

# 2002 BCSECCOM 675

COR#02/083

## Findings of the Commission

**Specialized Surgical Services Inc., James Swanney and David Steinart**

**Section 161 of the *Securities Act*, RSBC 1996, c. 418**

### Hearing

<b>Panel</b>	Adrienne Salvail-Lopez John K. Graf Roy Wares	Vice Chair Commissioner Commissioner
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**Dates of Hearing** May 13, 14 and 28, 2002

**Date of Findings** July 25, 2002

### Appearing

Mark Hilford For Commission Staff  
C. Paige Leggat

David Steinart For himself

James Swanney For himself

### Introduction

- ¶ 1 These findings relate to a hearing under section 161 of the *Securities Act*, RSBC 1996, c. 418. The Executive Director issued a notice of hearing in this matter on May 9, 2001 and amended it on July 18, 2001, September 16, 2001 and March 7, 2002.
- ¶ 2 The notice of hearing contained a myriad of allegations against the following respondents: Foster First Financial Corporation, M.W. Foster & Associates Ltd., Falconhouse Investments Inc., Mark Webster Vaughan Foster, Teresa Inez Marie Mitrou, Specialized Surgical Services Inc., James Swanney, David Steinart, Wayne A. Hansen, Peter Hoogewerf, Barry Crocker, George Gow, Miles F. Kilshaw and Robert B. Murray. Before the hearing, the Executive Director entered into settlement agreements, each containing an agreed statement of facts, with all

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but three of the respondents. Those settlement agreements are not in evidence in this hearing.

- ¶ 3 The remaining respondents are Specialized Surgical Services Inc. and two of its directors, James Swanney and David Steinart. The notice of hearing alleges that:
- Specialized Surgical made misrepresentations in two offering memorandums;
  - Swanney and Steinart authorized, permitted or acquiesced in misrepresentations made by Specialized Surgical, breached their duties as directors under the *Company Act*, RSBC 1996, c. 62 and distributed securities without a prospectus; and
  - Swanney perpetrated a fraud on a person in British Columbia.
- ¶ 4 The hearing began on May 13, 2002. Steinart attended the entire hearing and testified. Swanney attended only for final submissions.

### **Background**

#### **Specialized Surgical**

- ¶ 5 Swanney is a medical doctor. Steinart is a real estate developer. In the late 1980s, they began discussing the possibility of opening a private surgical hospital in British Columbia. After doing research, Steinart began looking for a suitable property.
- ¶ 6 In March 1995, Steinart found a property in Coquitlam with a building that he and Swanney agreed would make a good hospital. Steinart and Swanney incorporated Specialized Surgical in British Columbia on March 8, 1995, for the purpose of eventually buying the property and running the hospital, which would be called the Croft Clinic.
- ¶ 7 The founding directors of Specialized Surgical were Steinart, Swanney and one other person. Steinart testified that, though he is director, officer and sole shareholder of his own real estate development company, he has never been an officer or director of any other company. He also testified that he knew he had duties and responsibilities as a director and that he knew the sale of shares was regulated in British Columbia. However, he admitted that he did not take any steps to educate himself about these matters.
- ¶ 8 Steinart testified that he had no expertise in raising corporate funds and that his primary responsibility was to look after Specialized Surgical's real estate assets. Steinart was paid a salary of \$2,500 per month, until the fall of 1996.

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- ¶ 9 Specialized Surgical began raising money through an offering memorandum dated June 22, 1995. Specialized Surgical continued to distribute shares under this offering memorandum until March 7, 1997, by which time it had raised \$575,000 from 23 investors.
- ¶ 10 In late 1995, Steinart met twice with representatives from a registered dealer who advised him that they would be interested in underwriting an offering by Specialized Surgical for a 15% commission. When Steinart told Swanney about these meetings, Swanney said that Specialized Surgical would not pay that kind of money and refused to take the matter any further.
- ¶ 11 In October 1996, Swanney brought his cousin, George Holmes, into the company as general manager. Steinart understood at the time that Holmes had extremely good credentials and that he had opened and run a hospital in Dubai.
- ¶ 12 Both Swanney and Steinart recognized that Specialized Surgical needed to raise more capital. Swanney contacted a number of people in this regard, one of whom was Mark Foster. Foster was registered as a mutual fund salesperson and employed by Royal Advent Securities Corporation, which was registered as a securities dealer.
- ¶ 13 Holmes, Swanney and Steinart met with representatives of Royal Advent, including Foster. Royal Advent proposed to raise funds for Specialized Surgical on a best efforts basis at a total cost of 15%.
- ¶ 14 After that meeting, Steinart challenged Swanney as to why Specialized Surgical would pay Royal Advent 15% when it was not prepared to underwrite the offering. The two had an argument and, as Steinart testified:
- ... as a result of that and into the next previous several months, I was pretty much taken out of the loop of what was going on on a day-to-day basis. George Holmes was made manager of the company, and decisions more and more and more as time went on were made unilaterally by Dr. Swanney.
- ¶ 15 Steinart began to suspect that Holmes had been untruthful about his qualifications. By Christmas of 1996, Steinart told Swanney of his suspicions and his belief that Holmes was not “the right guy” for Specialized Surgical. This led to another argument between Steinart and Swanney. Steinart described the upshot of that argument as follows:

George Holmes was allowed to continue with his job as general manager, and over the next several months, I can’t tell you exactly when, I was

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systematically and deliberately ostracized from any decision-making process in the company.

- ¶ 16 Sometime over the next several months, Steinart was removed as a signing authority on Specialized Surgical's bank account. On March 12, 1997, Holmes was appointed secretary of Specialized Surgical.

