CBV Institute

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Inspired by an unwavering commitment to professional excellence, we establish the highest standards of business valuation practice and education to elevate the stature of the CBV designation and the profession globally.

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The Journal of Business Valuation

The Journal of Business Valuation is an annual publication. It is intended to provide research and informed comments on valuation and related fields. The opinions expressed by the individual writers do not necessarily carry the endorsement of the Institute or its Members.

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AVOIDING DOUBLE COUNTING IN COMPENSATION

AVOIDING DOUBLE COUNTING IN COMPENSATION

Coordinating business valuation and real estate appraisals in expropriations

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It is not uncommon for business valuation and real estate appraisal experts to be retained concurrently in expropriation proceedings. If a business is operating on land that is required for a public project, it's likely that the property owner will suffer from both business losses and a loss of property value.

Business Valuation vs Real Estate Appraisal

Generally, business valuators are retained to opine on two types of losses. One is the loss of business value that occurs when there is a full taking of land and it is not possible to relocate a business operating on it. The second type is business losses, which could result from a full taking of land where it is possible to relocate a business, a partial taking of land, or, sometimes, no taking of land.

On the other hand, real estate appraisers are retained to determine the market value of land taken for a full or partial taking or to determine the decline in the market value of the remaining land where there is a partial or no taking of land (sometimes referred to as injurious affection).

Significantly, even where there is no taking of land, compensation for injurious affection may still be available if damages were suffered as a result of construction or other expropriation related activities. For example, if a business is located adjacent to a roadway construction project, the value of that property can be impacted as a result of the construction. Moreover, if the construction makes it difficult for the business to operate normally, business losses can also become an unfortunate result.

Need for Consistent Assumptions

Both business valuators and appraisers have a duty to the adjudicator to impartially assist in determining the monetary compensation that would put a claimant back in the same economic position as before the expropriation. In fulfilling this duty, the compensation calculated by business valuators and appraisers should be based on a consistent set of assumptions to avoid issues like double counting. These assumptions often require coordination between the business valuators and the appraisers.

In a partial taking that results in injurious affection to the property as well as business losses, care must be taken to avoid potentially double counting with respect to the cash flows. Since these losses are typically considered in both the real estate appraisal and business loss calculations, it is not surprising to see losses inadvertently counted twice.

For example, assume that part of a hotel complex on a resort property is abutting a highway that requires widening. The widening requires the taking of part of the hotel's parking lot, as well as the demolishment of one of the hotel buildings on the property, and it becomes expropriated by a government authority in 2014. The result is a reduction in overall property size from 500,000 square feet to 400,000 square feet. In addition to reducing the property's square footage, the highway construction and demolition work resulted in financial setbacks due to intermittent hotel access restrictions and rerouting of traffic in the area until mid-2017. Once the highway-widening project was finally completed, the visibility and aesthetics of the hotel complex were both diminished.

An appraiser may calculate the following:

- Market value of subject property at expropriation date, reflecting pre-expropriation square footage (500,000 sq. ft.) and no impact of the expropriation (no injurious affection). Assume the appraiser uses discounted cash flow approach to arrive at market value, being Cash Flow A, resulting in market value of $30 million.
- Market value of subject property at expropriation date, reflecting post-expropriation (i.e. lower) square footage (400,000 sq. ft.) and no impact of the expropriation (no injurious affection). Assume the appraiser uses discounted cash flow approach to arrive at market value, being Cash Flow B, resulting in market value of $23 million.
- Market value of subject property at expropriation date, reflecting post-expropriation (i.e. lower) square footage (400,000 sq. ft.) and reflecting impact of the expropriation (injurious affection, due to loss of visibility, etc.). Assume the appraiser uses discounted cash flow approach to arrive at market value, being Cash Flow C, resulting in market value of $20 million.

Given this scenario, the appraisal losses may be calculated as follows:

- Market value obtained from Cash Flow A ($30 million) minus Cash Flow B ($23 million) = Market value loss of land expropriated ($7 million).
- Market value obtained from Cash Flow B ($23 million) minus Cash Flow C ($20 million) = Injurious affection ($3 million).

These calculations are illustrated in the Component Damage table below.

