

# 2003 BCSECCOM 132

COR#03/026

## Findings of the Commission

**Carl Glenn Anderson and Douglas Victor Montaldi**

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

## Hearing

<b>Panel</b>	Brent W. Aitken	Vice Chair
	Neil Alexander	Commissioner
	Robert J. Milbourne	Commissioner

**Dates of Hearing** January 13 to 17, January 23 and 24, 2003

**Date of Findings** February 14, 2003

## Appearing

James Sasha Angus For Commission staff  
Lorne Herlin

Robert W. Taylor For Carl Glenn Anderson and Douglas Victor Montaldi  
Carey D. Veinotte

¶ 1 This is a hearing under section 161(1) of the *Securities Act*, RSBC 1996, c. 418 in which Commission staff is seeking orders in the public interest that:

1. any or all of the exemptions described in sections 44 to 47, 74, 75, 98 or 99 of the Act do not apply to the respondents Carl Glenn Anderson and Douglas Victor Montaldi;
2. Anderson and Montaldi be prohibited from becoming or acting as a director or officer of any issuer;
3. Anderson and Montaldi be prohibited from engaging in investor relations activities;
4. Anderson and Montaldi each pay an administrative penalty; and
5. Anderson and Montaldi pay the costs of the hearing.

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¶ 2 On October 29, 2002 the Executive Director issued temporary orders and a notice of hearing against Anderson and Montaldi. On November 13, 2002 the Commission, with Anderson's and Montaldi's consent, extended the temporary orders until a hearing was held and a decision rendered.

### **I The Notice of Hearing**

¶ 3 The notice of hearing contains allegations arising out of a business operated by Anderson and Montaldi through a company called 439288 B.C. Ltd. (439) from January 1, 1996 to April 30, 2002.

¶ 4 439's principal business was described as the making of loans to individuals and small businesses in and around Burns Lake, British Columbia. To raise the necessary capital for its lending activities, it sold promissory notes to investors, primarily in the same area. Anderson and Montaldi are 439's sole shareholders. Until the temporary orders took effect, Anderson and Montaldi were 439's only directors, Montaldi was its president and Anderson its secretary.

¶ 5 Several of the allegations are admitted. The contested allegations are that Anderson and Montaldi made misrepresentations with the intention of selling securities, perpetrated a fraud on the public of British Columbia, and acted contrary to the public interest. The factual allegations are that Anderson and Montaldi knew or ought to have known that they:

- mismanaged 439 through inadequate record keeping, loan account supervision and business oversight;
- did not tell investors that they borrowed about \$8 million from 439 for themselves and related parties, did not make payments of principal and interest on some of these loans, and caused 439 to forgive interest payments on others of these loans;
- did not tell investors that they were using investors' funds for their own purposes and not for the proper conduct of 439's business;
- did not tell investors that the funds they invested might be used to pay interest and principal to existing investors;
- accepted investments, knowing that 439 was not profitable and its liabilities exceeded its assets, and without disclosing to investors the true state of 439's affairs;

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- encouraged investors to invest by giving them personal guarantees, when those guarantees were inadequate; and
  - failed to meet their obligations as directors and officers of 439 under the *Company Act*, RSBC 1996, c. 62.
- ¶ 6 These allegations are considered in “Analysis and Findings” below.
- ¶ 7 In October 2001, Commission staff became aware of 439’s activities and contacted Montaldi for information, which led to discussions and correspondence between the respondents and Commission staff. Eventually, Commission staff began a formal investigation, which led to the notice of hearing.
- ¶ 8 Meanwhile, the British Columbia Financial Institutions Commission (FICOM) undertook an investigation and concluded that 439, Anderson and Montaldi were in breach of the *Financial Institutions Act*, RSBC 1996, c. 141, and the *Mortgage Brokers Act*, RSBC 1996, c. 313. On April 30, 2002 FICOM issued an order freezing the bank accounts of 439, Anderson and Montaldi. On May 3, 2002, FICOM ordered 439, Anderson and Montaldi to cease carrying on business.
- ¶ 9 In these Findings, the closing of 439’s business by these actions is referred to as “Shutdown”.
- ¶ 10 At Shutdown, 439 had about 450 investors whose investments totalled about \$41 million. It had a loan portfolio of about 1,475 loans with a book value of about \$32 million.
- ¶ 11 On May 9, 2002, 439 filed a notice of intention to file a proposal under the *Bankruptcy and Insolvency Act (Canada)*. PricewaterhouseCoopers Inc. was named as the trustee in those proceedings and was appointed by the Supreme Court of British Columbia as interim receiver of 439.
- ¶ 12 On May 13, 2002 the FICOM freeze order was revoked.
- ¶ 13 On July 22, 2002, 439 filed its Proposal in the Supreme Court of British Columbia under the *Bankruptcy and Insolvency Act*. The Proposal, with some amendments, was approved by 439’s creditors on August 9, 2002 and by the Supreme Court on August 28, 2002. It is described under “The Proposal” below. Pricewaterhouse prepared a report in connection with the Proposal, which we refer to at times in these Findings.

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### II Background

#### A. 439's Business

##### *Overview*

- ¶ 14 439's principal business was ostensibly the receiving of funds from investors and the loaning of those funds to individuals and small businesses, primarily in Burns Lake and the surrounding communities, commonly known as the Lakes District.
- ¶ 15 Anderson and Montaldi began the business in the late 1980's in unincorporated form. In 1993, 439 was incorporated and the business was then carried on through that company. However, none of Anderson, Montaldi, their investors or borrowers made much distinction between 439 and its principals. Anderson and Montaldi regarded themselves as the ones carrying on the business, and their investors and borrowers largely felt they were dealing with Anderson and Montaldi, as opposed to the corporate entity 439.
- ¶ 16 Investors received a form of promissory note from 439 to document their investment. For most of the relevant period, 439 paid investors 12% on these notes. Funds were lent to borrowers at rates between 16% and 18%. The business model was that the spread between interest charged to borrowers and the interest paid to investors would be sufficient to cover operating expenses and loan losses and yield a profit.
- ¶ 17 Between 1995 and 2002, the business grew in an almost geometric progression. The principal owed to investors in 1995 was just under \$1.7 million; at Shutdown, investors' principal was \$41 million. In the one or two years before Shutdown, 439 had about 1,200 to 1,500 loans outstanding at any one time, and was administering up to 5,000 loans annually.

##### *Anderson and Montaldi*

- ¶ 18 Anderson and Montaldi are 439's sole shareholders. Until the temporary orders took effect, Anderson and Montaldi were 439's only directors, Montaldi was its president and Anderson its secretary. 439 had no other employees with significant decision-making responsibilities.
- ¶ 19 Both Anderson and Montaldi were born and raised in Burns Lake and have known each other most of their lives. Anderson, 59, finished high school but did not receive his diploma. He received no secondary education of any kind, and says he knows little of accounting, finance and related matters. Anderson has established, or is an investor in, several businesses in the Burns Lake area and owns a number of properties. He knows the people in the community very well and is known and

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trusted by them. It appears he is generally regarded as compassionate and devoted to his community. He has a reputation as a successful and honest businessman.

- ¶ 20 Anderson was primarily responsible for dealing directly with lenders and borrowers. He was the one who most often dealt with new investors, and managed the granting and collection of the loans to the borrowers.
- ¶ 21 Montaldi, 48, received a Bachelor of Commerce from the University of British Columbia in accounting and finance. He is also a certified public accountant, a US accounting designation corresponding to a chartered accountant in Canada. Montaldi is a co-owner of, and operates, an accounting firm based in Burns Lake (with an office in Houston, British Columbia) called Marmon Financial Management Co. Ltd. Marmon kept the books for 439, prepared (directly or through an affiliate) its financial statements, and prepared its tax returns.
- ¶ 22 Like Anderson, Montaldi established, or is an investor in, several businesses in the Burns Lake area and owns a number of properties. He is well-known and has a reputation as a successful businessman. Most investors considered him honest, and trusted him.
- ¶ 23 Montaldi's primary responsibility was overall management and oversight of the business from a financial point of view. He also had some dealings with investors.

### **B. Dealings with Borrowers**

- ¶ 24 439's loans to non-related parties were primarily to individuals and small businesses. Most of the loans were unsecured, although in some cases they were secured by mortgages on real or personal property. There were chartered banks and credit unions carrying on business in Burns Lake that offered loans at lower rates. 439's customers were those who could not qualify for loans at conventional financial institutions, did not wish to deal with them, or needed funds more quickly than the formal lending procedures required by conventional financial institutions would accommodate.
- ¶ 25 439 never directly advertised or solicited borrowers. Its business grew by word of mouth.
- ¶ 26 Several of 439's borrowers were also investors. Many in Burns Lake work in the forestry industry, or are direct suppliers to that industry. The industry is seasonal. Some individuals and businesses would therefore borrow funds from 439 for equipment and personal use when the industry was dormant, then repay their loans and invest surpluses with 439 when the industry became active.

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- ¶ 27 Unsecured loans were documented with a simple promissory note or loan agreement. Anderson managed this type of documentation on his own. If the loans were secured by a chattel or real property mortgage, 439 used legal counsel to document and register the security.
- ¶ 28 Prospective borrowers were asked to complete a loan application form. However, in making his decision about whether to lend, Anderson relied primarily on his knowledge of the applicant, acquired over years of living and working in the community. He kept himself abreast of the changing circumstances in these people's lives and factored that into his loan approval decisions.
- ¶ 29 This was also the approach he brought to collections. When a loan was in arrears, he would discuss it with the borrower and would often defer collection in cases where he felt that there was a foreseeable change in the borrower's circumstances that would enable repayment in future. He was very patient; collections were sometimes deferred for years on the strength of the borrower's future prospects.
- ¶ 30 By Shutdown, many individuals and businesses had come to depend on the liquidity provided by 439's loans. We heard evidence that the local residents of the Lakes District are anxious to see 439's business continued in some form.

### C. Dealings with Investors

- ¶ 31 As with the lending side of the business, 439 did not directly advertise or solicit investors. Those interested in investing with 439 sought out Anderson or, less frequently, Montaldi. The investment in 439 took the form of a loan to the company, evidenced by a document purporting to be a promissory note.
- ¶ 32 There are banks, credit unions and financial service providers in the area taking deposits at conventional interest rates and offering typical non-deposit investment products. Investors testified that they were attracted to the 12% interest rate. Most also perceived the investment risk to be low. This assessment was coloured by the losses some had recently experienced in the public equity markets and mutual funds.
- ¶ 33 Whether the investors dealt with Anderson or Montaldi, the basic approach was the same. The following paragraphs summarize the features of the notes.