### **The RACC offering memorandum**

- ¶ 17 In March 1997, Royal Advent agreed to raise funds for Specialized Surgical in return for a 10% commission and a 5% corporate finance fee. By this time, Specialized Surgical's offering memorandum of June 22, 1995, was out of date. Rather than preparing a new offering memorandum, Specialized Surgical and Royal Advent decided to use an offering memorandum dated December 11, 1996, of Royal Advent Capital Corporation, an unregistered affiliate of Royal Advent. Their plan was to issue shares of RACC and later exchange those shares for shares of Specialized Surgical.
- ¶ 18 The RACC offering memorandum contained no information about Specialized Surgical. However, in Foster's sworn interview with Commission staff of June 5, 2000, he indicated that the purchasers of the RACC shares were told that they would ultimately be investing in Specialized Surgical. This was confirmed by one of his clients who purchased under the RACC offering memorandum, Rosalind Collins. In her sworn interview with Commission staff of October 9, 2001, she said that her understanding at the time was that she would be investing in a private hospital called the Croft Clinic.
- ¶ 19 Swanney and Steinart knew that the RACC offering memorandum was being used to raise money from investors for Specialized Surgical. However, Steinart does not remember whether he read the offering memorandum.
- ¶ 20 Between March and May 1997, Royal Advent raised \$485,000 from 18 investors using the RACC offering memorandum. Foster raised \$300,000 of this from 11 of his clients. RACC purported to sell these shares pursuant to the exemption from the prospectus requirement then available in section 128(b) of the *Securities Rules*, BC Reg. 194/97. That exemption required that the purchaser be a sophisticated purchaser as defined in the Act.
- ¶ 21 Section 139 of the Rules required a company that distributed shares pursuant to the section 128(b) exemption to file a Form 20 Report of Exempt Distribution. Neither Royal Advent nor Specialized Surgical filed this report in respect of the distributions under the RACC offering memorandum.

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¶ 22 In May 1997, a holding company incorporated by Swanney and Steinart purchased the Coquitlam property for \$2,642,000. The holding company financed the purchase through two mortgages, the first for \$1,700,000 and the second for \$635,900. Swanney and Steinart jointly and severally guaranteed the second mortgage. On May 6, 1997, Specialized Surgical acquired the property by buying all the shares of the holding company from Swanney and Steinart. Swanney and Steinart received shares of Specialized Surgical in consideration.

¶ 23 Steinart continued to have concerns about Royal Advent's and Specialized Surgical's ability to raise capital. He "knew that the money wasn't coming in quick enough to pay the mortgage" and that something needed to be done. He said that:

Over the next several months there were two or three directors meetings when I verbalized my doubts and my dismay at what was going on and the fact that we weren't raising the funds that we should have been raising, and it was probably, I can't remember exactly, but probably sometime in the summer of 1997 when I suggested that we really desperately needed to find an exit strategy and possibly sell the building to get the equity that I had in it to get the equity out.

¶ 24 Steinart prepared a 30 page exit strategy, which he gave to Swanney. Swanney did not act on it and told Steinart to stop being negative as it was bad for the company.

¶ 25 On one occasion in 1997, Steinart went to the bank and asked to see Specialized Surgical's records. He was told by the bank that he could not see the records unless he had Swanney's or Holmes' approval. They would not give him that approval.

¶ 26 In the middle of 1997, Specialized Surgical opened an administrative office in Abbotsford, which is where Swanney lived and practiced medicine. Steinart testified as to what was happening in the office around this time:

... whenever the office in Abbotsford was opened up, the company administration office, and it was around the time when I was supposedly being very negative about everything, George Holmes was instructed by Dr. Swanney to come to my office and take all of my material, which comprised of probably eight or nine boxes, file box fulls of information, because he wanted to bring all the information together into one collective area, and I guess to some extent that made sense, and he came to my office and took everything I had away, and about six months later, after much nagging on my part, I finally got about a box and a half of information back, which was strictly related to our purchase and the business of the

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physical asset, the building, in other words I got all the real estate stuff back, the appraisals, communications I had with the City of Coquitlam with whom we purchased it from, but even so some of the information was gone, and I never could get back the rest of the information that I had from that date on. The amount of information that I got was very insignificant in my opinion, in comparison to what was actually happening at the company at the time.

### **The August 26, 1997 offering memorandum**

- ¶ 27 One thing that was happening at the company at the time was the discovery of a problem with the distribution under the RACC offering memorandum. In his interview, Foster described the problem as follows:
- A ... [Royal Advent] had created information flyers that outlined they were going to raise money for small venture businesses, but they were going to sell shares, preferred shares in Royal Advent Capital Corporation and then do a swap to the target investment for shares of, you know, one company and the other.
- Q Great. And that was an ongoing business ...
- A Well, I mean, it didn't work. I mean, that was their first day out was – was – with Specialized Services, and I'm not sure whether it was Royal Advent's own lawyer or whether – somebody shut it down anyway, and it wasn't going to work.
- ¶ 28 When Foster was asked if Royal Advent had an offering memorandum related to Specialized Surgical, he replied:
- A No. They had one that related to the sale of preferred shares of their own company, but they had backup documentation saying that the – based on the purchase within this offering memorandum, it would be swapped to shares within Specialized Surgical Services. But as much as they outlined this whole thing, as soon as they tried to do it, it sort of blew up in their faces. And they had no choice but to convert it all to shares in Specialized Surgical Services, which meant that Specialized had to race ahead and go and get their own offering memorandum done in order to catch that mess.
- ¶ 29 The problem was dealt with by having each of the purchasers under the RACC offering memorandum rescind that purchase and purchase an equivalent number of Specialized Surgical shares under the new Specialized Surgical offering memorandum.