COMPONENT OF DAMAGE

	Cash Flow A present value at $30 million	• Determined by appraiser • Market value of subject property at 500,000 sq. ft. (pre-expropriation) • Does not reflect impact of expropriation (injurious affection)
Market Value Loss of Land = Difference of $7 million		
	Cash Flow B present value at $23 million	• Determined by appraiser • Market value of subject property at 400,000 sq. ft. (pre-expropriation) • Does not reflect impact of expropriation (injurious affection)
Injurious Affection = Difference of $3 million		
	Cash Flow C present value at $20 million	• Determined by appraiser • Market value of subject property at 400,000 sq. ft. (pre-expropriation) • Does not reflect impact of expropriation (injurious affection)
Potential Business Loss = Difference of $1 million		
	Actual Cash Flow present value at $19 million	• Determined by business valuator • Reflects Cash Flow C and incremental temporary impact of construction work. • May also reflect impacts unrelated to expropriation.
Total Potential Compensation = $11 million		

Adding Business Losses to the Mix

When exploring whether any business losses exist—in addition to the property losses already mentioned—the business valuator needs to understand which factors are accounted for/reflected in calculating Cash Flow C. For instance, if Cash Flow C reflects lower lease rates due to loss of visibility, but does not reflect a reduction for the temporary impact of construction activities, additional business losses may be applicable unless the appraiser considered those in their valuation under injurious affection.

If it has been established that Cash Flow C does not account for/reflect all business losses, then calculating business losses should include a comparison of Cash Flow C with actual cash flow following the taking. If actual cash flow is lower, this suggests a possible business loss. As shown in the table, this potential business loss is approximately $1 million. Of course, further analysis is necessary to see if such difference between Cash Flow C and actual cash flow is exclusively due to the taking, or whether it is partially the cause of unrelated factors, such as competition or the economy, and therefore only partially claimable.

When Double Counting Occurs

If a business valuator were to calculate business losses as the difference between Cash Flow A and the actual cash flow, business losses would be double counted with the market value of land and injurious affection. Similarly, if business losses were calculated as the difference between Cash Flow B and actual cash flow, business losses would be double counted with injurious affection.

To avoid potential duplication of losses, business valuators and appraisers need to understand what factors are accounted for/ reflected in the various cash flows used in calculating appraisal losses and business losses, as using the inappropriate set of cash flows could result in double counting of losses. In this regard, early coordination between the appraiser and business valuator will prove invaluable in ensuring that all properly compensable losses are quantified, while minimizing the risk of double counting.

Considering Market Rents

In some contexts, there may an expropriation of land and a business that operates on the property. The business may or may not pay fair market rent in relation to the property. In order to value the business and in calculating cash flow used in the valuation, business valuators may have to reflect a fair market value rent figure (or normalize the rent actually paid by the business). This generally has to be consistent with the rent determined and used in their valuation of the property. For example, if the rent actually paid by the business is below market rate and the business is valued using this lower rent expense figure, this will overstate the value of the business.

Meanwhile, if the appraiser has valued the property assuming a higher fair market rent, this will result in a higher appraised fair market value of the property. As such, there is an inconsistency between the rent figures used in the valuation and appraisal exercises, resulting in potential overcompensation. It is crucial for the rent figures used in the valuation and appraisal to be consistent to avoid such overcompensation.

Addressing Land and Leasehold Improvements

Appraisers should clearly indicate what assets and liabilities (land and leasehold improvements) have been included as part of their appraisal. If a valuation is based on adjusted net book value, the business valuator should ensure that the fair market value of these assets are not reflected again in the business valuation—or are otherwise adjusted—to avoid double counting.

For example, with a complete taking where a business cannot relocate and is terminated, if the appraiser has included the value of leasehold improvements in the market value loss conclusion, the business valuator should not duplicate this in their business valuation. If the appraiser has not included the value of leasehold improvements, the business valuator should consider whether leasehold improvements should be included in the business valuation at full replacement or depreciated replacement costs, and they should consider whether there are any betterment issues to address.

Cost Considerations

Care should be taken to ensure that certain costs are considered by either the appraiser or the business valuator—but not both. Specifically, consideration should be given to out-of-pocket costs incurred by a business on disposition of a property, ongoing capital expenditures required to keep a business operating and/or environmental remediation costs. A business valuator should generally consider these costs in the business valuation as long as they were not already included by the appraiser.

