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(Winnipeg Centre)
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COURT OF QUEEN'S BENCH OF MANITOBA

BETWEEN:	**APPEARANCES:**
ASHRAF AZER plaintiff, - and - PAUL R. HESSE and PAUL R. HESSE LAW CORPORATION and CORPORATION 6823948 MANITOBA LTD. and 7289970 MANITOBA LTD. and PITBLADO LTD., defendants.	Brittany Tofangsazan for the Plaintiff Gavin Wood for the Defendant 7289970 Manitoba Ltd. No one appearing for the Defendants Paul R. Hesse, Paul R. Hesse Law Corporation, 6823948 Manitoba Ltd. and Pitblado Ltd. Judgment Delivered: July 09, 2021

MARTIN, J.

INTRODUCTION

[1] Paul R. Hesse was a Manitoba lawyer providing services to clients at the law firm Pitblado Ltd. ("Pitblado"), through Paul R. Hesse Law Corporation. At the same time,

Mr. Hesse was the sole shareholder of 6823948 Manitoba Ltd. ("682 Manitoba"), a corporation he used for an investment in 7289970 Manitoba Ltd. ("728 Manitoba"), a small, limited purpose, closely held corporation. Mr. Hesse was also President of 728 Manitoba.

[2] Mr. Azer sued 728 Manitoba, claiming various relief, including a judgment of $200,000 against 728 Manitoba, for a loan he made in that amount, orchestrated by Mr. Hesse, supposedly for the benefit of 728 Manitoba but which in fact was diverted to 682 Manitoba by Mr. Hesse.

[3] 728 Manitoba moved for summary judgment (Court of Queen's Bench Rule 20) dismissing Mr. Azer's claim against it. Mr. Azer did not file a similar motion for summary judgment against 728 Manitoba. Regardless, the summary judgment motion is a helpful and efficient process given the issue raised by 728 Manitoba and as the facts are not in dispute. Neither Mr. Hesse, his law corporation, nor 682 Manitoba participated in any of these proceedings. He is gone. By agreement, Pitblado also did not take part.

[4] Evidence on the motion comprised of an Affidavit of four persons representing three shareholders who hold 80% of 728 Manitoba's shares, personally or through corporations. 682 Manitoba held the remaining 20% and did not provide any evidence, nor did Mr. Hesse. Mr. Azer relied on an Affidavit of May 25, 2021. Neither party saw the need to cross examine on any Affidavit.

[5] While it is not clear what happened to 682 Manitoba and its holdings, it is common ground that in the end either Mr. Azer or 728 Manitoba (effectively its three shareholders) will bear the burden of Mr. Hesse's fraud.

FACTS

[6] In 2012, Mr. Azer retained Mr. Hesse, at Pitblado, for an unrelated legal matter and again in 2015 for legal and business matters.

[7] In 2018, Mr. Azer had further communication with Mr. Hesse. Mr. Hesse told him about a "great project" that provided high rates of return through a corporation that receives investment funds. Mr. Hesse advised he was the President, director and one of the shareholders of the corporation, 728 Manitoba, all of which was true.

[8] Mr. Azer deposed that Mr. Hesse showed him corporate documents confirming 728 Manitoba was in good standing and "he had authority as President to enter into the contract on behalf of the corporation". Further, he deposed that "given [Mr.] Hesse's position as a solicitor, President, Director and one of the shareholders of the Corporation, I invested my money by way of a loan into the Corporation."

[9] Mr. Hesse arranged for Mr. Azer to loan $200,000 to 728 Manitoba for three years. There was to be a 6% annual return, paid at $1,000 monthly dividend, plus a financial top-up at the end of the three years. The loan was secured by 15% of the class A voting common shares of 728 Manitoba, which shares were to be returned to 728 Manitoba once the investment had been repaid. At paragraph 20 of the agreement, Mr. Azer acknowledged having had the opportunity for independent legal advice and that the agreement was executed "without undue influence or fraud or coercion". Mr. Hesse drew up all the legal documents, dated August 9, 2018. Finally, Mr. Hesse issued a share certificate to Mr. Azer.