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- ¶ 30 That offering memorandum was dated August 26, 1997. It listed Specialized Surgical's directors as Swanney (who was also president and chief executive officer), Steinart, Wayne Hansen (who was also chief financial officer), Peter Hoogewerf, Barry Crocker and Mark Foster.
- ¶ 31 The offering memorandum disclosed that Specialized Surgical "may engage agents to sell the Units and may pay commissions to such persons entitled to receive such commissions in amounts agreeable" to Specialized Surgical. The offering memorandum did not disclose that the shares were being sold by Royal Advent and that Foster, who was now a director of Specialized Surgical, was one of the persons who would be receiving those commissions.
- ¶ 32 The certificate to the offering memorandum was signed by Swanney and Hansen. Steinart does not remember whether he read the document. However, he did know that Royal Advent was selling shares of Specialized Surgical and that Foster was one of the Royal Advent salespeople who was earning commissions on the sales of the shares.
- ¶ 33 Between August 26 and September 30, 1997, Royal Advent raised \$725,000 under the offering memorandum. Of this amount, \$485,000 represented the shares issued to the purchasers under the RACC offering memorandum. The remaining \$240,000 represented new investment from 22 investors, two of whom were clients of Foster. Once again, Specialized Surgical purported to sell most of these shares pursuant to the section 128(b) exemption.
- ¶ 34 The Forms 20 filed in respect of the distributions disclosed that the shares had been distributed pursuant to the section 128(b) exemption.
- ¶ 35 By late 1997, Steinart had become very concerned about the way in which Specialized Surgical was being run. He testified as follows:
- I would say at the end of '97, beginning of '98 and predominantly at the beginning of '98, I think, was when I first started to realize that there were meetings going on and that really Dr. Swanney was acting unilaterally, he would just go off and do whatever he wanted to do, and then basically inform did not just myself, but several inform other directors at a later date. I know that George Holmes, Mark Foster and Wayne Hansen were privy to what Dr. Swanney was doing, but I wasn't.
- ¶ 36 By the end of 1997, Steinart had reached the following conclusions respecting Swanney's abilities:

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And I mean basically Jim Swanney is a very naive man, he is a good doctor, but he's a terrible businessman. I think that probably had in retrospect so much to do with it.

### **The November 12, 1997 offering memorandum**

- ¶ 37 On September 15, 1997, Foster incorporated Foster First Financial Corporation. Foster was a director, president and majority shareholder. Swanney was a director and secretary. All of Foster First's shares were held by Foster and Swanney.
- ¶ 38 In support of Foster First's application for registration under the Act, Swanney signed a subordination agreement on September 23, 1997. In that agreement, Swanney acknowledged that Foster First had borrowed \$100,000 from him and agreed to subordinate any claim he might make in respect of that debt to those of Foster First's other creditors. That \$100,000 represented the working capital required by Foster First to obtain registration.
- ¶ 39 On September 30, 1997, Foster purchased 25,001 shares of Specialized Surgical.
- ¶ 40 On November 12, 1997, Specialized Surgical issued another offering memorandum. It offered units of 20,000 shares at \$25,000 per unit (\$1.25 per share). The certificate was signed by Swanney and Hansen. The offering memorandum disclosed that Specialized Surgical "may engage agents to sell the Units and may pay commissions to such persons entitled to receive such commissions in amounts agreeable to" Specialized Surgical. It did not disclose the names of the agents or the amounts of the commissions. It also did not disclose the various relationships between Swanney and Foster.
- ¶ 41 Foster's contract of employment with Royal Advent expired on November 30, 1997, and was not renewed by Royal Advent. On December 18, 1997, Foster First was registered under the Act as a securities dealer and on December 22, 1997, Foster was employed by Foster First as a mutual fund salesperson.
- ¶ 42 Foster sent a letter to Swanney dated December 31, 1997, advising Swanney that he was resigning as a director of Specialized Surgical. However, there is no reference in Specialized Surgical's Register of Directors to Foster's resignation. As well, Foster continued to attend Specialized Surgical's board meetings.
- ¶ 43 On January 2, 1998, Specialized Surgical entered into a contract with Foster First, pursuant to which Foster First would be sole financing agent for Specialized Surgical in return for a 10% commission and a 5% corporate finance fee. The contract was signed by Swanney on behalf of Specialized Surgical and Foster on behalf of Foster First.



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- ¶ 44 Foster First began distributing shares of Specialized Surgical on January 26, 1998, using Specialized Surgical's offering memorandum of November 12, 1997. These distributions continued throughout 1998 and into January 1999.
- ¶ 45 On several occasions, Specialized Surgical was late in making the payments on the first mortgage. The company defaulted entirely on the payment due February 9, 1998.
- ¶ 46 In February 1998, Foster became vice-president of marketing of Specialized Surgical. On March 12, 1997, Holmes ceased to be secretary of Specialized Surgical. He was replaced by Hoogewerf.
- ¶ 47 On March 27, 1998, Swanney transferred 100,000 of his shares in Specialized Surgical to Foster as partial compensation for services that Foster had rendered to Specialized Surgical.

### **The alleged fraud**

- ¶ 48 Around this time, Rosalind Collins approached Foster about an additional investment. In her interview, she described what happened as follows:
- A ... Then in the Fall of '97 I put my house on the market and it sold in the spring and I had some money. So I thought, well, I'll go back to Mr. Foster and so I went there and I asked him, you know, I said I have some money to invest again and what would he recommend that I do.  
...
- A ... He said really, you know, he said I think – he says that Croft Clinic is going to go ahead big time. He said I think it should – big things are going to be happening shortly.
- Q Mm-hmm.
- A So he said if I were you, he said I would invest in Croft again. He said that's what I would recommend.
- Q Okay.
- A He said by this time that the shares were now a dollar and a quarter, instead of before when I first purchased them they were a dollar.
- Q Okay. So you first bought 25,000 at a dollar?
- A Mm-hmm.

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Q Okay.

A So I said – he said I don't know for sure, he says but you know, he says, I think I can still – might be able to still get you some at a dollar, but he said, I can't get you all of it at a dollar, but he says I think – he says just let me leave and make a phone call.

He left the room. He came back and he said I can get you 50,000 at a dollar and the rest you're going to have to pay a dollar and a quarter.

I said that's great, I said I really appreciate that that you did that for me. That helps me a lot. ...

