

Prophylactic disgorgement order in case of corporate malfeasance imposed by Ontario Court of Appeal

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23 December 2021

In a decision that involved “acceptable standards of corporate conduct in Canada,” the Ontario Court of Appeal addressed the breakdown of the relationship between five founders of a venture capital fund in the technology sector: *Extreme Venture Partners Fund I LP v. Varma*, 2021 ONCA 853 (CanLII).

Established in 2007, Extreme Venture Partners Fund I LP (“Extreme”) was a venture capital fund that provided seed capital to start-up technology companies. Extreme was structured as a limited partnership between the five individual founders and a general partner, EVP GP. Extreme invested in various technology businesses over the years. While the fund grew rapidly, tensions grew with three of the founders of Extreme on one side and two of the founders on the other, who grew dissatisfied with their recognition and compensation for their efforts.

In 2011, the two disgruntled founders surreptitiously established a second fund known as “Annex Fund” with another investor. They disclosed confidential information about Extreme’s portfolio and investment strategy. Annex Fund invested in six of Extreme’s most successful portfolio companies and operated for two years until 2013.

In 2012, the two disgruntled founders also privately negotiated the sale of one of Extreme’s investments, a mobile software development lab business known as “Xtreme Labs,” to a prominent Silicon Valley entrepreneur. Xtreme Labs owned an equity interest in a business known as “Hatch Labs,” which had developed and launched the subsequently very well-known dating app, Tinder.

The two disgruntled founders presented an offer to purchase Xtreme Labs to Extreme’s board for approval. The sale closed without disclosure of their prior negotiations with the Silicon Valley entrepreneur or the fact that they would retain an interest in Xtreme Labs after the sale.

Once these actions were discovered by the other three founders, they sued their former business partners and the Silicon Valley entrepreneur for breach of fiduciary duty, knowing assistance thereof, inducing breach of contract, and conspiracy, amongst other things. The general and limited partnerships were also named as plaintiffs.

Concerning the Annex Fund, the plaintiffs alleged that the defendants had improperly established a competing business. With regard to the sale of Xtreme Labs, the plaintiffs alleged that the defendant founders had misrepresented the financial status of Xtreme Labs and had concealed material information from them. They argued that the defendant founders had conspired with the Silicon Valley entrepreneur to sell him Xtreme Labs at a grossly suppressed price. Further, they alleged that the defendant founders hid their ownership interest in Hatch Labs and Tinder as part of the sale to rid themselves of their co-partners and increase their personal stake in the business.

After a lengthy trial in 2019, the Ontario Superior Court of Justice (Commercial List) ruled in favour of the plaintiffs: 2019 ONSC 2907 (CanLII). The trial judge rejected the defendants’ arguments that they had engaged in standard corporate conduct and found that they had conspired to present the offer to buy Xtreme

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Labs without full disclosure to the board. Had the plaintiffs been given accurate information about the financial position and prospects of Xtreme Labs, the trial judge reasoned that they would have had the opportunity to negotiate the sale based on this accurate information or to continue to hold their shares.

The defendant founders were held liable for punitive damages of \$250,000 in connection with the Annex Fund. With regard to the sale of Xtreme Labs, the defendant founders and the Silicon Valley entrepreneur were held jointly and severally liable for U.S. \$3.36 million in damages and U.S. \$12.33 million in disgorgement of profits.

On appeal, the defendants argued that the trial judge made numerous errors in rendering her judgment, most especially regarding the awards of damages and disgorgement.

The plaintiffs cross-appealed, arguing that the court ought to have imposed a “prophylactic disgorgement” award that was aimed not at what the plaintiffs had lost as a result of the defendants’ conduct but at the entirety of the profits that the wrongdoers had gained.

A unanimous panel of the Court of Appeal found that the trial judge, described as “an experienced commercial judge,” applied well-established tort and corporate law principles and made several findings of illegality on the part of the defendants which were amply supported by the record. In the Court of Appeal’s view, had the defendants’ conduct not been the subject of adverse findings by the trial judge, “the court would have communicated a message that there are few, if any, limits to corporate malfeasance” which would have caused “significant uncertainty in the Canadian business world” (para.10).

In its decision, the Court of Appeal provided insight with respect to the issue of whether the defendants had breached their duties and/or engaged in tortious conduct in the sale of Xtreme Labs. The defendants argued that the trial judge had improperly extended the scope of duties of fairness between business counterparts. However, the Court of Appeal found that the trial judge had not imposed some new “morality-based constraints” on the way businesses typically operate. Rather, the trial judge had correctly viewed the case as one where a purchaser conspired with fiduciaries of a company to acquire a business in breach of established fiduciary and contractual duties.

The Court of Appeal took the opportunity to confirm that the fiduciary duty of the defendant founders extended to include a duty to the limited partnership (Extreme) in addition to the general partner (EVP GP). The defendant limited partners had conducted themselves in a manner that breached their duties to EVP GP. It was not a situation where they were balancing the general partner’s interests against those of the limited partnership. Instead, they acted solely in their self-interest and contrary to the interests of both the general partner and the limited partnership.

Given the unique structure of limited partnerships, the Court of Appeal reasoned that the common law should impose a fiduciary duty on corporate directors of the general partner towards the limited partnership. If the law offered no remedy for a breach of a director’s fiduciary duty in circumstances where the limited partnership suffered the resulting loss, then directors could act with impunity to damage the interests of the limited partnership without being held to account, including engaging in self-dealing: “The law of fiduciary duties, which is based in equity, should not brook such a lacuna in its remedies” (para.96).

The defendants’ grounds of appeal were rejected accordingly.

As to the cross-appeal, the Court of Appeal referred to the leading Supreme Court of Canada case on disgorgement of profits, *Strother v. 3464920 Canada Inc.*, 2007 SCC 24, and found that the purpose of the disgorgement order imposed by the trial judge was prophylactic, namely to disgorge all of the profits realized by the fiduciaries who breached their duties in the pursuit of personal interests.

In such circumstances, the trial judge was obliged to fashion a remedy that would have a deterrent impact and simply ordering the defendants to pay the plaintiffs what they would otherwise have been entitled to receive did not serve as a disincentive. A party calculating the potential consequences of breaching a fiduciary duty could theoretically conclude that in a worst-case scenario, they would only be forced to pay over to the aggrieved beneficiary what they were owed in any event, thereby profiting from the breach of their fiduciary duties.

While there may be circumstances where it would be inequitable to order a faithless fiduciary to disgorge all profits, this was not an issue given the egregious circumstances at hand. There was nothing to suggest that a partial disgorgement order should be made in this case. Accordingly, the Court of Appeal increased the amount of the order for disgorgement of all profits to \$29.5 million (U.S.) to account for all of the profits earned by the defendants.

The case demonstrates that the courts will firmly uphold the fundamental duties of honesty, disclosure and fair dealing between fiduciaries in a business enterprise, and will impose significant sanctions resulting from breaches thereof. A PDF version is available to download [here](#).

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