Following are some other areas that require cost considerations:

Borrowing Capacity: An appraisal is performed on a debt-free basis and therefore may not have considered whether there is any unused borrowing capacity available to the property owner. As such, the business valuator may need to adjust for this and reflect an increase in the valuation of the business.

Betterment: Some expropriation statutes may specify that any betterment ascribing to a property owner from an expropriation can only be set-off against injurious affection to the owner's land or remaining lands. It may be important to consider whether the betterment in question is unique and specific to the expropriated property as opposed to a benefit that is available to all neighboring landowners. This is an analysis that is usually undertaken by appraisers.

Start of Loss Period vs. Expropriation Date: In some cases, facts may suggest that the start date for the quantifying business losses may be earlier than the expropriation date. This may occur when the claimant can prove that the impacts were experienced prior to the expropriation date, such as when lower lease rates are demanded by tenants in anticipation of an impending expropriation. Business valuators and appraisal experts may need to review relevant documents to determine if an earlier date is appropriate in quantifying business losses, and whether certain detrimental impacts to cash flow noted prior to the expropriation date were indeed the result of the impending expropriation.

In Summary

In expropriation proceedings, coordinating certain aspects of the compensation calculated by business valuation and appraisal experts is of paramount importance. By discussing potential overlapping areas of compensation, such as cash flow streams, market rents, leasehold improvements and various costs, valuators and appraisers can avoid double counting and other factors associated with calculating losses.

The early coordination between appraisers and business valuators is invaluable in ensuring that all compensable losses are quantified, while minimizing the risk of duplication.

02

BUSINESS VALUATIONS IN THE LONG-TERM CARE HOMES SECTOR: THE ONTARIO EXAMPLE

BUSINESS VALUATIONS IN THE LONG-TERM CARE HOMES SECTOR: THE ONTARIO EXAMPLE

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Introduction

The expected growth in the seniors' age demographic in the coming decades has garnered considerable attention in social, political and financial discourse of late. This has brought attention to expense and capacity issues around seniors' residential care. In addition to the costs of administering care, residential facilities involve substantial capital costs in the form of land, buildings and equipment. Further, while provincial governments have historically provided funding to the sector, we are likely to see significant policy changes in coming years, particularly in jurisdictions facing intense budgetary pressures. These dynamics are common to most jurisdictions within Canada.

Within the seniors housing and residential care industry, market participants typically segment properties as retirement homes (RHs) or long-term care homes (LTCHs). While the two segments are related, the businesses are different enough to warrant the distinction, particularly as it relates to the level of care delivered within the residence, the extent of government operating funding and regulatory involvement in the business operations. Residents of LTCHs most often have more significant care requirements and benefit from government subsidies to cover the personal care services delivered within the property, whereas the cost of RH services and accommodation is most often exclusively the responsibility of the resident.

The valuation of firms that own and operate LTCHs must take into consideration numerous market and government policy factors. Critical market factors include demographics, cost of capital, resident choice, competition, economies of scale, availability of staffing, and the impact of negative media coverage. The principal policy factors can be divided, practically, into those affecting government funding, and those related to governance, which include licensing, regulation of services, inspection and compliance.

Ontario, which is home to Canada's largest population of seniors, is the focus of this paper. Though valuation issues will vary by market and by provincial regulatory regime, the valuation issues in the Ontario context are illustrative of the issues and analyses applicable in similarly structured jurisdictions throughout Canada.

Legal and Regulatory Landscape

Services provided by LTCHs are not within the Canada Health Act (CHA) definition of "medically necessary" services. As such, they are not insured services[i] and are not subject to the CHA principles of universality or comprehensiveness. The CHA classifies them as "extended health services," to be governed by provincial and territorial legislation. This results in differences across the country in terms of service offerings and public-versus-private responsibilities for the cost. It also implies that policy on these matters can change from time to time, though historically all provinces have maintained the practice of funding seniors' residential care in some form.