#### *Interest rate*

- ¶ 34 The rate on the notes was generally 12% throughout the relevant period, although investors who invested more than \$200,000 or who were willing to invest for long periods were sometimes offered 14%. Shortly before Shutdown, 439 reduced its offered rate to 10%. Investors were given the option of having interest paid

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monthly, or allowing interest to accrue until the loan matured, in which case interest compounded monthly.

### *Term*

- ¶ 35 Most notes were for a term of one year or less, although some investors invested for longer periods. It was Anderson's practice to contact an investor about three months before a note became due to ask whether the investor wished to be paid out, or to reinvest the principal and accrued interest for another term. Many investors chose to roll their investments over for subsequent terms; several did this many times.
- ¶ 36 Investors were told that, if they wished to withdraw their money prior to maturity, 439 would usually be able to accommodate them on a day's notice or so if the amount was small (say, \$10,000 to \$15,000). Larger withdrawals required more notice. Anderson and Montaldi said they managed 439's cash so that there was enough cash in the bank to cover early withdrawals as well as 439's usual working capital requirements.
- ¶ 37 Essentially all of 439's transactions were handled through a single bank account, so funds from investors, principal and interest received from borrowers, and general working capital were all commingled in one account.

### *Use of proceeds*

- ¶ 38 Anderson and Montaldi told investors that their funds would be lent to individuals and small businesses in the Lakes District. However, Anderson and Montaldi increasingly used invested funds for loans to themselves and related parties (described under "Related Party Loans" below) and to purchase other assets (described under "Other 439 Assets" below). Investors were generally not told about the nature or extent of these loans, or the details of 439's other assets.

### *Security*

- ¶ 39 Each note included a guarantee of Anderson and Montaldi of 439's obligations to pay interest and principal. Other than this guarantee, the notes were unsecured (other than a few secured by mortgages on real property) but for most investors, the guarantee was all that mattered – they trusted Anderson and Montaldi, and the guarantee showed them that Anderson and Montaldi stood behind the investment.
- ¶ 40 Anderson and Montaldi maintained life insurance policies, with 439 as the beneficiary, to support 439's obligations to investors. At first the policies were for \$1 million each; as the company grew, Anderson and Montaldi increased the coverage to \$4 million each.

### *Risks*

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- ¶ 41 There was very little discussion of risk between Anderson and Montaldi and the investors. Many investors recall no discussion on the subject at all. Some recall a discussion to the effect that 439's borrowers were almost all dependent on the forest industry, so if the industry were to suffer a major setback, there could be problems. Anderson and Montaldi said they told investors that in the case of a major economic collapse in the Lakes District, it might not be possible for 439 to repay the notes for a long period after their due date, and perhaps not at all. Most investors did not seem to recall this discussion, but in any event, this is the only disclosure about risk that took place in connection with the sale of the notes.
- ¶ 42 All of this information was communicated verbally. No offering memorandum or other disclosure document was prepared.
- ¶ 43 It is clear from the testimony of several witnesses that the Burns Lake area is the kind of community in which much business can be done, and is done, on the basis of a handshake. Anderson and Montaldi were well known and respected. Investors trusted them, and this essentially was the basis on which they assessed the risk of their investment in 439.

### *Documentation*

- ¶ 44 After an investor agreed to invest, Anderson or Montaldi (usually Anderson) would take the funds and issue the investor a temporary receipt. He would then prepare a document purporting to be a promissory note, arrange for it to be signed by himself and Montaldi, and deliver it to the investor. If the investor elected to be paid interest monthly, Anderson would enclose post-dated cheques from 439 for the monthly interest payments. This process was usually complete within a day or two of the receipt of the investor's funds.
- ¶ 45 This is an excerpt from a typical note:

We, Carl Glenn Anderson and Douglas Victor Montaldi, both businessmen of Box 813, Burns Lake, B.C., jointly and severally personally guarantee for 439288 B.C. Ltd. (The Borrower); to pay [name of investor] . . . the sum of [amount invested] . . . together with interest at the rate of [interest rate] per annum, by or before [due date].

- ¶ 46 Although this document identifies 439 as the "borrower", it contains no promise to pay from 439 (or anyone else, for that matter), nor were these documents executed by 439. The only signatures are those of Anderson and Montaldi, and the witness. This demonstrates the approach of all concerned – Anderson and Montaldi, the borrowers, and the lenders – that the business was essentially with Anderson and Montaldi, rather than with 439 as an entity separate from them.



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- ¶ 47 The evidence is that 439 missed no payments of principal or interest to its investors until Shutdown, and that investors who wished to take advantage of the early withdrawal of their funds as promised by 439 were able to do so.
- ¶ 48 Anderson and Montaldi were investors as well as borrowers. The Pricewaterhouse report shows investments at Shutdown by Anderson and Montaldi totalling \$385,000. Montaldi says his portion of that was \$340,000 and that at Shutdown his companies, spouse and relatives had investments in 439 notes totalling about \$900,000.

### **D. Related Party Loans**

- ¶ 49 On January 1, 2001, 439's loan portfolio included about \$6.5 million in loans, all unsecured, to Anderson, Montaldi and related parties. By Shutdown, this had increased to about \$8 million. This represented 25% of the book value of the loan portfolio and 22% of total company assets.
- ¶ 50 This summarizes the status of the related party loans during the 16-month period from January 1, 2001 to Shutdown (all figures rounded):
- There were five unsecured loans to Anderson and related parties representing borrowings of \$2.4 million. Accrued interest on this amount totalled \$511,000. No payments were made in this 16-month period on three of the loans. On the remaining loans, 439 forgave \$10,000 in interest and the borrowers paid \$32,000 in interest and repaid \$78,000 of the principal, leaving a balance outstanding on all the loans, principal and interest, of \$2.8 million. The largest single loan in this group was Anderson's alone. He borrowed \$1.1 million on which \$259,000 in interest had accrued. Anderson had \$10,000 in interest forgiven, paid \$10,000 in interest and repaid no principal, leaving an outstanding balance of \$1.4 million.
  - There were nine unsecured loans to Montaldi and his spouse representing borrowings of \$4.7 million. Accrued interest on this amount totalled \$864,000. No payments were made in this 16-month period on three of the loans. On the remaining loans, 439 forgave \$486,000 in interest and these borrowers paid \$146,000 in interest and repaid \$62,000 of the principal, leaving a balance outstanding on all the loans, principal and interest, of \$4.9 million.
  - A group including both Anderson and Montaldi had one loan under which they borrowed \$321,000. Accrued interest on this amount totalled \$82,000. These borrowers had made no payments on this loan, leaving a balance outstanding, principal and interest, of \$403,000.

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- At Shutdown, Anderson and Montaldi and their related parties had therefore borrowed a total of \$7.4 million, of which they had repaid \$140,000. Interest had accrued on the outstanding principal in the amount of \$1.5 million, of which \$178,000 had been paid and \$486,000 forgiven. This left outstanding balances of principal and interest on all these loans totalling \$8 million, with an ongoing interest obligation of about \$1.3 million per year.

- ¶ 51 Anderson characterized these as 439's "best loans".
- ¶ 52 According to the Pricewaterhouse report, the interest forgiven Anderson and Montaldi by 439 was in lieu of salary.
- ¶ 53 Anderson says he spent most of his working time, generally close to six days a week, on 439 business. In the period 1997 through 2001, the company waived interest totalling about \$360,000 on his loans. He was also paid a salary of \$9,000 per month, effective November 1999.
- ¶ 54 Montaldi said he typically spent about half an hour a day on 439 business. In the period 1997 through 2001, the company waived interest totalling about \$1.4 million on Montaldi's loans, \$486,000 of which was in the year 2001.
- ¶ 55 At the hearing Montaldi was asked whether he thought that was fair compensation. He replied:
- On an hourly basis, probably quite exorbitant. On the basis of being involved with the operations and the decision making, you know, I think we could probably find some people that would say it was fine and some people that would say that it was high.
- ¶ 56 These waivers are already accounted for in the interest payments noted above, so they do not explain the remaining unpaid interest and none of the unpaid principal.
- ¶ 57 For the purposes of the Proposal, the Pricewaterhouse report rated the loans in 439's portfolio by quality. The related party loans were not rated in the report, but Richard Pallen, the Pricewaterhouse representative, testified that had they been, many of the related party loans would have fallen into the lowest category (labelled "Bad").

### **E. Other 439 Assets**

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- ¶ 58 At Shutdown, 439 owned various assets in addition to its loan portfolio. These had a book value of \$4.9 million, or about 15% of 439's assets. This summarizes the other 439 assets as Shutdown:

**Table 1 – Other 439 Assets**

(\$000's)

ASSET	ESTIMATED VALUE
Land – developed and rented	2,062
Land – vacant / no cash flow	1,404
Land – mixed use	505
Shares and investments	350
Buildings	209
Portable bridges	55
Vehicles	34
Art work	34
Silver bars	17
Currency, coins, gold nuggets	14
Racehorse	5
Miscellaneous	11
<b>TOTAL</b>	<b>4,700</b>

Source: Pricewaterhouse report

- ¶ 59 The total estimated value of the lands shown in Table 1 is \$4.0 million. According to the Pricewaterhouse report the estimated value of these lands, net of encumbrances, was \$2.7 million. The report also shows the net cash flow from these properties, after debt service on the encumbrances, was negative \$91,000 per annum.

### **F. Management of 439's Business**

- ¶ 60 There was extensive evidence about 439's management. An important component of this evidence came from the report prepared by Pricewaterhouse in support of its recommendation to the creditors of 439 (who were predominantly the 439 investors) that they accept the Proposal.
- ¶ 61 The report was signed by Pricewaterhouse senior vice president Michael Vermette, but was prepared by Richard Pallen, who also did the field work on which the report was based. Pallen has been with Pricewaterhouse for 26 years and is a vice president. He has a forensic accounting specialization and is a certified fraud examiner.