[10] Mr. Hesse executed all the documents as President of 728 Manitoba, and impressed them with 728 Manitoba's corporate seal. He and 682 Manitoba guaranteed the investment. No other 728 Manitoba director, officer, or shareholder signed the documents.

[11] Mr. Azer provided a bank draft for $200,000 to Mr. Hesse, payable to 728 Manitoba. It was deposited in the Pitblado trust account. Then, Mr. Hesse quickly had the $200,000 paid out to his own corporation, 682 Manitoba. Subsequently, Mr. Hesse paid Mr. Azer the monthly investment return of $1000 from September 2018 until May 2019. It is not clear where those funds came from. Further, in 2019 Mr. Hesse caused 728 Manitoba to issue a T5 to Mr. Azer for the 2018 payments.

[12] As to 728 Manitoba, it is a non-public corporation set up in 2016 for the sole purpose of purchasing and operating 2 Donald Street, in Winnipeg Manitoba, as a source of rental income. It had four shareholders, one of whom was 682 Manitoba which had a 20% interest. It appears Mr. Hesse was the person who put the arrangement all together, including the legal documents.

[13] 728 Manitoba has various enacting documents and by-laws, and the shareholders of 728 Manitoba have a Unanimous Shareholders Agreement ("USA").

[14] By-Law No. 2 is a general borrowing by-law allowing 728 Manitoba to borrow money from time to time, on execution of the President and Secretary, or as otherwise authorized, and the corporate seal "may be attached as occasion may require, when same shall be valid and binding on the Corporation".

[15] The USA provides that:

i. all documents on behalf of the corporation must be signed by two directors or officers (section 2.8);

ii. borrowing "new money" from any person, the disposition of corporation property, the payment of dividends, and the granting of security requires the consent of 80% of the voting shares (section 2.11);

iii. notwithstanding section 2.11, Mr. Hesse, in his capacity as President, had authority "to make all day-to-day operational, planning and other decisions as required to be made in the ordinary course of business of the Corporation"; and

iv. the Corporation was prohibited from issuing further shares without the written consent of all of the shareholders (section 4.1).

[16] Clearly, as President during the relevant time of August 2018, Mr. Hesse had considerable authority respecting the day-to-day operations of 728 Manitoba. But, he did not have actual authority to alter or effect the financing or share structure of the corporation. Among the shareholders, there was no contemplation of further borrowing, investments, or of issuing new shares.

[17] None of the other three shareholders of 728 Manitoba were personally aware of, or participated in, any aspect of Mr. Hesse's dealings with Mr. Azer, including the payments made to Mr. Azer or issuing of the T5. Neither 728 Manitoba nor the other three shareholders benefitted from the scheme in any way. As noted, Mr. Hesse quickly diverted Mr. Azer's $200,000 payment for 728 Manitoba to 682 Manitoba.

[18] The other 728 Manitoba shareholders became aware of this scheme in June 2019, when Mr. Azer sued 728 Manitoba for return of the $200,000, and Mr. Hesse's considerable unrelated misconduct became public knowledge.

[19] In 2020, Mr. Hesse was disbarred for 27 fraudulent acts and other misconduct, costing innocent clients about $6.5 million.

THE ISSUE

[20] Broadly stated, the claim turns on whether, in law, Mr. Azer can, or cannot, rely on representations Mr. Hesse made, supposedly in his capacity as an officer/director of 728 Manitoba, to bind 728 Manitoba to the investment/loan agreement. If so, effectively, its innocent shareholders will bear the burden of the so-called investment/loan in 728 Manitoba. If not, Mr. Azer will bear the burden of being defrauded by Mr. Hesse.

[21] As this is only 728 Manitoba's summary judgment motion, the issue is narrower: whether it is entitled to judgment dismissing the claim against it, based on its defence that it cannot be held liable for Mr. Hesse's fraud upon Mr. Azer because Mr. Hesse's action cannot be attributed to it, pursuant to corporate identification theory. However, based on the pleading, facts and arguments on the motion, this issue is integrally linked to Mr. Hesse's actual or apparent authority, and the indoor management rule. Hence, all these concepts need be addressed and determined.

