests corporations have a greater responsibility to put in place procedures to detect fraud and other wrongdoing and that the extent of such procedures should, on policy grounds, become a factor in determining the availability of the defence to a third party. Where a corporation has failed to prevent the wrongdoing at issue, it should, on policy grounds, be prohibited from externalizing the cost of prevention by seeking damages from third parties, even if those thirds parties were themselves culpable. This represents a policy choice of requiring corporations to take robust steps to ensure oversight of corporate officers and directors.

41 Such an approach is in keeping with Justice Estey's original formulation of the corporate identification doctrine in Canadian Dredge. Justice Estey described the doctrine as one of "judicial necessity" whose rationale was the "protection of interest within the community" and providing an "advantage to society by advancing law and order" (Canadian Dredge, at 707-8 and 718-19).

42 The use of corporate identification both as a sword and a shield creates a socially beneficial incentive for corporations to police their own controlling minds by preventing an offloading of corporate responsibility onto third parties. This is a socially beneficial goal that should guide the courts as the use of the corporate identification doctrine is developed.

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1 Standard Investments Ltd v Canadian Imperial Bank of Commerce *(1985), 52 OR (2d) 473* (CA).

2 See Darcy L McPherson, "The Civil and Criminal Applications of the Identification Doctrine: Arguments for Harmonization," Alta L Rev (2007). According to McPherson, the typical use of the doctrine as a shield in claims against insurance companies arises in policies indemnifying the corporation for employee misconduct. In response to a claim under the policy, the insurer invokes the doctrine to argue that the actions of the employee are the actions of the corporation, and thus the corporation cannot claim indemnification for its own actions. The cases typically fail or succeed on the question of whether the employee in question was or was not a controlling mind of the corporation such that his or her knowledge is attributable to the corporation.

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