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- ¶ 62 Anderson was interviewed by Commission staff in connection with its investigation and was asked about the Pricewaterhouse report. Anderson said that he did not disagree with the report, that it was “reasonably accurate”, and that he accepted the report’s criticism of him. When asked “Do you want to justify yourself in any way, shape or form”, Anderson replied “I’m satisfied with it.” Anderson confirmed at the hearing that he stands by those statements.

### *Lending and collection practices*

- ¶ 63 Pricewaterhouse stated the following in its report:

Credit granting policies were never formalized by the Company, however, it appears that the objectives of community investment, community support, and a degree of benevolence ranked equal to or above the profit motive for the Company.

...

The Company’s lending practices were very casual and relied primarily on Mr. Anderson’s knowledge of the individual borrower. Loan documentation that would typically be found in the credit files of a financial institution was absent.

The Company followed a very patient and non-aggressive practice for collections.

...

[T]he following factors contributed to the financial problems not being detected by management:

- An overall lack of management information to measure the performance of the loan portfolio and evaluate lending policies;
- Inadequate financial reporting; and
- Inadequate and/or inconsistent effort in the collection of delinquent loans.

### *Loan accounts*

- ¶ 64 Pricewaterhouse concluded that 439’s accounting for its loan portfolio was inadequate.
- ¶ 65 Anderson and Montaldi kept two parallel sets of records for the loan portfolio. Anderson kept a manual record consisting of handwritten notations on the notes. Marmon kept a computerized loan portfolio record updated from bank records and

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the notes Anderson gave Montaldi from time to time as loans were made and repaid.

- ¶ 66 These two sets of records were reconciled once a year to generate a report of interest and outstanding balance for each of the loan accounts. Montaldi said this was an enormous task that took Anderson and Montaldi several weeks to complete at the end of each year.
- ¶ 67 Pricewaterhouse said that although the accounting was sufficient for the filing of tax returns, it was not sufficient for management decision-making purposes. The system, it said, did not provide management with the information necessary to:
- set appropriate loan loss provisions,
  - segment and analyze the loan accounts by borrower and security,
  - determine the ratio of interest paid to interest accrued, and
  - identify problem loans.
- ¶ 68 Anderson and Montaldi recognized these problems as early as 1997. In that year, Montaldi hired a software designer to write a suitable system but he was unable to complete the task. Montaldi asked Marmon employee, Marlene McPhail, to locate off-the-shelf software, but she was unable to find anything suitable. Montaldi spoke to a major finance company about buying a copy of its system but it was not available for purchase. In February 2002, Montaldi had some discussions with another software designer but decided to defer the matter until after the 2002 tax season. Shutdown intervened before those discussions could be resumed.
- ¶ 69 As part of its work, Pricewaterhouse designed a computerized management system for the loan portfolio. We heard it was an expensive and complex task, but seems to be working for 439 and the new company formed under the Proposal.
- ¶ 70 The Pricewaterhouse report also notes that they found some instances where 439's loan documentation was incomplete, for example: precise identity of borrower unclear, promissory note not signed, deficiencies in registration of security.

### *Financial accounting and reporting*

- ¶ 71 Pricewaterhouse concluded that the overall financial accounting and reporting for 439 was inadequate. It said that even though 439 is a private company, "accurate financial statements measuring the financial position of the Company and the results of its operations are essential."
- ¶ 72 439's financial statements from its incorporation to the end of its 1998 financial year were prepared by Marlene McPhail. McPhail started out as an employee of

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Montaldi's accounting firm, Marmon, while she earned her designation as a certified general accountant. She later became a co-owner of Marmon with Montaldi. Once she earned her CGA, she established her own practice in Marmon's offices. In September 2000, McPhail left Marmon to set up her own practice. At the time of her departure, the 1999 financial statements were nearly completed but not signed off. Montaldi was responsible for 439's 1999 and 2000 financial statements.

- ¶ 73 Anderson and Montaldi were candid about the approach they took to 439's financial statements. They did not rely on them for management purposes; their sole purpose was for filing 439's tax returns. Montaldi knew that the statements would generally show a loss, and was therefore in no hurry to file 439's tax returns because he knew it would owe no tax. The statements were therefore usually prepared months, or even years, after the end of the financial year. For example, entered into evidence were the financial statements for the years December 31, 1996, 1997, 1998 and 2000. These statements were prepared 23, 14, 9 and 11.5 months respectively after those year ends.
- ¶ 74 Montaldi attributed the delay to two things. First, the lengthy exercise needed to reconcile Anderson's and Marmon's loan account records, and the intervention of the tax return preparation season, which was a busy time of year for Marmon. These two factors, although significant, would not seem to account for all the delay. It appears that the financial statements were simply not a priority for Anderson and Montaldi, as they made no use of them in running the business.
- ¶ 75 Pricewaterhouse noted that the statements were not audited. They were prepared on a "notice to reader" basis and, in the case of the 2000 statements prepared by Montaldi, included overstatements of revenues and understatements of expenses that would be inappropriate for public disclosure purposes. As McPhail explained, a professional accountant preparing statements on a "notice to reader" basis must be satisfied that management of the company understands the statements and believes them to be accurate. McPhail met with Anderson or Montaldi, or both, for this purpose regarding each set of financial statements she prepared.
- ¶ 76 When McPhail met with Anderson and Montaldi to review the 1997 financial statements (this meeting took place in early 1999), she expressed concern about 439's financial position. She believed the financial statements indicated that 439 may be facing liquidity problems. One factor she identified was the number of loans that were not performing. At the meeting, McPhail cited a few examples of what she considered to be problem loans. Anderson reviewed each one and gave reasons why he believed it would ultimately be collected, but said he "would put a little more effort to collecting the delinquent loans."

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¶ 77 In its report, Pricewaterhouse said:

A lack of proper management information undoubtedly delayed the time in which management might reasonably have become aware of the underperformance of the loan portfolio and income generated by other Company assets. Notwithstanding, management had been aware of the trading losses suffered by the Company for some time.

¶ 78 At the hearing, Pallen was asked, “given the information systems that were in place . . . were Anderson and Montaldi acting in a prudent manner . . . in terms of how they conducted their business?” Pallen replied, “Oh, no, they weren't, in my opinion.”

### **F. 439's Financial Position**

¶ 79 The 439 financial statements for the years ended December 31, 1996 through 2000 were before us. (The 2001 statements were not prepared when Shutdown occurred.)

¶ 80 Pricewaterhouse found two items in the 2000 financial statements that in its opinion required adjustment in order for the statements to more accurately reflect 439's financial position. The first resulted in a reduction of revenue by \$750,000; the second resulted in an increase in expenses of \$1.2 million. In these Findings we have used the adjusted 2000 statements.

#### *Assets, liabilities and capital*

¶ 81 439's assets were primarily its loan portfolio and other assets described in the financial statements as “investments”. Its liabilities were primarily the amounts owed to investors under the notes.

¶ 82 439 did not have capital reserves to fall back on. Shareholder equity was nominal, and 439 carried a deficit from 1997 onward. This deficit, which was \$311,000 in 1997, reached \$2.4 million at the end of 2000.

¶ 83 439's notes payable, which represented the money 439 owed to its investors, exceeded notes receivable, which represented the money owed to 439 by borrowers, and the shortfall increased throughout the period.

¶ 84 439 also increased its investment in illiquid assets that did not generate revenue consistently or on demand. This meant less money advanced to borrowers, and therefore less cash flow to service the investors' notes. As noted above, the non-producing assets included developed and vacant land, shares of private companies,

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silver and gold bullion, portable bridges, and a racehorse. This is summarized in the following table:

**Table 2 – 439 Assets and Liabilities**

(\$000's; excludes accrued interest on notes)

YEAR	NOTES RECEIVABLE* (OWED BY BORROWERS)	NOTES PAYABLE (OWED TO INVESTORS)	NOTES RECEIVABLE LESS NOTES PAYABLE	OTHER ASSETS
1996	6,865	7,651	(786)	65
1997	8,349	10,012	(1,663)	66
1998	12,078	15,316	(3,238)	823
1999	15,070	21,454	(6,384)	1,438
2000	18,811	28,610	(9,799)	3,170
Shutdown	27,800	39,404	(11,604)	4,700

Source: 439 financial statements; Pricewaterhouse report

\*including related party loans

- ¶ 85 An important indicator of financial health is the “current ratio” – the relationship between current assets and current liabilities. From an accounting perspective, if current liabilities continually exceed current assets, it means the assets of the business are illiquid and it may lack the working capital necessary to sustain operations. This is indicated when the “current ratio” – current assets divided by current liabilities – is less than 1. As the following table shows, 439’s financial statements during the relevant period show a generally rising excess of current liabilities over current assets, and a generally falling current ratio, an indication of illiquidity:

**Table 3 – 439 Current Ratio**

(\$000's)

YEAR	CURRENT ASSETS	CURRENT LIABILITIES	CURRENT ASSETS LESS CURRENT LIABILITIES	CURRENT RATIO
1996	5,721	7,465	(1,744)	0.77
1997	7,607	10,173	(2,566)	0.75
1998	10,088	14,775	(4,687)	0.68
1999	13,897	21,801	(7,904)	0.64
2000	20,006	27,213	(7,207)	0.74

Source: 439 financial statements

- ¶ 86 439’s major asset was its loan portfolio. In connection with the proposal, Pricewaterhouse divided 439’s non-related party loans into four categories labelled A – Good, B – Fair, C – Poor, and D – Bad. These labels appear more to reflect the relative, rather than the absolute, quality of the loans. For example, a



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loan that paid only 50% of the interest due was categorized as “Good”, so long as the loan balance had dropped by at least 50% between January 1, 2001 and May 9, 2002. This was the distribution of 439’s non-related party loans among these categories at Shutdown:

**Table 4 – 439 Loan Performance – Non-related Party Loans**

(\$000's)

CATEGORY	LOAN BALANCES	PERCENTAGE OF PORTFOLIO
A (Good)	10,684	35%
B (Fair)	5,094	17%
C (Poor)	1,090	4%
D (Bad)	13,426	44%

Source: Pricewaterhouse report

- ¶ 87 Under the Pricewaterhouse rating system, the “Bad” loans were those in which less than 51% of interest earned during the period January 1, 2001 and May 9, 2002 was paid, and in which the loan balance increased during that period.
- ¶ 88 In his testimony, Pallen succinctly summarized 439’s position based on the book value of its assets and liabilities on May 9, 2002:

We have total assets including those loans of \$37.6 million, and we have total liabilities of \$41 million. We're insolvent.