THE PARTIES' POSITIONS

[22] Simply put, 728 Manitoba asserts that Mr. Hesse's dealings with Mr. Azer were a fraud upon him, and upon 728 Manitoba, that cannot be attributed to 728 Manitoba in

that (i) Mr. Hesse's wrongful actions were not done within the scope of his real or ostensible authority, and (ii) Mr. Hesse used 728 Manitoba merely as a tool for his fraud against Mr. Azer. Given the lack of knowledge and lack of any benefit to 728 Manitoba, it would be unfair and inconsistent with public policy considerations, and with the corporate identification theory, to hold it, and hence its innocent shareholders, responsible for dealings exclusively between Mr. Azer and Mr. Hesse.

[23] Conversely, Mr. Azer asserts that Mr. Hesse was acting within his real or ostensible authority on behalf of 728 Manitoba and as such, it is bound by the investment/loan agreement, including the repayment of the $200,000. He asserts that he was not required to have made behind-the-scene inquiries as to Mr. Hesse's actual authority to enter into the agreement or bind 728 Manitoba, in part because of s. 18 of *The Corporations Act,* C.C.S.M. c. C225, and the common law indoor management rule.

ANALYSIS

[24] I start by noting several findings:

i. Mr. Hesse committed a fraud – he obtained money for a specific business purpose but converted it to his personal use;

ii. both Mr. Azer and 728 Manitoba are wholly innocent parties;

iii. Mr. Hesse had no actual authority to arrange the loan/investment with Mr. Azer. In fact, according to 728 Manitoba's USA, he was expressly prohibited from doing so;

iv. Mr. Hesse used his roles, as Mr. Azer's lawyer (advising and drawing the legal documents, and using Pitblado's trust account) and business adviser, and as

728 Manitoba's lawyer and President, to facilitate the fraud. These roles lent a veneer of credibility.

[25] As to the law, several legal principles were raised including ostensible or apparent authority of a corporate agent, the indoor management rule and corporate identification or attribution theory. Jurisprudence and academic authority on these concepts is extensive, as demonstrated by Kevin P. McGuinness in ***Canadian Business Corporations Law***, 3rd ed. (Toronto: LexisNexis Canada Inc., 2017). More elusive is how the concepts operate in the same space. I will deal with this matter relatively summarily, limited to what is useful here, but hopefully completely. As always, facts are key to sorting out liability.

[26] Corporations act through natural persons, as agents, who are most usually either directors, officers or employees. Agents can bind the corporation (i.e. the principal) to agreements or liabilities. They do so through the agency law principles and authority to act for the corporation.

[27] By mutual consent, either express or implied, agents may be given actual authority to act on behalf of the corporation, for a litany of circumstances quite specific to their role and the corporation's objectives. As commented by McGuinness at §13.252, an agent may exceed his actual authority for an ulterior purpose, such as fraud for his personal benefit. In such a case, "the principal cannot escape liability merely because the agent may have abused the authority or betrayed the trust". Greater scrutiny of the circumstances is necessary to determine the principal's liability, if at all.

[28] Related, is a type of ostensible or apparent authority where the agent is held out to possess authority that, unknown to the third party, exceeds the actual authority agreed by the corporation. The third party acts on his impression of the extent of the agent's authority. As such, except in very narrow circumstances, that impression must be directly conveyed or attributable to representations from the principal, either expressly or by conduct, about the agent's scope of authority. So here for example, 728 Manitoba appointed Mr. Hesse as its solicitor, a director and President. He was also an investor and a shareholder. Mr. Azer knew nothing of the limits put on Mr. Hesse's authority by internal 728 Manitoba arrangements.

[29] Moving on, McGuinness notes that:

- "a director validly appointed may bind the corporation by exercising the type of authority that director would normally possess even though the Board of Directors has decided that the directors individually should not so act" (§13.255); but also
- if the contract at issue is so out-of-the-ordinary as to take it beyond the range of normal transaction for that director, "the creditor is put on notice and must inquire as to whether the director or officer possesses actual authority. A creditor who does not do so will not be able to rely upon apparent authority." (§13.257)

In a situation where the agent commits a wrong for which the third party seeks to hold the principal responsible, determining the scope of apparent authority is obviously

critical. It is essentially a question of fact, §13.264:

> It depends not only on the nature of the contract involved, but also the position held by the officer or other agent negotiating it, the corporation's usual manner of conducting business, the size of the corporation, the circumstances that give rise to the contract, the nature and character of the contract and whether it is apparently in the best interest of the corporation, the amounts involved, and the contracting party and its relationship and history of dealings with the corporation. The foregoing is not an exhaustive list.