- ¶ 49 Also around this time, Swanney called Steinart one evening with respect to a \$25,000 loan that Swanney had made to Steinart. Swanney told Steinart he needed the money to pay for his daughter's wedding. Swanney also told Steinart there was an opportunity for Steinart to sell some of his Specialized Surgical shares to another director, who wanted to purchase a block of 350,000 shares. Steinart agreed to consider selling some of his shares.
- ¶ 50 Later that evening, Swanney called Steinart again and told him that it was Foster who wanted to purchase his shares, through a company of Foster's called Falconhouse Investments Inc. Swanney said that Foster would pay \$52,500 for 350,000 shares (\$0.15 per share). When Steinart suggested that he sell only the number of shares required to raise the \$25,000 that Swanney needed, Swanney told him that Foster was only interested in purchasing 350,000 shares. By the end of the conversation, Steinart agreed to sell 350,000 of his shares to Foster.
- ¶ 51 In an undated letter from Swanney to Devlin Jensen, Specialized Surgical's lawyers, Swanney gave instructions relating to certain transfers of shares, two of which Swanney described as follows:

There is also to be a transfer from David Steinart's account of 300,000 shares to Falconhouse Investments Inc. at no cost. The address of this is the same as Mark Foster's office in that he manages this company.

Falconhouse Investments Inc.  
208-2187 Oak Bay Ave  
Victoria  
BC  
V8R 1G1

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David will also transfer 50,000 to Rosaland Collins. There will be a cheque, to Devlin and Jensen in trust to be paid to David Steinart from Rosaland Collins for \$50,000.00 this is to be paid to David on transfer of the shares.

- ¶ 52 In a letter dated March 31, 1998, from Foster to Devlin Jensen, Foster referred to Swanney's letter and enclosed Collins' cheque of March 31, 1998, for \$50,000 payable to Devlin Jensen in trust.
- ¶ 53 Specialized Surgical's Register of Transfers shows that, on April 6, 1998, Steinart transferred 50,000 shares to Collins and 300,000 shares to Falconhouse. Steinart received a trust cheque from Devlin Jensen dated April 6, 1998, for \$50,000. Steinart testified that he did not discuss the transaction with Foster as, by this time, they were not speaking to each other and that he has yet to receive the \$2,500 still owing for his shares.
- ¶ 54 Steinart first learned of Collins' involvement in the transaction when she called him several months later. Steinart testified that, until then, he had had no idea that 50,000 of his shares had ended up in her hands.
- ¶ 55 Steinart asked Swanney for an explanation. He received an undated letter from Swanney, which read in part as follows:

In reply to your request regarding the above transaction, I will confirm that it was my understanding and that of the board that the shares you transferred to Falconhouse were a single block transferred to a wholly owned company which was owned by Mark Foster.

At no time was the board or myself aware that Mrs. Rosalind Collins was involved with Falconhouse.

...

On the other hand I was personally involved with the cost of the shares and it was my understanding that Mr. Foster was buying 350,000 shares from you for \$52,500.00 and that this was a single transaction between his company and you. Further more I was aware that Mr. Foster failed to pay the final \$2,500.00.

It would have been totally illogical for you to have knowingly sold 50,000 shares to Ms. Collins and given Mr. Foster 300,000 share for nothing. ...

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¶ 56 Foster's position with respect to these transactions was set out in a letter to Commission staff dated August 19, 1999. In that letter, Foster said, among other things, that:

- Mrs. Collins purchases 50,000 from David Steinart by way of a cheque made payable to law firm of Devlin Jensen (the company lawyers for Specialized Surgical Inc.). In other words the company's lawyer facilitated this purchase.
- Myself, Foster First Financial Corporation or Falconhouse Investments Inc. did not purchase shares but instead received them at no cost from David Steinart and were valued by Specialized Surgical Services Inc. CEO, Dr. James Swanney at \$0.17 for tax purposes.

### **Further developments in Specialized Surgical**

¶ 57 At a meeting of Specialized Surgical's directors on May 12, 1998, which was attended by Foster, they discussed Foster's resignation from the board and the need to replace him. The relevant section of the minutes reads as follows:

Mark Foster has resigned as a board member several months ago because of pressure from the Securities Commission. Nevertheless the situation still exists where both he and the board wish to have representatives of Foster First Financial on the board and Mark has appointed Rob Murray [an employee of Foster First] to fill this position until such time as either he can fulfil it himself or until another appointee is made.

¶ 58 On June 1, 1998, Foster First entered into a contract with Specialized Surgical to provide administrative services to Specialized Surgical. The contract provided that Specialized Surgical would pay Foster First \$2,000 per month plus disbursements and that the signatories to Specialized Surgical's bank account would be Foster and Murray. The contract was signed by Swanney on behalf of Specialized Surgical and Foster on behalf of Foster First.

¶ 59 On August 27, 1998, Specialized Surgical's auditors entered a judgment against Specialized Surgical's property. The judgment was for non-payment of their bill.

¶ 60 On October 8, 1998, Foster was allotted 100,000 shares of Specialized Surgical from treasury for past services rendered to the company.

¶ 61 Specialized Surgical defaulted on the October 9, 1998 payment due under the first mortgage.

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¶ 62 On November 1, 1998, Specialized Surgical's new auditors released Specialized Surgical's audited financial statements for the 16 months ended September 30, 1998. Note 2 to those financial statements provides in part as follows:

### 2. CONTINUATION OF THE BUSINESS

While the consolidated financial statements have been prepared on the basis of accounting principles applicable to a going concern, several adverse conditions cast substantial doubt upon the validity of this assumption.

The Company has incurred significant operating losses over the past three periods (\$521,676 in the current period) and has a working capital deficiency of \$2,695,116. Its continued existence is dependent upon its ability to restructure financial arrangements and obtain new financing (Note 15a).

Note 15(a) discloses that, subsequent to September 30, 1998, Specialized Surgical entered into preliminary negotiations for the sale and leaseback of its property, but that the material terms of the transaction had not been finalized.

¶ 63 Specialized Surgical defaulted on the November 9, 1998 payment due under the first mortgage. On January 8, 1999, the holder of the first mortgage filed a certificate of pending litigation against the property.