***Earnings and cash flow***

- ¶ 89 439 operated at a loss for most of the relevant period, and in three years, cash flow was negative:

**Table 5 – 439 Income, Losses and Changes in Cash Position**

(\$000's)

YEAR	INCOME (LOSS) FROM INCOME STATEMENT		INCOME (LOSS) FROM LENDING ACTIVITIES*		INCREASE (DECREASE) IN CASH**
	YEAR	CUMULATIVE	YEAR	CUMULATIVE	
1996	8	8	64	64	235
1997	(352)	(344)	(167)	(103)	(88)
1998	(90)	(434)	49	(54)	(33)
1999	(1,316)	(1,750)	(919)	(973)	1,046
2000	(715)	(2,465)	(418)	(1,391)	(919)

Source: 439 financial statements; Pricewaterhouse report

\*interest income less interest expense and bad debts

\*\*includes new funds raised from investors

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¶ 90 Grace Yu is a chartered accountant and an investigator with Commission staff. Yu analyzed 439's financial statements and noted the following trends during the relevant period:

- The interest receivable from borrowers as a percentage of principal receivable grew over the period from 4.6% in 1996 to 12.3% in 2000. Interest receivable as a percentage of interest income grew over the period from 40% in 1996 to 82% in 2000. Yu said the rate of collection of interest fell during the period, indicating either that borrowers were defaulting, or management was extending the time for payment, or both. Yu said that the trend is significant, and should have been a warning flag to management, because it meant the loan interest revenue available to pay interest due to investors was falling.
- The interest payable to investors as a percentage of principal payable to investors grew from 1.4% in 1996 to 3.0% in 2000. Interest payable to investors as a percentage of interest expense grew from 16% in 1996 to 25% in 2000. Yu said the ratio of interest paid investors to interest owed investors was dropping, indicating either that 439 was defaulting on payments to investors (the evidence is that it was not), or that the choice of many investors to let interest on their investments compound, instead of receiving monthly interest payments, masked cash demands that otherwise would have occurred from this source.
- Interest paid to investors in cash exceeded interest collected from borrowers in cash throughout the period:

**Table 6 – 439's Cash Loss from Lending Activities, and Other Income**

(in \$000's)

YEAR	CASH INTEREST COLLECTED FROM BORROWERS	CASH INTEREST PAID TO INVESTORS	CASH INTEREST COLLECTED LESS CASH INTEREST PAID	OTHER CASH INCOME	NET CASH FROM OPERATIONS
1996	667	670	(3)	680	677
1997	926	1,015	(89)	6	(83)
1998	1,625	1,656	(31)	51	20
1999	1,989	2,507	(518)	27	(491)
2000	2,164	3,216	(1,052)	72	(980)

Source: Commission staff analysis; 439 financial statements

¶ 91 In its report, Pricewaterhouse said:

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The primary cause of the Company's financial difficulty was incurring more interest expense on investor contributions than the Company was earning on its loan portfolio and other assets. Many of the loans were accruing interest but the borrowers were not paying this interest.

...

Instead of receiving monthly interest payments, many investors let their investments compound over the period. This practice concealed cash shortages that otherwise would have occurred.

### *Anderson's and Montaldi's view*

¶ 92 Anderson said he never paid much attention to the financial statements. He said:

I always felt that the company was profitable, that we had assets to back up all the money we obtained from investors, and that the combined total of the assets of the company and [Montaldi] and I would always handle any money we borrowed from investments.

...

In rough numbers I would always look at if we had investments of \$40 million that we were paying 12% that would cost us \$4.8 million. If we put that same \$40 million out in loans and other investments and were getting 18% that would be whatever 18 times 4 is . . . there was a large spread. And I always felt that that spread would certainly handle all of our operating expenses and allow for a large number of bad debts. We realized when we put out loans at high interest rates that were certainly going to be bad risks, bad debts.

¶ 93 Asked his definition of a bad loan, Anderson said "I guess I would call a bad loan one that we would never be able to collect on."

¶ 94 Both Anderson and Montaldi believed that the financial statements did not reflect the true value of 439 because they recorded assets at cost, and did not reflect their fair market value. They believed that the assets at fair market value easily exceeded 439's liabilities. They also believed that the assets held by 439 outside the loan portfolio were available for liquidation if necessary to meet principal and interest payments to investors.

¶ 95 Anderson and Montaldi also believed that the best proof of 439's health was that it was able to maintain a cash balance in the bank of between \$500,000 and \$600,000 (at Shutdown, the bank balance was about \$763,000) and that it never missed a payment of principal or interest to an investor. Anderson and Montaldi believe that 439's financial difficulties are solely attributable to the Shutdown.

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- ¶ 96 Montaldi, however, was not content with 439's profitability. He testified about the 1997 financial statements, which showed a loss of about \$352,000, including a write-off for bad debts of about \$400,000, saying "so there was concern about how the loan portfolio was performing, the level of bad debts that was substantially higher than what we had ever written off previously . . . ."
- ¶ 97 Of the 1998 financial statements, showing a loss of about \$90,000, Montaldi said "there was a loss, but it was substantially less. . . . And so that made me feel that, okay, this is better. It's not perfect, not where we want to be, but it's certainly a lot better."
- ¶ 98 Then came the 1999 financial statements, showing a loss of \$1.3 million. About this, Montaldi testified "So, once again, it appeared that we weren't in control of our receivables and that we were suffering more bad debts than we had expected. . . ."
- ¶ 99 Montaldi went on to say:

And by this time, we were handling between 20 and 30 million dollars' worth of investments. And I had discussions with Glenn saying a couple of things. One, that the company wasn't making adequate profits for the amount of work that they were doing in managing 20 to 30 million dollars' worth of investments, and that we needed to strengthen our financial statements . . . the financial statements aren't strong enough. I mean, we obviously, once again, discussed the bad debts and, you know, why were there is as many as there were. Once again, [Anderson] felt that he had a pretty good handle on the vast majority of the loans, but of course the number of loans was increasing as well, because of the growth.

And we decided that we needed to strengthen the margins. And so in November of 2001, we made the decision that we would give investors three months' notice . . . that we would be reducing their rate from 12% to 10% . . . . We also decided that we should increase the interest rate that we charge those that borrowed from the company. So . . . we increased that to 18% compounded monthly . . . , which the effective rate I believe is about 19.5, 6 or 8 percent . . . we expected that that 3% shift in margins would generate somewhere between \$900,000 to \$1.2 million in bottom-line profits.

- ¶ 100 Anderson and Montaldi began to implement this strategy right away. Following his practice of contacting investors three months before their investments matured, Anderson began contacting investors whose investments were coming due in

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February 2002 that the interest rate would fall from 12% to 10%. The loans made by 439 after January 1, 2002 reflected the new lending rate.

### G. Regulatory Matters

- ¶ 101 Anderson and Montaldi both testified that they were not aware that 439's business was subject to regulation. They said they first became aware of this when Commission staff wrote them on October 26, 2001, expressing concern that 439 may have breached the Act. In early November, Anderson and Montaldi, on the advice of their local counsel, met with a law firm in Vancouver experienced in securities matters. According to Montaldi, at the conclusion of that meeting, they realized that their business was regulated by the *Securities Act*, the *Financial Institutions Act* and the *Mortgage Brokers Act*. (FICOM administers the latter two.)
- ¶ 102 Some time later, Anderson and Montaldi met with Commission staff, which led to regular correspondence and telephone conversations between Commission staff and Montaldi over the next few months. On December 19, 2001, Montaldi sent information that staff had earlier requested. On February 6, 2002, staff wrote to Montaldi stating that 439 had indeed breached the Act, discussion their findings, and mentioning the enforcement options, including settlement or proceeding to a hearing.
- ¶ 103 By this time, it was tax season, and Montaldi was busy. He said, "It's income tax time. I'm working seven days a week. So we didn't act at that point. The intention was to pursue it later."
- ¶ 104 In the meantime, Commission staff notified FICOM of the matter on April 24, 2002, and FICOM initiated the process leading to Shutdown.

### H. Investors

- ¶ 105 In connection with its investigation, Commission staff sent questionnaires to investors in 439. Over 100 investors responded, and took the opportunity to describe the personal consequences to them as a result of having invested in 439. For example:
- Aganetha Bergen is 87 years old. She invested all her savings in 439. She says her health is failing and she needs her money to move into a retirement home.
  - Joseph Comeau is 79. His wife is in an extended care home outside Burns Lake, and it is a 60-mile round trip for him to go and visit her. He had bought

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a lot closer to his wife so he could visit her more easily and invested the funds he was going to use to develop the lot. Those plans are now on hold.

- Eva Giesbrecht is 57. Her investment in 439 was her, and her late husband's, life savings. Her dream of building a new home for herself is gone. She says she is devastated.
- Doris Jeffrey is 64. She is on a disability pension and was looking forward to using her savings to send her granddaughter to college, do some travelling and "enjoy life". Now, she says there is little left after her bills are paid, and her granddaughter was unable to attend college.

### **III The Proposal**

¶ 106 According to the Pricewaterhouse report, the purpose of the Proposal is to:

- Maximize the overall economic return to investors;
- Enable the business, previously conducted by the 439, to continue to serve investors, borrowers and the Lakes District communities;
- Enable the business to comply with all relevant legislation and regulations; and
- Provide a regular payment to investors on their ongoing investments.

#### **A. Terms of the Proposal**

¶ 107 This is a summary of the terms of the Proposal:

- A new company was formed, called Area Finance Inc.
- Pricewaterhouse divided 439's non-related party loans into four categories labeled A – Good, B – Fair, C – Poor, and D – Bad, as described above (see "Management of 439's Business").
- The A, B and C loans were transferred to Area Finance. Area Finance also assumed the liabilities related to these assets. Area Finance has about \$1 million in capital and is intended to operate as a going concern. However, neither Pricewaterhouse nor Area Finance has undertaken a detailed review of the loan portfolio or determined appropriate reserves for these loans.
- The D loans were left with 439, along with most of the related party loans and most of the assets not related to the loan portfolio; 439 is in liquidation.