[30] With this brief framework, I turn to the indoor management rule. Its purpose is neatly summarized in ***Midas Investment Corporation v. Bank of Montreal***, 2016 ONSC 3003, at para. 4:

> The indoor management rule originated in the English case of *Royal British Bank v. Turquand* (1856), 119 E.R. 886 (Eng. Exch.). The principle is that if a corporation holds someone out as a director, officer or agent to third parties, the corporation cannot deny that the person is duly appointed or that he or she has the authority customary or usual for such a director, officer or agent. A person dealing in good faith with a corporation is entitled to assume that the corporation's internal procedures have been followed. The outsider is not required to conduct an inquiry into compliance with those procedures unless that person has actual knowledge to the contrary or where the person ought to have had knowledge to that effect. The rule is based on the assumption that the company, which has hired and supervises its officers and holds them out as its agents, should bear the burden of their unauthorized activity, as opposed to the outsider dealing with the company in good faith who has no opportunity to investigate compliance with the company's internal procedures.

[31] While originating in common-law, the rule is now supplemented, or codified, in most Canadian corporation statutes. Typically, the statutory provisions across the country are very similarly worded and comprise two concepts that fit together.

[32] Thus, in Manitoba, s. 17 of *The Corporations Act* has done away with any common law concept of constructive notice of contents of a corporation's governance documents, articles or by-laws. And, s. 18 sets up a form of estoppel precluding corporations from relying on deficiencies or irregularities in certain dealings between

third parties and the corporation or its agent. This is the statutory indoor management rule. In this situation, relevant portions of s. 18 provide:

> [18] A corporation … may not assert against a person dealing with the corporation … that
>
> > (a) the articles, by-laws or any unanimous shareholder agreement have not been complied with;
> > …
> >
> > (d) a person held out by the corporation as a director, an officer or an agent of the corporation … has no authority to exercise the powers and perform the duties that are customary in the business of the corporation or usual for the director, officer or agent;
> >
> > (e) a document issued by any director, officer or agent of the corporation with actual or usual authority to issue the document is not valid or not genuine; or
> > …
>
> except where the person has or ought to have, by virtue of his or her position with or relationship to the corporation, knowledge to the contrary.

[33] While various authorities were relied on by Mr. Azer, the Court invited additional comments respecting another case, ***Martin v. Artyork Investments Ltd.***, [1997] 2 SCR 290. The Supreme Court of Canada reversed the Ontario Court of Appeal and endorsed the original trial judgement. The case is markedly analogous to Mr. Azer's dealings with Mr. Hesse.

[34] Dr. Martin's solicitor suggested he invest in a rental property owned by Artyork, a small corporation. The solicitor was also an investor and director, and operated the company. He induced Dr. Martin to invest $120,000 through a debenture. The funds were sent to the solicitor's personal account and misappropriated by him. The debenture was a fraudulent document. Relying on the indoor management rule and the relevant sections of the Ontario corporation statute, the trial judge held that

Dr. Martin was entitled to rely on s. 19(d) that the words "customary" or "usual", in conjunction with other provisions of the statute, applied as did s. 19(e). The Ontario Court of Appeal focused on whether the $120,000 was paid to Artyork, and finding it was not, concluded "that unfortunately both Martin and Artyork were defrauded by the lawyer they trusted, and each will have to bear his and its own loss". In a short judgment, as noted, the Supreme Court disagreed and restored the trial judgment, saying simply that based on the trial judge's findings, Dr. Martin was entitled to the protection of s. 19 in his "dealings with the director of" the company; Artyork was "bound by its director's representations". It is unclear to me whether any of the $120,000 flowed through Artyork.