¶ 64 Between January 26, 1998 and January 15, 1999, Specialized Surgical sold shares to 20 investors using the November 12, 1997 offering memorandum. Of the \$607,000 raised, \$432,000 came from 17 clients of Foster First. During that period, Specialized Surgical made no changes to the offering memorandum.

¶ 65 The Forms 20 filed in respect of the distributions disclosed that the shares had been distributed pursuant to the section 128(b) exemption.

### Findings

¶ 66 The notice of hearing alleges that:

1. Specialized Surgical made statements that it knew or ought reasonably to have known were misrepresentations in the August offering memorandum and the November offering memorandum, contrary to section 50(1)(d) of the Act;

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2. Swanney and Steinart authorized, permitted or acquiesced in the misrepresentations made by Specialized Surgical in the August offering memorandum and the November offering memorandum, contrary to
  - (a) section 50(1)(d) of the Act, and
  - (b) section 118 of the Company Act;
3. Swanney and Steinart authorized, permitted or acquiesced in misrepresentations made by Specialized Surgical in the Forms 20 filed in respect of distributions under the August offering memorandum and the November offering memorandum, contrary to section 50(1)(d) of the Act;
4. Swanney and Steinart distributed shares of Specialized Surgical without a prospectus, contrary to section 61 of the Act; Commission staff say that the exemption from the prospectus requirement in section 128(b) of the Rules was unavailable for distributions under the November offering memorandum because the offering memorandum contained misrepresentations; and
5. Swanney perpetrated a fraud on Collins, contrary to section 57(b) of the Act.

¶ 67 At the hearing, Commission staff made additional allegations against all three respondents. Commission staff did not, however, amend the notice of hearing to include these allegations. We conclude that the respondents did not have notice of these allegations and we will make findings only in respect of allegations in the notice of hearing that Commission staff proceeded with at the hearing.

### **1. Misrepresentations in offering memorandums by Specialized Surgical Section 50(1)(d)**

¶ 68 Section 50(1)(d) of the Act provides as follows:

50(1) A person, while engaging in investor relations activities or with the intention of effecting a trade in a security, must not do any of the following:

...

- (d) make a statement that the person knows, or ought reasonably to know, is a misrepresentation.

A trade is defined in section 1(1) of the Act and includes “a disposition of a security for valuable consideration”.

A misrepresentation is defined in section 1(1) of the Act as follows:

“misrepresentation” means

- (a) an untrue statement of a material fact, or

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- (b) an omission to state a material fact that is
  - (i) required to be stated, or
  - (ii) necessary to prevent a statement that is made from being false or misleading in the circumstances in which it was made;

A material fact is defined in section 1(1) of the Act as follows:

“material fact” means, where used in relation to securities issued or proposed to be issued, a fact that significantly affects, or could reasonably be expected to significantly affect, the market price or value of those securities;

- ¶ 69 Commission staff allege that Specialized Surgical, with the intention of effecting trades in its shares, made statements that it knew or ought reasonably to have known were misrepresentations in the August offering memorandum and the November offering memorandum.
- ¶ 70 Commission staff allege that the August offering memorandum contained two misrepresentations in that it omitted to state the following material facts:
  - 6. Specialized Surgical was paying commissions to agents of Royal Advent, including Foster; and
  - 7. Foster faced a conflict of interest as he was a director of Specialized Surgical while receiving commissions for selling its shares.
- ¶ 71 Commission staff allege that the November offering memorandum should have been amended to disclose the following material facts that arose between November 12, 1997, when the certificate to the offering memorandum was signed, and January 15, 1999, the date of the last distribution under the offering memorandum:
  - 8. There were conflicts of interest arising from the relationships between the principals of Specialized Surgical and Foster First;
  - 9. There were changes in Specialized Surgical’s directors and officers. Foster resigned from Specialized Surgical’s board on December 31, 1997, “because of pressure from the Securities Commission”, and became vice-president of marketing in February 1998. In May 1998, Murray replaced Foster on Specialized Surgical’s board as a “representative[s] of Foster First Financial”;

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10. Specialized Surgical and Foster First entered into a contract on January 2, 1998, pursuant to which Foster First became sole financing agent for Specialized Surgical;
  11. Specialized Surgical and Foster First entered into a contract on June 1, 1998, pursuant to which Foster First provided administrative services to Specialized Surgical;
  12. Specialized Surgical's auditors filed a judgment against Specialized Surgical's property on August 27, 1998, and the company retained new auditors;
  13. The financial statements included in the offering memorandum became outdated. On November 1, 1998, Specialized Surgical released its audited financial statements for the 16 months ended September 30, 1998, which stated that
    - a. "several adverse conditions cast substantial doubt upon the validity of [the] assumption" that Specialized Surgical should be treated, for accounting purposes, as a going concern,
    - b. Specialized Surgical's "continued existence is dependent upon its ability to restructure financial arrangements and obtain new financing", and
    - c. Specialized Surgical had entered into preliminary negotiations for the sale and leaseback of its property; and
  14. The holder of the first mortgage on Specialized Surgical's property filed a certificate of pending litigation against the property on January 8, 1999.
- ¶ 72 A misrepresentation includes an omission to state a material fact that is required to be stated. The form of offering memorandum used at the time, Form 43, required the company to state:
15. in item 2, "if appropriate to a clear understanding by purchasers of the risk factors and speculative nature of the enterprise or the securities being offered ... the factors that make the purchase a risk or speculation";
  16. in item 6, "the name of any person selling the securities on behalf of the issuer, any relationship between such person and the issuer, particulars of any agency or similar agreement and the remuneration, if any, to be paid to such person for the sale of the securities"; and
  17. in item 14, "any existing or potential conflicts of interest among the issuer, distributor, promoter, director, officers, principal holders and persons



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providing professional services to the issuer which could reasonably be expected to affect the purchaser's investment decision.”