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- The 439 notes held by investors were replaced with two debentures – one from 439 and one from Area Finance – each with a face value of 50% of the investor’s proven claim under the Proposal. The two debentures satisfy all claims of the investors against 439.
- The debentures have a seven year term. The Area Finance Debentures bear interest at 6%, payable monthly. The 439 debentures pay no interest; semi-annual payments are made to investors from the realization of assets under 439’s liquidation.
- A percentage of Area Finance’s profit, determined under a formula, is to be paid annually to 439 and distributed to the 439 debentureholders.
- Both the 439 and the Area Finance debentures are guaranteed by Anderson and Montaldi, and they have each pledged all their existing and after-acquired assets as security for the guarantee. Area Finance is the beneficiary of life insurance policies on Anderson and Montaldi of \$4 million each.

¶ 108 The impact of the Proposal on the investors’ investment in 439 is that their interest rate has, in effect, been cut from about 12% to about 3%, and the term of their investment has been extended to seven years. All concerned also seem to be of the view that the liquidation of 439 will not provide investors with a payout equal to half their investment, so it appears investors will lose a portion of their capital as well.

¶ 109 The total cost to investors remains to be seen. The Pricewaterhouse report states:

Given the uncertain nature of many of the assets of the Company, it is not possible for us to provide a reasonable estimate of the return that creditors can expect to receive from this Proposal. However, given that [Area Finance] will be issuing debentures for 50% of the investor claims, we can estimate that the return to creditors will be in excess of 50 cents on the dollar of proven claims.

¶ 110 The 439 assets have also been reduced by about \$900,000 in fees to Pricewaterhouse. Its work as trustee under the Proposal is concluded, but it remains involved as the interim receiver of 439.

### **B. New Capital**

¶ 111 The Proposal contemplates that Area Finance will continue to raise new money from investors in future through an issue of debentures. We asked Montaldi,

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Pallen, and one of Area Finance's independent directors whether it would be possible for Area Finance to meet its obligations to investors under its debentures if it were not possible for it to raise capital. They all testified that it was possible, but only if Area Finance performed at the higher end of the range of possible scenarios.

### C. Governance of Area Finance

¶ 112 An important issue for Pricewaterhouse and the investors is the governance structure of Area Finance, to ensure that the management problems identified in the Pricewaterhouse report would not re-occur in Area Finance. This is not an academic concern, because it is contemplated that, subject to the outcome of these proceedings, Anderson and Montaldi will be officers and directors of Area Finance.

¶ 113 Anderson and Montaldi are currently involved in running Area Finance. Area Finance is paying Anderson and Montaldi \$240,000 per year collectively. Anderson receives about \$160,000 and Montaldi about \$80,000.

¶ 114 Many investors believe that Anderson's involvement, in particular, is important to Area Finance. Although some investors expressed doubts about Anderson in the questionnaires, it appears that many still trust him and believe his knowledge of the borrowers, and his relationships in the community, are important to maximize the collection of the loans in both Area Finance and 439. Here is a sample of the testimony we heard from investors on this issue:

Witness 1:

Question . . . do you think this company can survive without [Anderson]?

Answer No.

Witness 2:

Question Do you think the proposal will work without the involvement of [Anderson and Montaldi] in the new company?

Answer No, no, no it won't work. Not without [Anderson] anyway, need to have [Anderson].

Witness 3:

Question In your opinion, is Glenn Anderson important to the collection of those loans for 439?

Answer Absolutely.

¶ 115 Pricewaterhouse also believed that the continued involvement of Anderson and Montaldi is important. Pallen testified as follows:



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Question . . . at the time of the proposal . . . did you believe that Mr. Anderson and Mr. Montaldi's continued involvement in management of what would be Area Finance . . . was necessary?

Answer They were necessary to the management of the new company?

Question Yes. The success of the new company?

Answer Yes.

¶ 116 However, Pricewaterhouse believes that Area Finance's governance structure is also important:

Question Do you have any reservations about Mr. Montaldi and Mr. Anderson's ability to exercise the plan in the proposal?

Answer If they were doing it in isolation to the other directors.

Question [In your report] you identify a number of activities that give rise to questions about how the company's managed.

Answer Yes.

Question And is there anything -- is there anything arising out of that that leaves you any lingering reservations at all about having these gentlemen execute the plan, even with the board that's been put in place to oversee the operation, or do you consider that all of the issues that you raised in the conduct of the debtor section have been fully addressed by the proposal and we don't need to worry about any of that?

Answer We believe that the expanded governance and real control in the outside directors compensates adequately for those issues that we addressed with conduct of the debtor.

Question That's what you're relying on?

Answer Yes.

¶ 117 The following sections summarize the governance arrangements for Area Finance, which is incorporated under the *Canada Business Corporations Act (CBCA)*.

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They are contained in a unanimous shareholders agreement, and in resolutions of the company passed as of October 29, 2002.

### *Shareholders*

- ¶ 118 Area Finance has seven shareholders. Five of the shareholders hold one voting share each. These shareholders are also Area Finance's directors. The other two shareholders are Anderson and Montaldi, who each hold one non-voting share.

### *Directors*

- ¶ 119 The shareholders are also Area Finance's directors. They are all independent of Anderson, Montaldi, and 439, and all are investors but for one, who is not an investor but has family members who are. Some of the directors have business or professional experience, but none has any experience in overseeing or managing a lending business. One of the directors testified that he had no experience as a director of an operating company and has no plans to take any training about the duties of being a director. He also said that the board as a whole has not considered the idea of getting training on those issues.

- ¶ 120 Anderson and Montaldi are not directors of Area Finance because of the Commission's temporary orders, but it is contemplated that they will be, depending on the outcome of these proceedings.

### *Officers*

- ¶ 121 Until the temporary orders took effect, Montaldi and Anderson were President and Secretary-Treasurer, respectively. Independent directors now fill the officer positions. Anderson and Montaldi are, however still significantly involved in the operation of Area Finance. Anderson has the title of "Manager", and each have the same authority to sign cheques and to bind the company as the officers and directors.

### *Signing Authority*

- ¶ 122 Any two of the officers, directors, Anderson and Montaldi can sign cheques up to \$75,000. For cheques over that amount, one of the two signatories must be an independent director.

### *Board authority and quorum*

- ¶ 123 Board approval is required for related party loans, investments by related parties, capital expenditures over \$15,000, and activities unrelated or unnecessary to the company's current business. The unanimous shareholder agreement also requires board approval for the incurrence of new debt by the company, but excepts from this the issuance of debentures as contemplated by the Proposal. However, it appears that under the CBCA, board involvement would be required to issue the debentures, which is consistent with the evidence of the witnesses.

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### *Lending policy*

¶ 124 The board has adopted a lending policy, which includes the following features:

- The policy includes “lending guidelines”. They are intended to be flexible; the policy states:

The following guidelines are to be used in the analysis of an application and should remain flexible enough to allow the loans officer to make an objective decision. The guidelines must not overrule the loans officer’s judgment in making a credit decision . . .

The policy goes on to state that a successful applicant “must have the ability to repay” but also says that “the loans officer’s personal knowledge about the applicant and their overall qualifications, including future creditworthiness, may also be used to establish capacity”.

The Area Finance loan officers are Anderson and his son, Jarrett.

- The policy has a section dealing with loan limits and security. It says that loans up to \$35,000 can be made on an unsecured basis. Loans over that amount must either be secured or be supported by a credit check and a net worth statement of the borrower (the latter two requirements are apparently not required for loans under \$35,000). Jarrett Anderson is authorized to approve loans up to \$5,000 per borrower and Anderson up to \$75,000. Loans over \$75,000 must be approved by the board’s credit committee. Interest rates are at the discretion of the loan officer, within ranges set by the board.
- The board credit committee consists of three directors, two of whom must be independent. The policy says that all credit committee members must have “knowledge applicable to the granting of credit”.
- The policy sets out a detailed process for collecting “delinquent” (the policy does not define “delinquent”) loans, and sets performance targets for delinquent loans as a percentage of the total portfolio. The target is for delinquent loans to be less than 3% of the total portfolio. The policy says that if the target is missed, then the target is to “reduce the delinquent loan balances by 2% each month” but imposes no overall timeframe in which the loan portfolio must re-achieve the general 3% target.

### *439 management agreement*

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¶ 125 Area Finance has a management agreement with 439 under which it takes responsibility for liquidating 439. Beginning in October 2003, Area Finance will earn a commission of 5% on the assets realized, except for related party loans.

### *Financial reporting*

¶ 126 Area Finance is required to deliver “quarterly financial reports” to the directors within 30 days of the end of each quarter, and audited annual financial statements within 120 days of year-end.

### **IV Analysis and Findings**

¶ 127 The notice of hearing alleges that Anderson and Montaldi:

1. traded and distributed securities without being registered or filing a prospectus, contrary to sections 34 and 61 of the Act;
2. made misrepresentations, contrary to section 50(1)(d) of the Act;
3. perpetrated a fraud on persons in British Columbia, contrary to section 57(b) of the Act; and
4. acted contrary to the public interest in dealing with investors.

¶ 128 The standard of proof required to establish contraventions of the Act is set forth in *Re Capital Reserve Inc. and In the Matter of Jerome Rak, et al.* [1988] 98 BCSC Weekly Summary, where the Commission enunciated the standard as follows (at page 26):<sup>1</sup>

The basic test in our proceedings is the balance of probabilities. It may be that in serious matters, like the present case, we require a relatively high degree of proof within that standard.

¶ 129 The notice of hearing alleges fraud. Those allegations in particular require proof at the high end of the range.

### **A. Failure to Register or to File a Prospectus**

¶ 130 Paragraph 9 of the notice of hearing alleges:

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<sup>1</sup> The Commission was upheld by the British Columbia Court of Appeal. See *Rak v. British Columbia (Superintendent of Brokers)* (1990), 51 B.C.L.R. (2<sup>nd</sup>) 27.

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9. (a) [Anderson and Montaldi] traded in securities without registration and without an exemption from the registration requirements of the Act, contrary to section 34(1) of the Act.

9. (b) [Anderson and Montaldi] distributed securities without filing a prospectus and without an exemption from the prospectus requirements of the Act, contrary to section 61(1) of the Act.

¶ 131 Anderson and Montaldi admit that in causing 439 to issue notes to investors, they traded in securities, that those trades were a distribution of securities as defined in the Act, that they failed to register or to file a prospectus as required by the Act, and that they had no exemptions from the requirements to register or to file a prospectus.