[35] *The Corporations Act* in Manitoba has equivalent provisions to all Ontario provisions relied on in ***Martin.***

[36] In submissions, not surprisingly, Mr. Azer said the case was conclusive of his position. 728 Manitoba argued ***Martin*** is unique and corporate identification principles that impose liability on a corporation for the conduct of an agent, starting with ***Canadian Dredge & Dock Co. v. The Queen***, [1985] SCR 662, have evolved in a way that compels a different result here. To be clear, neither ***Dredge*** nor corporate identification theory were addressed in ***Martin***.

[37] ***Dredge*** articulated how criminal liability fell to a corporation through the identification theory, where, in essence, the directing mind(s) of a corporation (which may be broadly defined depending on the circumstances: para 50) and the identity of the corporation coincide or merge. Thus, the intent, or *mens rea*, of the actor (a natural

person) becomes the intent, or *mens rea*, of the corporation (a legal entity or person). However, the Court explained it makes no sense to apply such a rule where the fraud was committed totally upon the corporation. The case headnote provides a succinct yet sufficient primer:

> Where the criminal act is totally in fraud of the corporate employer and where the act is intended to and does result in benefit exclusively to the employee-manager, the employee-directing mind, from the outset of the design and execution of the criminal plan, ceases to be a directing mind of the corporation and consequently his acts cannot be attributed to the corporation under the identification doctrine. Thus, the identification doctrine only operates where the Crown demonstrates that the action taken by the directing mind (a) was within the field of operation assigned to him; (b) was not totally in fraud of the corporation; and (c) was by design or result partly for the benefit of the company.

[38] Further, as to policy considerations of innocent shareholders potentially bearing the brunt of an agent's unlawful actions, the Court noted at para 51:

> The corporation which set the directing mind in position to do the wrong will suffer an economic penalty. While it is true that this penalty would feed through to the stockholders, who may well be totally innocent … [for a small closely held corporation] that simply reflects the economic identification, as well as the legal identification, present in such a corporation.

[39] While ***Dredge***, and other similar cases, involve criminal law, the identification theory operates within the civil realm as well. These principles were accepted in ***Deloitte & Touche v. Livent Inc. (Receiver of)***, 2017 SCC 63, but were further explained and qualified (para's 100 – 104). A few years later, in ***Christine DeJong Medicine Professional Corp. v. DBDC Spadina Ltd.***, 2019 SCC 30, the court further clarified at para 2:

> In view of the statement of the majority at the Court of Appeal that this Court's decision in *Deloitte & Touche v. Livent Inc. (Receiver of)*, 2017 SCC 63, [2017] 2 S.C.R. 855, invited a "flexible" application of the criteria stated in *Canadian Dredge & Dock Co. v. The Queen*, [1985] 1 S.C.R. 662, for attributing individual wrongdoing to a corporation, we respectfully add this.

> What the Court directed in *Livent*, at para. 104, was that *even where those criteria are satisfied*, "courts retain the discretion to refrain from applying [corporate attribution] where, in the circumstances of the case, it would not be in the public interest to do so" (emphasis added). In other words, while the presence of public interest concerns may *heighten* the burden on the party seeking to have the actions of a directing mind attributed to a corporation, *Canadian Dredge* states *minimal* criteria that must always be met …

[40] As to 728 Manitoba's case authority, of note, ***Christine*** was a complicated action in fraud, breach of trust and breach of fiduciary duties (under the doctrine of "knowing receipt" or "knowing assistance"). ***Deloitte*** was a negligence claim against Livent's auditors for its flawed execution of its audit role of a fraud committed by two of Livent's directors, against the publicly traded company shareholders. Corporate identification theory was advanced as a defence by the auditors, saying (i) Livent should not be able to profit from its own illegality (para 98), and (ii) Livent was contributorily negligent and hence the auditor could not be responsible for the whole of the loss (para 106). The court disagreed with both arguments for various specific reasons, but also generally because identification doctrine, as a defence, was illogical on the facts and pleadings. As to ***Dredge***, the court imposed criminal liability on the corporations for acts of its agents. And finally, in an insurance case, ***Oger v. Chiefscope Inc.***, [1996] OJ No 1684, the court refused to attribute criminal acts of its directors to the company, where they looted the whole company. The company's insurance carrier could not avoid covering the third party's loss.