- ¶ 73 We are of the view that the facts relating to the commissions to be paid to Foster (facts 1 and 5) were required to be stated pursuant to item 6 of Form 43, which dealt with sales agents. We are of the view that the facts relating to the relationships between Specialized Surgical, Swanney, Foster First, Foster and Murray (facts 2, 3, 4 and 6) were required to be stated pursuant to item 6 and item 14, which dealt with existing or potential conflicts of interest. Finally, we are of the view that the facts relating to the judgment and certificate of pending litigation filed against Specialized Surgical's property and the September 30, 1998 financial statements (facts 7, 8 and 9) were required to be stated pursuant to item 2, as they were appropriate to a clear understanding by purchasers of the risk factors and speculative nature of Specialized Surgical's enterprise.
- ¶ 74 We are also of the view that, had these facts been stated, each could reasonably have been expected to significantly affect the market price or value of Specialized Surgical's shares. Consequently, we conclude that Specialized Surgical's failure to include each of these facts in the August offering memorandum or the November offering memorandum was a misrepresentation.
- ¶ 75 Section 50(1)(d) of the Act provides that a person must not “make a statement” that the person knows or ought reasonably to know is a misrepresentation. One might argue that section 50(1)(d) does not apply here because Specialized Surgical did not “make a statement” but rather omitted to state certain facts. We do not agree.
- ¶ 76 The purpose of section 50(1)(d) is to prohibit people from making misrepresentations in order to sell securities. A “misrepresentation” is defined to include both an untrue statement of a material fact and an omission to state a material fact. Specialized Surgical did not disclose the various material facts identified above in the August and November offering memorandums. We are of the view that, had those material facts been disclosed, it would have been more difficult for the company to sell its shares. This is exactly the type of conduct that section 50(1)(d) is designed to prevent.
- ¶ 77 We are of the view that each of the August offering memorandum and the November offering memorandum can itself be characterized as a statement which, because of the omission of material facts, was untrue and misrepresented Specialized Surgical's affairs. We find that Specialized Surgical, by making misrepresentations in the August and November offering memorandums, contravened section 50(1)(d) of the Act.

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### 2. Misrepresentations in offering memorandums by Swanney and Steinart Section 50(1)(d) and *Company Act* Section 118

¶ 78 Section 50(1)(d) of the Act provides as follows:

50(1) A person, while engaging in investor relations activities or with the intention of effecting a trade in a security, must not do any of the following:

...

- (d) make a statement that the person knows, or ought reasonably to know, is a misrepresentation.

Section 118(1) of the *Company Act* provides as follows:

118(1) Every director of a company, in exercising the director's powers and performing the director's functions, must

- (a) act honestly and in good faith and in the best interests of the company, and
- (b) exercise the care, diligence and skill of a reasonably prudent person.

¶ 79 We have found that Specialized Surgical contravened section 50(1)(d) of the Act by making misrepresentations in the August and November offering memorandums. Commission staff allege that Swanney and Steinart, by authorizing, permitting or acquiescing in Specialized Surgical's misrepresentations, also contravened section 50(1)(d), as well as section 118(1) of the *Company Act*.

¶ 80 Commission staff referred us to *Re Slightham* [1996] 30 BCSC Weekly Summary 38, for a description of the duty of care imposed on directors. After reviewing the case law, the Commission concluded at page 70 of that decision:

In summary, though there may be a dearth of case law in Canada on the issue of the duty of care of directors, there is sufficient law from which we can derive certain basic principles. Those principles certainly take us beyond the standards established for English directors in *Re City Equitable Fire Ins. Co.* They impose on directors a duty to put in place adequate systems for the management of the company, which would include the flow of information that is necessary to the directors and upon which they will base their decisions. Should that information generate concerns or otherwise put the directors on inquiry, they must take the necessary steps to resolve those concerns or initiate the appropriate inquiry. In short, the directors, all the directors, have a duty to ensure that the affairs and business of the company are being properly managed.

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...

The Company Act duties faced by Tranter, Watson and Redford can be summarized as follows. As directors, Tranter, Watson and Redford were required to either manage, or supervise the management of, the affairs and business of Beauchamps and Beaufield. Though it may have been appropriate for them to leave the day to day activities in Slightham's hands, they were still responsible for supervising his management of the two companies. In doing so, they were required to act honestly and in good faith and in the best interests of the companies, and to exercise the care, diligence and skill of a reasonably prudent person. In order to meet these duties, they were obliged to put in place adequate systems for management of the companies, including the flow of necessary information to the directors, to make their decisions on an informed basis, and to take the necessary steps to resolve any concerns or suspicions that came to their notice. Moreover, they could not be relieved of these duties by the circumstances of their appointments.

The evidence is overwhelming that, during the period of their directorships, both Beauchamps and Beaufield were managed with almost total disregard for the regulatory requirements of the Exchange, the Securities Act and the Company Act, and in a manner that was rife with conflict of interest.

- ¶ 81 In *Slightham*, the Commission specifically addressed the obligation on directors to ensure that the company is obeying the law. At page 74, the Commission stated that:

It is the responsibility of the directors to ensure that a company complies with applicable legislation and its listing agreement. Directors exercising the care, diligence and skill of a reasonably prudent person may delegate this responsibility to management of the company, but, if they do so, must also set up adequate systems to satisfy themselves that compliance is in fact taking place and, if matters arise that should put them on notice, take the steps necessary to resolve the concern. ...

- ¶ 82 There is no evidence before us that Swanney or Steinart made any attempt to put in place adequate systems to ensure compliance with the regulatory requirements relating to Specialized Surgical's offering memorandums. Steinart does not even remember if he ever read them. Rather, both Swanney and Steinart argued that they should have been able to rely wholly on their lawyers, Devlin Jensen, and their securities dealers, Royal Advent and Foster First, to ensure that these regulatory requirements were met.