In Ontario, the Long-term Care Homes Act, 2007 (the Act)[II] and Ontario Regulation 79/10 (O Reg 79/10)[III] address the governance of LTCHs, including licencing, residents' rights, care standards, safety and security, protections against abuse and neglect, powers of inspectors, and the establishment of offences, penalties, appeals and enforcement. In addition, the Act is the authority by which funding is provided to homes through the Ministry of Health and Long-Term Care (MOHLTC). In essence, LTCHs receive full government funding for the costs associated with three "envelopes" including nursing care, therapies and food for residents. Funds are provided on a "pass-through" basis, meaning that all funds received for these envelopes must be spent by the home for the purposes prescribed or refunded to the MOHLTC. In addition, s.245 of O Reg 79/10 specifies that homes may not levy any additional charges on residents for any goods or services to which the funding envelopes are intended to apply. The effect of these provisions is that homes cannot earn a profit from any of these care services, but only from revenues associated with accommodation.

As distinct from care services, the costs of accommodation in LTCHs are generally the responsibility of the resident, unless the resident qualifies for a subsidy based on income. Amounts earned by homes in respect of accommodation and operations charges may earn a profit but these are regulated as to amount. In addition, these dollar amounts apply to all homes, whether they are owned by for-profit entities (FPs), not-for-profits (NFPs), or municipalities, and across all locations, regardless of local real estate or labour costs.

Licensing

Pursuant to the regulations under the Act, LTCHs are now subject to limitations on the term of the license, which is required in order to offer government funded long-term care accommodation in the Province of Ontario. Homes and LTCH licenses are classified based on their structural compliance with MOHLTC design standards, as follows:

TABLE 1. MOHLTC STRUCTURAL COMPLIANCE STANDARDS

License Class	Definition	License Term (Years)
Class **New**	Facilities substantially exceeding the 1998 design standards	30 [1],[2]
Class **A**	Facilities substantially meet the 1998 design standards	25 [3]
Class **B**	Facilities substantially exceeding the 1972 standards but not meeting the 1998 design standards	15 [4]
Class **C**	Facilities determined to be in compliance with the 1972 standards	15 [4]
Class **D** (Compliant)	Facilities not in compliance with the 1972 structural compliance, but were upgraded in accordance with the 2002 Class D Bed Upgrade Option Guidelines	10 [4]
Class **D** (Non-Compliant)	Facilities not in compliance with the 1972 structural compliance, and were not upgraded in accordance with the 2002 Class D Bed Upgrade Option Guidelines	4[4]

[1] Starting on the day the first resident was admitted to a New bed, but in no event shall the term be less than 20 years from July 1, 2010, the date that the Long-Term Care Homes Act, 2007 came into effect

[2] On January 1, 2015, the aforementioned maximum term of Class "New" long-term care home licenses was extended from 25 to 30 years from the later of date a home was constructed or July 1, 2010

[3] On January 1, 2015, the MOHLTC provided a one-time automatic extension of 5 years to the license term of existing eligible LTCH licenses where all the beds meet the Class "A" or "New" design standards; effectively extending the license term of Class "A" homes from 20-25 years

[4] From July 1, 2010, unless redeveloped into a Class New facility

Generally, the Class New/A homes are up to 20 years old, and the consensus amongst market participants is that licenses to operate these homes will be renewed after the initial 25 or 30 year term. Class B/C homes on the other hand are much older and vary considerably with respect to their quality and remaining physical useful life. The uncertainty surrounding the Class B/C licenses beyond June 30, 2025 has resulted in a trend of declining market values for these properties. Class D homes are now few in number and are not referenced further in this discussion.

Sector Dynamics

Increasing demand for seniors' residential care is expected from demographic factors, but the more pressing supply-demand factors in Ontario are related to a dearth of new construction in the sector in the past decade. While both the previous Liberal government and the current Progressive Conservative government have made promises to fund an increase in the stock of homes, the province-wide wait list to enter LTCHs exceeds 30,000 beds, while the number of existing beds has remained fairly static at less than 80,000[IV]. Based on MOHLTC statistics for the period 2010 to 2015, the number of licensed LTCH beds in Ontario grew by only 1.5% over the five-year period, compared to an increase of 12% in the population of Ontarians over 75.[V]

The shortage of beds available for seniors, combined with a provincial policy that encourages seniors to age in place, has resulted in significant increases in the average care needs of residents in LTCHs. According to the Ontario Long-term Care Association (OLTCA), 85% of residents require extensive help with activities of daily living (e.g., dressing, eating, mobility, toileting), 90% have cognitive impairment, 46% exhibit some level of aggressive behaviour and 40% need monitoring for an acute medical condition.[VI]

As of February 2018, there were 627 licensed LTCHs, of which 58% were owned by FPs, 24% by NFPs and 16% by municipalities. The sector is quite fragmented in terms of ownership concentration, with the largest 15 operators in Canada constituting 25.8% of total units. The top five of these firms by numbers of beds (Extendicare, Revera, Sienna Senior Living, Chartwell Retirement Residences and Schlegel Villages) are all FPs and all have operations in Ontario[VII] .