[41] All things considered, I find this situation factually distinguishable from authorities relied on by 728 Manitoba in advancing identification theory as a defence. I question the application of ***Dredge*** principles here. The issue is not whether

728 Manitoba may be criminally responsible for its President's fraud against Mr. Azer. Nor do I consider the issue being civil liability for the fraud or some tort of deceit, per se, which has not been pled. The action is framed in contract, and hence agency. To put it another way, Mr. Azer is not saying 728 Manitoba is bound because of corporate identification principles. He says 728 Manitoba is bound on agency principles and is protected by the indoor management rule, to which 728 Manitoba essentially responds saying they need not defeat the indoor management rule, but rather can prevail by asserting they are not liable under the identification doctrine. In other words, the identification doctrine trumps the indoor management rule. I cannot agree.

[42] Ultimately, there is a distinction between being liable for the criminal act of an agent and being bound by an agent exceeding his authority, even where the agent's actions commit a fraud upon a third party. I would agree that 728 Manitoba should not be liable in fraud, criminally or civilly, for Mr. Hesse's actions. However, that is conceptually different from advancing that a fraud by an agent upon a third party, is a complete retort to the agent exceeding his actual and apparent authority. If that were the case, the forgery component set out in s. 18(e) of *The Corporations Act* indoor management rule would be redundant.

[43] Moreover, if as 728 Manitoba defends, in argument and pleadings, it has been defrauded by Mr. Hesse, then necessarily this position must assume the validity of the loan agreement Mr. Hesse arranged with Mr. Azer, for that is the only way 728 Manitoba would have color of right over the $200,000 in order to assert it was defrauded by

Mr. Hesse. Then, it becomes illogical to assert that Mr. Azer should bear the burden of Mr. Hesse's defrauding 728 Manitoba.

[44] As noted, this situation, and motion, is intertwined with agency principles. I can find no stark rule that a principal is, or is not, bound by its agent's actions, supposedly for the benefit of the principal, where he exceeds his authority and commits a fraud on a third party. Like many things in jurisprudence, the answer seems to depend on the facts.

[45] Mr. Hesse deliberately exceeded his actual authority to bind the company when he arranged the investment/loan with Mr. Azer. He did so to defraud Mr. Azer. He was successful in doing so because of the actual authority he was given by 728 Manitoba and by other apparent authority attributable to 728 Manitoba's conduct.

[46] To determine the scope of Mr. Hesse's apparent authority, I return to McGuinness' non-exhaustive list of relevant factors, cited at para 29 above. I note 728 Manitoba is a small, limited purpose corporation that Mr. Hesse was integral to founding, including setting up its structure and governance. In 2018 he remained as an investor, director and President, and he also remained as its solicitor, thus having access to corporate documents he could disclose and to share certificates he could issue. He also possessed the corporate seal, which he used to impress the investment/loan agreement and the share certificate, significantly boosting the authenticity of his authority and the legitimacy of binding 728 Manitoba (consistent with By-law No. 2). Additionally, as President, he was tasked to handle all day-to-day operations, including the ability to issue T5s. All in, he actively handled all facets of

728 Manitoba. While I need not go so far as to conclude he was 728 Manitoba's "alter-ego", he certainly was the face and operator of 728 Manitoba. Finally, the size and nature of Mr. Azer's loan/investment was not extraordinary given the value of 728 Manitoba and its financing.

[47] Turning to s. 18 of *The Corporations Act*, indoor management rule cases are fact specific. For the reasons mentioned, I do not see that 728 Manitoba can reasonably assert against Mr. Azer that Mr. Hesse had no apparent authority to exercise borrowing powers to arrange such a transaction; that it was not usual for him in his position. And, nothing suggests Mr. Azer should have, or could have, known otherwise.

CONCLUSION

[48] In conclusion, 728 Manitoba's summary judgment motion is denied. I do not find that 728 Manitoba is entitled to judgment dismissing Mr. Azer's claim as:

i. I do not find the corporate identification doctrine provides a complete defence to the action; and

ii. I do not find that 728 Manitoba has established that Mr. Azer cannot rely on agency principles to enforce the investment/loan agreement or that he is not entitled to the protection afforded by s. 17 and s. 18(a) and (d) of *The Corporations Act*.

[49] Mr. Azer shall have tariff costs on the motion.

_____ J.