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- ¶ 83 We do not accept their argument. It is the responsibility of the directors, all the directors, to ensure that a company complies with applicable regulatory requirements. Moreover, we are of the view that circumstances should have put Swanney and Steinart on notice that it would be prudent for them to inquire more closely into these matters. First, capital raising was Specialized Surgical's primary focus during this period; the company had no revenues and was wholly dependent on the money raised through share issuances to keep it alive. Second, both Swanney and Steinart should have known that they could not rely on Royal Advent and Foster to raise capital in compliance with regulatory requirements; the distribution orchestrated by Royal Advent and Foster under the RACC offering memorandum "blew up in their faces" and Specialized Surgical was forced "to race ahead and go and get their own offering memorandum done in order to catch that mess."
- ¶ 84 Steinart had additional reasons for suspicion. He had expressed concern at directors' meetings in 1997 that "we weren't raising the funds that we should have been raising". As well, he came to realize in 1997 that he was being ostracized from Specialized Surgical's affairs and that the company was being run "unilaterally" by Swanney, whom Steinart had come to realize was "very naïve" and "a terrible businessman".
- ¶ 85 Swanney, as well as being a director, was Specialized Surgical's president and chief executive officer. He signed both the August and the November offering memorandums. He ran the company throughout the distribution periods under both offering memorandums. Swanney should have been the first to recognize that these documents omitted to state material facts.
- ¶ 86 We are not prepared to find that Swanney and Steinart contravened section 50(1)(d) of the Act as it was Specialized Surgical, not them, that made the misrepresentations. However, as directors of Specialized Surgical, they were responsible for ensuring that the company complied with the regulatory requirements relating to the August and November offering memorandums. We find that, by permitting Specialized Surgical to make misrepresentations in these offering memorandums, both Swanney and Steinart failed to "act honestly and in good faith and in the best interests of the company, and exercise the care, diligence and skill of a reasonably prudent person", contrary to section 118(1) of the Company Act.

### **3. Misrepresentations in Forms 20 by Swanney and Steinart Section 50(1)(d)**

- ¶ 87 Section 50(1)(d) of the Act provides as follows:

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50 (1) A person, while engaging in investor relations activities or with the intention of effecting a trade in a security, must not do any of the following:

...

- (d) make a statement that the person knows, or ought reasonably to know, is a misrepresentation.

¶ 88 Commission staff say that the Forms 20 filed by Specialized Surgical in respect of distributions under the August offering memorandum and the November offering memorandum contained misrepresentations. Specially, they argue that the section 128(b) exemption, which Specialized Surgical claimed to rely on, was unavailable for many of the distributions. Commission staff allege that Swanney and Steinart authorized, permitted or acquiesced in the misrepresentations made by Specialized Surgical in these Forms 20, contrary to section 50(1)(d) of the Act.

¶ 89 Section 50(1)(d) requires that the person make the misrepresentation “while engaging in investor relations activities or with the intention of effecting a trade in a security”. A company files a Form 20 with the Commission after a distribution of securities has taken place, to report details of that distribution. We are of the view that a company filing a Form 20 does not do so while engaging in investor relations activities or with the intention of effecting a trade in a security, as the Form 20 merely discloses information about a trade that has already taken place. Therefore, we dismiss Commission staff’s allegation.

#### **4. Distributions without a prospectus by Swanney and Steinart Section 61**

¶ 90 Section 61(1) of the Act provided as follows:

61 (1) Unless exempted under this Act or the regulations, a person must not distribute a security unless a preliminary prospectus and a prospectus respecting the security

- (a) have been filed with the executive director, and
- (b) receipts obtained for them from the executive director.

¶ 91 A distribution is defined in section 1(1) of the Act and includes “a trade in a security of an issuer that has not been previously issued”. A trade is defined in section 1(1) of the Act and includes “a disposition of a security for valuable consideration”.

¶ 92 Commission staff allege that Swanney and Steinart distributed shares of Specialized Surgical without a prospectus as the exemption from the prospectus requirement in section 128(b) of the Rules was unavailable for distributions under the November offering memorandum.

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¶ 93 Section 128(b) of the Rules provided as follows:

128. Section 61 of the Act does not apply to a distribution in the following circumstances:

**\$25 000 – sophisticated purchaser**

- (b) the trade is made by an issuer in a security of its own issue if
  - (i) the purchaser purchases as principal,
  - (ii) the purchaser is a sophisticated purchaser,
  - (iii) the aggregate acquisition cost to the purchaser is not less than \$25 000, and
  - (iv) an offering memorandum is delivered to the purchaser in compliance with section 133;

Section 133(1)(c) of the Rules provided as follows:

133.(1) An offering memorandum required to be delivered in connection with a distribution under section 74(2)(4) of the Act or section 128(a), (b) or (c) of these rules, or delivered in connection with a distribution under section 128(h) of these rules, must

...

- (c) be in the required form.

¶ 94 In 1998, the required form was Form 43. Item 20 of that form provides as follows:

**Item 20 Certification**

Include a certificate in the following form:

The foregoing contains no untrue statement of a material fact and does not omit to state a material fact that is required to be stated or that is necessary to prevent a statement that is made from being false or misleading in the circumstances in which it was made.

**INSTRUCTIONS:**

The certificate is required to be signed by the president or chief executive officer and by the chief financial officer of the issuer. If no chief financial officer has been designated, then a director of the issuer other than the president or chief executive officer, must sign the certificate.

¶ 95 Commission staff submit that, because the November offering memorandum contained misrepresentations, it was not in the required form. As a result, they

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say, Specialized Surgical did not deliver the offering memorandum to purchasers in compliance with section 133 and therefore was unable to rely on the exemption in section 128(b).

- ¶ 96 Item 20 of Form 43 requires that an offering memorandum include a certificate stating, in effect, that the offering memorandum does not contain a misrepresentation. Form 43 does not require that the certificate be true or that the offering memorandum not contain a misrepresentation. Consequently, we cannot conclude that the offering memorandum was not in the required form simply because it contained a misrepresentation.
- ¶ 97 That does not mean that a company distributing securities under an offering memorandum that contains a misrepresentation can do so with impunity. The company could face both sanctions from the Commission, as in this case, and civil actions brought by purchasers under the offering memorandum.
- ¶ 98 That also does not mean that the Commission cannot conclude that the misrepresentations are so serious and pervasive that the offering memorandum cannot be considered to be in the required form. However, we do not consider that to be the case with the November offering memorandum. Therefore, we dismiss Commission staff's allegation.