¶ 132 We therefore find that Anderson and Montaldi each traded securities without being registered, contrary to section 34 of the Act, and each distributed securities without filing a prospectus, contrary to section 61 of the Act. At Shutdown, about 450 investors held \$41 million of these securities.

### **B. Misrepresentation**

¶ 133 Paragraph 9 of the notice of hearing alleges:

9. (c) [Anderson and Montaldi] made statements with the intention of effecting a trade in securities, which they knew or ought to have known were misrepresentations, contrary to section 50(1)(d) of the Act. In particular, they did not disclose to Investors that the funds that they invested in the Company might be used to pay interest and capital due to existing Investors.

¶ 134 On its face, the second sentence narrows this allegation to one misrepresentation. Anderson and Montaldi say this is the proper way to interpret the notice of hearing, and that they prepared their case on that basis. They acknowledge that staff could have omitted the second sentence, but in that case, they say, they would have asked for particulars of the misrepresentations that staff intended to pursue. They say that was unnecessary because paragraph 9(c) particularized the allegation on its face.

¶ 135 Commission staff says that the second sentence is just an example of a number of misrepresentations alleged throughout the notice of hearing, and we are entitled to find a breach of section 50(1)(d) based on any of them.

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¶ 136 We agree with Anderson and Montaldi. Staff has a responsibility to draft notices of hearing that clearly state the facts on which staff is relying to establish a breach of the Act. Elsewhere in the notice of hearing there are several allegations which, if proven, could have formed the basis for a finding that Anderson and Montaldi breached section 50(1)(d) of the Act. Instead, it particularized only one, and in our view Anderson and Montaldi were entitled to regard that as the sole allegation of misrepresentation that they had to meet.

¶ 137 Section 50(1)(d) provides:

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

. . .

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

“Material fact” and “misrepresentation” are 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;

“misrepresentation” means

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

¶ 138 The misrepresentation alleged in the notice of hearing involves the failure to disclose material facts. Section 50(1)(d) says a person must not “make a statement” that is a misrepresentation. Does that mean that section 50(1)(d) does not apply to a mere omission to state material facts? No. In *Re Specialized Surgical Services Inc.*, 2002 BCCSECCOM 675, the Commission found that a misrepresentation under section 50(1)(d) includes the non-disclosure of material information. The Commission stated (at paragraph 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

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here because Specialized Surgical did not "make a statement" but rather omitted to state certain facts. We do not agree.

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.

¶ 139 The investors felt they were essentially dealing, not with 439, but with Anderson and Montaldi directly. To some extent they, and Anderson and Montaldi, conducted themselves as if that were so. Nevertheless, 439 was the entity that had their money and carried on the business. Its circumstances are therefore highly relevant to the issues before us in this hearing.

¶ 140 To find that Anderson and Montaldi breached section 50(1)(d), we therefore have to find that:

- funds from new investors might have been used to pay interest and capital due to existing investors,
- this was a material fact,
- Anderson and Montaldi did not inform investors of this fact,
- Anderson and Montaldi knew or ought reasonably to have known that this was a misrepresentation, and
- Anderson and Montaldi made the misrepresentation with the intention of effecting a trade in a security.

***Were funds from new investors used to fund amounts owing to existing investors?***

¶ 141 439 had significant cash demands. It needed sufficient cash to cover interest and principal payments to investors, loan losses and general and administrative expenses. Anderson and Montaldi say that 439's large bank balances, and its spotless record of principal and interest payments to investors, shows that its cash position was strong. The question is, however, where was that cash coming from?

¶ 142 Table 3 (see: "439's Financial Position" above) shows that 439 was in a negative working capital position throughout the relevant period.

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- ¶ 143 Table 5 shows that 439 was in a cumulative loss position throughout the relevant period, both from its total operations and its lending operations. In three of the years, the financial statements showed a decrease in cash, notwithstanding the continuing inflow of funds from investors.
- ¶ 144 Table 6 shows that on a cash basis, 439 lost money on its lending operations every year, and that the losses were growing markedly – in the last three years, the growth of these cash losses was exponential. Anderson and Montaldi suggested that this does not tell the whole story, because 439 had other assets that produced cash through rental income, or through gains on sale of assets held for investment. Yet the Pricewaterhouse report shows that the net cash flow of the other assets held by 439 at Shutdown was negative, and, as Table 6 shows, the other income shown on 439’s financial statements during the relevant period came nowhere near to covering its cash losses from lending operations.
- ¶ 145 Apart from the information in 439’s financial statements and the Commission staff analysis, an objective assessment of the company’s general circumstances would lead a reasonable observer to conclude that cash flow from operations might well be compromised:
- Investment in other assets (those not generating revenue consistently or on demand) grew significantly during the relevant period, both in absolute and relative terms (see Table 2). Other assets grew from \$65,000 in 1996 to \$4.7 million at Shutdown; as a percentage of notes payable, they grew from less than 1% in 1996 to 11.9% at Shutdown.
  - 439 was inadequately capitalized and had accrued a substantial operating deficit.
  - 439 made loans totalling, at Shutdown, \$8 million (including accrued interest) to related parties. These loans did not generate significant revenue, because the borrowers were generally not making principal and interest payments. In addition, Anderson and Montaldi caused 439 to forgive over \$1.7 million of interest payments on these loans due from themselves.
  - There were significant performance problems with the rest of the loan portfolio. As shown in Table 4, nearly half of 439’s loans at Shutdown were in category D – “Bad”. In fact, only 35% were categorized as “Good” under Pricewaterhouse’s rating scheme.
- ¶ 146 The 439 business model, as represented to investors, was founded on raising money from investors at 12% and lending it out at 18%. This spread was to cover



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loan losses and expenses and provide a profit. However, a significant portion of investors' funds were deployed in a manner inconsistent with this model – they were applied to related party loans and other assets that did not yield cash returns. At Shutdown the related party loans and other assets totalled \$12.8 million, or 32% of investors' funds. The cash problem this created was exacerbated by the poor performance of the loan portfolio.

¶ 147 The evidence shows that 439 did not generate enough cash from lending operations to meet its obligations to borrowers, and that it had no other significant sources of cash income. The inescapable conclusion is that 439's cash losses were covered, at least in part, by funds raised from new investors.

¶ 148 We therefore find that 439 used money from new investors to pay interest and capital due to existing investors.

### ***Was this a material fact?***

¶ 149 The degree of credit risk assumed is an important factor in the value of a debt security. The fact that 439 could not cover its interest and principal payments to investors from operations, and therefore needed new money from new investors to do so, clearly affects the credit risk, and could therefore be reasonably expected to affect the value of the notes. Certainly many investors thought so; 33 investors who completed questionnaires gave responses indicating that this information, had they known it, would have been relevant to their investment decision. We find that 439's use of money from new investors to pay interest and capital due to existing investors was a fact that could reasonably be expected to significantly affect the value of the notes, and therefore a material fact.

### ***Did Anderson and Montaldi fail to inform investors of this fact?***

¶ 150 There is no dispute that Anderson and Montaldi did not inform investors of this material fact, and therefore we find that they made a misrepresentation.

### ***Ought Anderson and Montaldi reasonably to have known that this was a misrepresentation?***

¶ 151 Anderson's and Montaldi's evidence on this point is that they did not believe that 439 had cash difficulties because they always had large cash balances and never missed a payment to investors.

¶ 152 Anderson testified that he didn't understand financial statements and paid little attention to them. Instead, he gauged 439's business at a high level – he believed the spread between \$40 million in at 12% and lent out at 18% would be adequate to cover expenses and loan losses. He also said he believed that the related party loans were the “best loans” and that 439's assets (including the “other assets”), together with his and Montaldi's, were sufficient to cover 439's obligations to

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investors. He said he had faith that most of 439's problem loans would eventually be paid. He saw that 439 had significant cash balances and was meeting its obligations.

¶ 153 Anderson and Montaldi had divided things up so that Anderson was primarily responsible for the relationships with the investors and the borrowers, and Montaldi was responsible for the financial end of the business. This does not mean, however, that Anderson was not in a position to know about 439's cash position had he fully turned his mind to it, which as an officer and director he had a duty to do.

¶ 154 He may have no secondary education, nor, as he testified, much knowledge about accounting, finance and related matters. However, he did not need these things to see the indicators staring him in the face that his high-level view of 439's business was flawed:

- It was not reasonable for Anderson to apply the interest spread to all the funds that 439 raised from investors. He knew that a significant portion of these funds (at Shutdown, 32%) was going to the related party loans and other assets – uses that did not generate significant cash returns.
- Therefore, he ought to have realized that substantially less money was being lent out at 18% than was coming in at 12%.
- He was the one who dealt with the borrowers on a regular basis and knew that many of 439's borrowers were not paying. He may have believed that ultimately the loans would be paid, but he knew that in the meantime these loans were not producing cash returns.
- He was alerted by McPhail about her concerns over 439's financial position and recognized that he needed to “put a little more effort to collecting the delinquent loans.”

¶ 155 Whether or not Anderson actually knew that 439 had cash problems, these factors ought to have alerted him to that possibility, and as a director and officer of 439, he had a duty to make further inquiry to find out if, in fact, there was a problem. Montaldi was similarly aware that a significant portion of the investors' funds were going to the related party loans and the other assets. He was similarly alerted by McPhail that there may be liquidity problems and that there may be problems with the loan portfolio. Like Anderson, whether or not he knew these problems to exist in fact, he had enough information to put him on notice, and, as a director and officer of 439, had a duty to pursue that matter. Montaldi also has a commerce

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degree and CPA. He is a trained, qualified and practicing accountant. Accounting was his main profession. His responsibility, for which he was very well paid, was to ensure that 439 remained on a solid financial footing. Whether or not he in fact knew that 439 had cash problems, it was his job to ensure he had sufficient information, and to do the necessary financial analysis to satisfy himself as to the financial position of the company. Had he done so, he would have discovered the difficulties.

¶ 156 We therefore find that Anderson and Montaldi ought reasonably to have known that, in failing to disclose to investors that the funds they invested in 439 might be used to pay interest and capital due to existing investors, they were making a misrepresentation.

*Did Anderson and Montaldi make the misrepresentation with the intention of effecting a trade in a security?*

¶ 157 Anderson's and Montaldi's misrepresentation happened when they spoke to people about investing in 439, and was therefore a misrepresentation made with the intention of effecting a trade in a security.