### 5. Fraud by Swanney Section 57(b)

- ¶ 99 Section 57(b) of the Act provided as follows:

**57** A person must not, directly or indirectly, engage in or participate in a transaction or scheme relating to a trade in or acquisition of a security or a trade in an exchange contract if the person knows, or ought reasonably to know, that the transaction or scheme

...

(b) perpetrates a fraud on any person in British Columbia ...

- ¶ 100 Commission staff allege that Swanney, through his participation in the April 6, 1998 transfer of shares from Steinart to Collins and Foster, perpetrated a fraud on Collins.
- ¶ 101 The test for fraud under section 57 of the Act has been considered by the Commission in several cases including: *Re Pinchin* [1996] 41 BCSC Weekly Summary 7; *Re Mindoro* [1997] 7 BCSC Weekly Summary 13; *Re Excel* [1999] 18 BCSC Weekly Summary 29; and *Re Schiller* [2000] 32 BCSC Weekly Summary 26. The Commission has consistently referred to the decision of the

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Supreme Court of Canada in *R. v. Olan, Hudson and Hartnett* (1978) 41 C.C.C. (2d) 145 in which Dickson J. stated at page 150:

Courts, for good reason, have been loath to attempt anything in the nature of an exhaustive definition of 'defraud' but one may safely say, upon the authorities, that two elements are essential, 'dishonesty' and 'deprivation.' To succeed, the Crown must establish dishonest deprivation.

The Supreme Court of Canada considered the concept of dishonesty in the context of an allegation of fraud pursuant to section 380 of the Criminal Code in *R. v. Zlatic*, [1993] 2 SCR 29. McLachlin J. observed at page 45 of that decision:

...Would the reasonable person stigmatize what was done as dishonest? Dishonesty is, of course, difficult to define with precision. It does, however, connote an underhanded design which has the effect, or which engenders the risk, of depriving others of what is theirs. J.D. Ewart, in his *Criminal Fraud*, (1986), defines dishonest conduct as that 'which ordinary, decent people would feel is discreditable as being clearly at variance with straightforward or honourable dealings' (p. 99).

With regard to the element of deprivation, Dickson J. observed at page 150 of *Olan* that:

The element of deprivation is satisfied on proof of detriment, prejudice, or risk of prejudice to the economic interest of the victim. It is not essential that there be actual economic loss as the outcome of the fraud.

- ¶ 102 By the time that Swanney sent the instructions to Devlin Jensen for the transfer of Steinart's 350,000 shares, Swanney clearly knew all of the details of the transaction. He also clearly knew what each of the parties to the transaction understood would be happening. Steinart understood that he was selling 350,000 shares at \$0.15 per share to Foster. Collins understood that she was buying 50,000 shares at \$1.00 per share from an unknown person. Foster understood that he was getting 300,000 shares at no cost from Steinart and that Collins was buying 50,000 shares at \$1.00 per share from Steinart. Neither Steinart nor Collins knew that Foster would be getting 300,000 shares for free as a result of the transaction.
- ¶ 103 Swanney was a key participant in the transaction. He approached Steinart about selling a block of his shares. He presented Steinart with a specific volume and price: 350,000 shares at \$0.15 per share. He instructed Devlin Jensen to transfer the shares from Steinart to Collins and Foster. In response to an inquiry from Steinart, Swanney sent Steinart a letter purporting to describe the transaction.



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- ¶ 104 Swanney had a personal interest in seeing the transaction complete. He would get the \$25,000 that Steinart owed him. As well, Foster, with whom Swanney was developing an increasingly close business relationship, would get 300,000 free shares.
- ¶ 105 While Steinart owed Swanney money, we have no evidence that Steinart was forced to sell his shares. Consequently, we accept that Steinart was a willing seller and that he valued his shares in the company at \$0.15. Yet Swanney allowed Collins to pay \$1.00 for them. Had Collins had full knowledge of the transaction, she would have realized that she was paying \$0.85 per share too much. In effect, she paid \$50,000 for shares that were worth, according to a director of the company, \$7,500.
- ¶ 106 We are of the view that Swanney acted dishonestly. He kept critical information about the transaction from both Steinart and Collins, as well as lying about his understanding of what had transpired in his subsequent letter to Steinart. We are also of the view that Collins suffered deprivation as a result of the transaction. She paid \$50,000 for shares that were worth only \$7,500 at the time. Therefore, we find that Swanney, through his participation in the transfer of shares from Steinart to Collins, perpetrated a fraud on Collins, contrary to section 57(b) of the Act.

### Orders

¶ 107 We have found that:

18. Specialized Surgical, by making misrepresentations in the August and November offering memorandums, contravened section 50(1)(d) of the Act;
19. Swanney and Steinart, by permitting Specialized Surgical to make misrepresentations in these offering memorandums, contravened section 118(1) of the Company Act; and
20. Swanney, through his participation in the transfer of shares from Steinart to Collins, perpetrated a fraud on Collins and thus contravened section 57(b) of the Act.

¶ 108 We will hear further submissions before issuing orders in respect of our findings. If the parties wish to make written submissions, we direct Commission staff to file their submissions and send a copy to each respondent by August 23, 2002, and the respondents to file their submissions and send copies to Commission staff by September 20, 2002. If the parties wish to make oral submissions, we direct them to contact the Commission Secretary before September 6, 2002, to fix a date for the hearing of those submissions.

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¶ 109 July 25, 2002

¶ 110 **For the Commission**

Adrienne Salvail-Lopez  
Vice Chair

John K. Graf  
Commissioner

Roy Wares  
Commissioner