¶ 158 We therefore find that Anderson and Montaldi breached section 50(1)(d).

### C. Fraud

¶ 159 Paragraph 9 of the notice of hearing alleges:

9. (d) [Anderson and Montaldi] perpetrated a fraud on persons in British Columbia, contrary to section 57(b) of the Act when they:

(i) accepted investments from Investors:

(A) after they were aware that the Company was not profitable and that its liabilities exceeded its assets; and

(B) without disclosing to Investors the true state of the Company's affairs;

thereby concealing from Investors the true risk of investing in the Company;

(ii) gave personal guarantees to Investors to encourage them to invest, when the aggregate value of the guarantees exceeded their combined net worth; and

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- (iii) did not disclose to Investors that they were using Investors' funds for their own purposes and not for the proper conduct of the Company's business.

¶ 160 Section 57(b) provides:

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.

¶ 161 In *Re Timothy James Pinchin*, [1996] 41 BCSC Weekly Summary 7, the Commission followed the definition of fraud found in *R. v. Olan, Hudson and Hartnett* (1978) 41 C.C.C. (2d) 145 (S.C.C.) (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 element of deprivation is satisfied on proof of detriment, prejudice, or risk of prejudice to the economic interests of the victim. It is not essential that there be actual economic loss as the outcome of the fraud.

¶ 162 In *Re Excel Asset Management*, [1999] 18 BCSC Weekly Summary 29, the Commission followed the test for dishonesty found in *R. v. Zlatic*, [1993] 2 S.C.R. 29 (at page 45):

. . . 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). Negligence does not suffice. Nor does taking advantage of an opportunity to someone else's detriment, where that taking has not been occasioned by unscrupulous conduct, regardless of whether such conduct was willful or reckless. The dishonesty of “other fraudulent means” has, at its heart, the wrongful use of something in which another person has an interest, in such

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a manner that this other's interest is extinguished or put at risk. A use is "wrongful" in this context if it constitutes conduct which reasonable decent persons would consider dishonest and unscrupulous.

¶ 163 In *R. v. Cuerrier*, [1998] 2 S.C.R. 371, the court dealt with whether non-disclosure can constitute fraud. Citing *Olan* and *Zlatic*, the court said (at paragraph 116), “the essential elements of fraud are dishonesty, which include non-disclosure of important facts, and deprivation or risk of deprivation.”

¶ 164 Counsel cited authorities establishing the appropriate state of mind necessary to find guilt under the *Criminal Code*. These cases are not relevant to the test for fraud under the Act.

¶ 165 The state of mind relevant specifically to section 57(b) was considered in *R. v. White* (25 February 1999), Vancouver Registry No 22210-01 (B.C. Prov. Ct.) in which Smith, J. stated as follows (at page 25-26):

. . . the section does not require that the defendant be shown to have a fraudulent state of mind. The element of dishonesty that is essential to fraud need not attach to the defendant, but it must be a feature of the scheme. A defendant who participates in a transaction or scheme unaware that it perpetrates a fraud is entitled to an acquittal. . . . It follows from this that I am also not in agreement with the contention that [section 57(b)] is an offence of strict liability. While the mental element required to be proved in the defendant is not the mental element of fraud, it is not enough for conviction to fix the defendant only with participation in the transaction or scheme. The Crown must prove at the least that the defendant knew of facts from which he or she ought reasonably to have known that the transaction or scheme perpetrated a fraud.

¶ 166 *White* establishes that fraud can be established under section 57(b) in absence of actual dishonest conduct by the defendant.

¶ 167 In *Re Eron Mortgage Corporation*, [1999] 48 BCSC Weekly Summary 84, the Commission considered the matter further and said the following (at page 180):

Billier [a respondent] argued, on the basis of these cases, that the words “ought reasonably to know” in section 57 must be interpreted in such a way that the respondent must be found to have been reckless or wilfully blind. We do not agree. The language of section 57 is plain on its face, and there is no reason to interpret it differently from its ordinary meaning.

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As held in *White*, a finding that Biller ought reasonably to have known that [the other] respondents were perpetrating a fraud does not require a finding that Biller acted dishonestly or with fraudulent intent, just that he knew of facts from which he ought reasonably to have known that the transaction perpetrated a fraud.

¶ 168 To find that Anderson and Montaldi breached section 57(b), we therefore have to find:

- the facts on which the alleged fraud is based,
- that those facts constituted the perpetration of a fraud, and
- that Anderson or Montaldi ought to have known that the facts constituted the perpetration of a fraud.

### *Allegation in paragraph 9(d)(i)*

¶ 169 Paragraph 9(d)(i) of the notice of hearing, reproduced above, alleges that Anderson and Montaldi accepted investments from investors, knowing that 439 was not profitable and its that liabilities exceeded its assets, and without telling investors the true state of 439's affairs, thus concealing risk from the investors.

### **Was 439 profitable? Did its liabilities exceed its assets?**

¶ 170 Table 5 (see "439's Financial Position" above) shows that 439 operated at a loss every year from 1996 forward, and that its cumulative losses for the relevant period were \$2.4 million. Table 6 shows that 439 lost money on a cash basis, and we have so found.

¶ 171 439 carried a deficit every year from 1996 forward, which means on a book value basis its total liabilities exceeded its total assets. From the perspective of its lending activities, Table 2 (see "439's Financial Position" above) shows that its notes payable exceeded its notes receivable throughout the relevant period. And, as previously discussed, its current liabilities exceeded its current assets.

¶ 172 Anderson and Montaldi say that if assets were valued at fair market value, the story would be different. However, many of 439's assets were difficult to value in the absence of independent appraisals or an actual arm's-length disposition. In the absence of any independently-verified evidence of value, we have no alternative than to accept the value of the assets as recorded on 439's books, imperfect though that may be.

¶ 173 The evidence shows that Anderson and Montaldi accepted funds from investors during the relevant period.

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¶ 174 We therefore find that Anderson and Montaldi accepted investment in 439 while it was not profitable, and while its liabilities exceeded its assets.

**Were investors told of the true state of 439's affairs?**

**Did this have the effect of concealing from investors the true risk of investing in 439?**

¶ 175 Investors were told essentially nothing about the state of 439's affairs. They were told about the business model – that funds were raised by Anderson and Montaldi at 12% and loaned out at 18%, and that the spread was how 439 made its money. They were told that Anderson and Montaldi personally guaranteed their investment. Fundamentally, they invested because they were attracted by the high interest rate and perceived the risk to be low because they trusted Anderson and Montaldi.

¶ 176 There was little or no discussion of risk with investors, and what there was had nothing to do with 439's financial position. The true state of 439's affairs was this:

- Its liabilities exceeded its assets, it was unprofitable, and it was incurring losses on a cash basis.
- It was making loans in significant amounts to Anderson and Montaldi and related parties, most of these loans were not generating cash returns, and in fact substantial amounts of interest were being forgiven.
- It was investing in other assets that did not generate cash returns (in fact the cash flow from these assets was negative). The assets included items that had no apparent relevance to 439's business purpose, such as coins, silver and gold bullion, artwork and a racehorse.
- Its loan portfolio contained a large number of non-performing loans and no adequate system in place to track the performance of the portfolio.

¶ 177 This was the true state of 439's affairs. Objectively, it is clear that any one of these factors would have been an important consideration for a reasonable investor's decision to invest in 439. Certainly we know from the investor questionnaires and testimony at the hearing that 439 investors, had they known about the cash problems or the related party loans, it would have affected their investment decision.

¶ 178 We therefore find that Anderson and Montaldi failed to disclose to investors the true state of 439's affairs, and this failure concealed from the investors the true risk of investing in 439.

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### *Allegation in paragraph 9(d)(ii) – adequacy of the guarantees*

¶ 179 Paragraph 9(d)(ii) of the notice of hearing, reproduced above, alleges that the value of Anderson and Montaldi’s personal guarantees exceeded their combined net worth.

### **Did the aggregate value of the guarantees exceed Anderson and Montaldi’s combined net worth?**

¶ 180 The phrasing of this allegation implies that Commission staff believes that Anderson and Montaldi ought to have had a net worth equal to or greater than the total amount owed to investors by 439. We do not think that is correct. If it was the investors’ expectation that they would be made whole in the case of a 439 default (and the evidence shows it was), then Anderson’s and Montaldi’s obligation would be to ensure that their combined net worth, together with that of 439, equaled or exceeded notes payable to investors and accrued interest from time to time.

¶ 181 In other words, all an investor should reasonably have expected from Anderson and Montaldi is that they had the wherewithal to fund any shortfalls after 439’s assets were liquidated.

¶ 182 Anderson and Montaldi testified at the hearing that their net worth each is between \$3 million and \$3.5 million, after netting out their obligations to 439 as borrowers, but that is not relevant to the state of affairs during the relevant period, and there is no evidence of their net worth during the relevant period.

¶ 183 At Shutdown, investors other than Anderson and Montaldi were owed about \$38 million. Had 439 simply proceeded to liquidation, the Anderson and Montaldi guarantees would have been put to the test. As it is, 439’s creditors agreed to the Proposal and accepted the debentures issued to them under the Proposal as full satisfaction of all their claims against 439. The original guarantees of Anderson and Montaldi are therefore moot, and they have given new ones to secure the debentures issued under the Proposal.

¶ 184 Fraud allegations demand proof at the high end of the range within the balance of probabilities standard. Without evidence as to Anderson’s and Montaldi’s net worth during the relevant period, or as to the true value of the 439 “other assets” during the same period, we are not in a position to make any findings on this allegation.

### *Allegation in paragraph 9(d)(iii) – use of funds for own purposes*



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¶ 185 Paragraph 9(d)(iii) of the notice of hearing, reproduced above, alleges that Anderson and Montaldi used investors' funds for their own purposes and not for the proper conduct of 439's business.

### **Did Anderson and Montaldi use investors' funds for their own purposes and not for the proper conduct of 439?**

¶ 186 Anderson and Montaldi caused 439 to make loans to themselves and related parties. Generally speaking, these borrowers made no significant payments of principal and interest on these loans; on some, 439 forgave the interest. At Shutdown, these loans totalled \$7.4 million in principal amount, of which only \$140,000 had been repaid. Of the \$1.5 million interest outstanding at Shutdown, only \$178,000 had been paid. During the relevant period, interest had also been forgiven on loans to Anderson and Montaldi to the tune of \$1.7 million.

¶ 187 Anderson and Montaldi also caused 439 to purchase illiquid assets that produced no cash flow. These assets represented a significant portion of 439's assets (at Shutdown, 15%).

¶ 188 The investors were told that the primary business of 439 was making loans to individuals and small businesses in the Lakes District. The concept of the spread was explained. The conclusion that reasonable investors would draw from the description they received from Anderson and Montaldi was that their money was going to be put to that purpose so the spread could be earned.

¶ 189 The making of loans in such significant amounts to related parties, on conditions that meant that those loans contributed no meaningful cash flow to the company, and the significant investment by 439 in illiquid assets that also produced no cash, was an utter contradiction of 439's business plan. We find that the use of investors funds for these purposes was not for the proper conduct of 439's business.

¶ 190 Anderson and Montaldi used the proceeds of the related party loans for other business ventures and investments. These loans came from investors' funds, so we find that Anderson and Montaldi used investors' funds for their own purposes.

### ***Did these findings constitute the perpetration of a fraud? Ought Anderson and Montaldi reasonably to have known that?***

¶ 191 We have found that the facts upon which the allegations of fraud in paragraphs 9(d)(i) and 9(d)(iii) have been proven to the standard demanded by *Rak*. The next steps are to determine whether those facts constitute the perpetration of a fraud and, if so, whether Anderson or Montaldi, or both of them, ought reasonably to have known that.

¶ 192 As discussed above, two elements must be present: dishonesty and deprivation.

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- ¶ 193 Dealing first with deprivation, we need not concern ourselves with whether mere prejudice to the economic interest of the victim is sufficient, although *Zlatic* makes it clear that it is. In this case, actual deprivation has been established. Investors invested in 439 expecting a 12% return. Most of them invested for the short term, some because they needed the funds for other purposes at the end of the term. Their return is now in effect 3%. The results of the liquidation of 439 are not yet known, but according to Pricewaterhouse it is highly probable that the 439 investors will lose some of their original investment. Their remaining investment is tied up for seven years, and there is no assurance it will be paid then. As is evident from some of the responses to the questionnaires (see “Investors” above), some investors are suffering financially as a result of their investment in 439.
- ¶ 194 Is the element of dishonesty present? As held in *White*, the element of dishonesty that is essential to fraud for the purposes of section 57(b) “need not attach to the defendant, but it must be a feature of the scheme”.
- ¶ 195 The test for dishonesty, as outlined in *Zlatic*, is that “which ordinary, decent people would feel is discreditable as being clearly at variance with straightforward and honourable dealings.”
- ¶ 196 Applying the test to the findings we have made, we are of the opinion that ordinary, decent people would see this conduct as being clearly at variance with straightforward and honourable dealings:
- accepting investments from investors when the company is in poor financial condition to the extent that 439 was, without telling them about the true state of the company’s affairs; and
  - using investors’ funds for a purpose different from that which a reasonable investor would have expected, based on Anderson’s and Montaldi’s description of 439’s business.
- ¶ 197 We therefore are of the opinion that dishonesty was a feature of this conduct, and therefore this conduct perpetrated a fraud on persons in British Columbia.
- ¶ 198 What remains to be determined is whether Anderson and Montaldi ought reasonably to have known that.
- ¶ 199 We found earlier that Anderson and Montaldi ought to have known that 439 had cash problems. In addition:

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- Anderson and Montaldi knew 439's loans to related parties and the cash flow implications surrounding those loans.
- Anderson and Montaldi knew that 439 was making substantial investments in other assets that did not produce cash.

¶ 200 As to 439's financial condition generally, we know that both Anderson and Montaldi were alerted to 439's problems by McPhail. From his testimony it is clear that Montaldi was aware of, and concerned about, 439's losses, although curiously he seemed content to wait for months until the next financial statements were prepared to see how things were going. When in late 2000 he learned that the 1999 the loss was \$1.3 million, he concluded "we weren't in control of our receivables and . . . were suffering more bad debts than we had expected." He recommended to Anderson that they widen the spread by reducing the rate offered to investors and raising the rate to borrowers.

¶ 201 Anderson and Montaldi had notice of potential problems and, as directors and officers of 439, had a duty to determine whether in fact those problems were real. They also, as directors and officers, had a duty to be knowledgeable about the company's financial affairs in any event. We therefore find that Anderson and Montaldi ought to have known about 439's financial position generally.

¶ 202 In the meantime, Anderson and Montaldi continued to sell 439 notes to investors.

¶ 203 Whether Anderson and Montaldi had actual knowledge of the full depth of 439's difficulties is not relevant. As directors and officers they had a duty to know, and moreover, the evidence shows that they had been put on notice, and had taken notice, of potential difficulties. We have found that their continued sale of 439 notes to investors without advising them of the state of the company's financial condition was dishonest. Whether or not they in fact turned their minds to that, it is sufficient if they ought to have done so.

¶ 204 We are of the opinion that Anderson and Montaldi, given their duties as directors and officers, and the knowledge they had, ought to have known that the conduct we have found would perpetrate a fraud on persons in British Columbia.

¶ 205 We therefore find that Anderson and Montaldi breached section 57(b).

### **D. Failure to Act in the Public Interest**

¶ 206 Paragraph 10 of the notice of hearing alleges:

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10. Anderson and Montaldi acted contrary to the public interest:

(a) by the conduct set out above; and

(b) by failing to exercise the care diligence and skill of a reasonably prudent person, contrary to sections 118 and 135 of the *Company Act*, RSBC 1996, c. 62.

¶ 207 In light of the evidence and the findings we have made, we find that Anderson and Montaldi have acted contrary to the public interest. They traded and distributed securities without being registered and without filing a prospectus, made a misrepresentation and committed fraud within the meaning of the Act.

¶ 208 Section 118(1)(b) of the *Company Act* reads as follows:

Every director of a company, in exercising the director's power, and performing the director's functions, must

...

(b) exercise the care, diligence and skill of a reasonably prudent person.

¶ 209 Section 135(1)(b) imposes the same duties on officers.

¶ 210 The duties of directors and officers under sections 118 and 135 were considered by the Commission in *Re Slightham* [1996] 30 BCSC Weekly Summary 38 (at page 70):

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.

¶ 211 In this case, the allegations are that Anderson and Montaldi did not meet this test because they failed to ensure systems were in place to manage the loan accounts

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properly and to provide them with sufficient management information to run the company properly.

- ¶ 212 The Pricewaterhouse report says that 439's accounting for its loan portfolio was inadequate, and that the lack of appropriate management information delayed the time when Anderson and Montaldi could deal with the underperformance of the loan portfolio. It also said that 439 demonstrated "inadequate or inconsistent effort in the collection of delinquent loans".
- ¶ 213 As noted above, Anderson agrees with this assessment.
- ¶ 214 Anderson and Montaldi argued, however, that they acted prudently to take steps to rectify the situation. They acknowledged that they were not successful, but argued that the standard is prudence, not perfection. What is demanded, they say, is not a successful outcome, but the taking of reasonable steps to address the issue.
- ¶ 215 It is true that Montaldi took steps to rectify the problem, but in our opinion, as time went by without a solution, knowing that he and Anderson were lacking key information about 439's core business activity, ordinary prudence would have dictated that he explore at least temporary solutions to improve their oversight of that part of the business. What is missing, in our view, from Montaldi's account of this situation, is a sense of urgency on his and Anderson's part for a solution. It is clear that Montaldi's first priority during this time of year was the preparation of tax returns for Marmon's clients. There were significant time lapses between his various attempts to deal with the problem, and come the 2002 tax season, he again deferred the matter for this reason.
- ¶ 216 We therefore find that Anderson and Montaldi did not keep adequate records to allow 439 to keep track of payments due to it by borrowers, and that they did not adequately supervise the collection of loans.
- ¶ 217 The Pricewaterhouse report says that even for a private company, the preparation of accurate and timely financial statements are "essential". That on its own is persuasive, but 439 was not just an ordinary private company. It was a company that ultimately raised over \$40 million from the public. Issuers who raise funds from the public, even if technically "private" companies, have a duty to manage themselves prudently. This is particularly so in this case, where the investors' perception of risk was so strongly influenced by their trust in Anderson and Montaldi.
- ¶ 218 However, Anderson and Montaldi made virtually no use of financial statements in running the business, apart from using them to file 439's tax returns. Financial statements were prepared only for year end, not for any interim periods, and were

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not completed for months, sometimes years, after the end of the financial year. In effect, Anderson and Montaldi chose not to acquire the information necessary for them to manage the business prudently.

- ¶ 219 Pallen testified that he did not think that given the state of 439's information systems, that Anderson and Montaldi acted prudently in terms of running the business.
- ¶ 220 We therefore find that Anderson and Montaldi did not adequately monitor the performance of the Company's business and its profitability.
- ¶ 221 As stated in *Slightham*, Anderson and Montaldi had a duty to have in place adequate systems for the management of the company, so they would have the information necessary to make decisions
- ¶ 222 We therefore find that Anderson and Montaldi acted contrary to the public interest by failing to exercise the care, diligence and skill of a reasonably prudent person, contrary to sections 118(1)(b) and 135(1)(b) of the *Company Act*.

### D. Summary of Findings

- ¶ 223 In summary, we find that Anderson and Montaldi:
- traded and distributed securities without being registered and without filing a prospectus, contrary to section 34 and 61 of the Act;
  - made misrepresentations, contrary to section 50(1)(d) of the Act;
  - perpetrated a fraud on persons in British Columbia, contrary to section 57(b) of the Act; and
  - acted contrary to the public interest.

### V Public Interest Orders

- ¶ 224 We have found that Anderson and Montaldi breached the Act and acted contrary to the public interest.
- ¶ 225 The temporary orders referred to at the beginning of these Findings remain in effect. During the hearing, we set February 26 as the date on which the parties may appear to make submissions on the subject of the orders that the Commission ought to make in the public interest.

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¶ 226 We encourage the parties to agree on a procedure that they consider appropriate for the exchange of briefs prior to the hearing on February 26.

¶ 227 February 14, 2003

¶ 228 **For the Commission**

Brent W. Aitken  
Vice Chair

Neil Alexander  
Commissioner

Robert J. Milbourne  
Commissioner