The fixed cost nature of seniors' residential care encourages economies of scale in terms of number of beds per home and the number of homes in the enterprise. LTCHs average approximately 123 beds per home[VIII]. Economies apply to staffing, property management, labour relations, administration, regulatory compliance, supply chain management and bulk purchasing.

Significant regulatory and operational barriers to entry exist. LTCHs must be licensed in order to operate (LTCHA s.95) and care and safety standards are detailed and onerous. Though competition exists among homes, differentiation is muted by several factors. All LTCHs are required to provide the same level of services and all are prevented from earning a profit on the care provided by virtue of the envelope system. In addition, homes tend to be dispersed fairly evenly throughout the province. To ensure that all local areas have at least one home, the Act requires all municipalities to establish and maintain a municipally-owned LTCH. Also, section 96 of the Act requires the number and location of beds throughout the province to be determined with regard to (i) existing LTCH bed capacity in a given area, (ii) other facilities or services available, (iii) demand for LTCH home beds in the area, and (iv) the funds available for LTCHs. These factors, combined with persistently long wait lists, result in occupancy rates in LTCHs that are consistently over 98% across the province.[IX]

Profitability

A discussion of profitability necessarily centres on those LTCHs owned and operated by FPs. Though a non-profit business, by definition, cannot distribute a return, NFPs can be valued on an adjusted equity basis, reflecting the net assets in the enterprise and NFPs can in certain circumstances be converted or sold to NPs with the potential to then earn a return.

The residential care industry is highly capital intensive due to required investments in land, buildings and fixtures. As detailed above, financial returns for LTCHs are affected by the flow-through structures of funding envelopes, which do not provide for a profit margin on care services, and by controls on accommodation charges.

Some of the larger chains that own and operate LTCHs, such as Chartwell, Sienna and Extendicare, are publicly traded and their annual and quarterly financial statements are subject to disclosure requirements. However, returns are difficult to extract from public filings, given the limited disclosure provided by line of business. Reports often combine the results of LTCHs and RHs, though RHs in Ontario differ from LTCHs in terms of service offering, pricing of services, funding and regulatory structure. Reported results from public companies may also include revenues from third party management contracts and related business ventures, which make it difficult to separate margin and return metrics that relate specifically to LTCH operations.

For the reasons discussed above, profits for FPs are principally from accommodation, as distinct from care, with some supplementary inflows from charges for non-care-related amenities (e.g., grooming and other non-care services). These amounts, in turn, are funded by the residents.

As part of its Pre-Budget Submission to the Ontario government, the Ontario Long-Term Care Association (OLTCA), which represents the sector, conducted an analysis of operating costs for LTCHs relative to the operating cash flows that homes are permitted to earn from accommodation[X]. Their study purports to summarize the annual audited financial statements of 50% of the LTCHs filed with the province in 2012, including the expenses to which accommodation revenues are applied. Table 1 shows the percentage breakdown according to expense categories.

TABLE 2. EXPENSES AS A PERCENTAGE OF FUNDS FROM ACCOMMODATION

Salaries, Benefits and Purchased Services	53%
Utilities	9%
Management and Allocated Fees	6%
Maintenance and Building Services	4%
Supplies and Equipment	7%
Property Taxes	2%
Insurance and Communication	1%
Other Items	2%
Debt Service, Mortgage Interest, Capital Expenditures and Return on Investment	16%
Total	**100%**

Adapted from OLTCA Pre-Budget Submission, 2015

As shown, the majority of funds received go directly to salaries, benefits and wage-related expenses, with much of the balance to administrative expenses, such as office supplies, communication (phones and internet), accounting, recruitment, and payroll. In addition, homes must cover 50% of their bad debt expenses (uncollected resident payments) with the other half reimbursed by government. These data suggest that 16% of accommodation funding remains after all expenses listed, to cover returns on capital, as well as capital expenditures, roof and heating system repairs, furniture, hospital bed and technology infrastructure.

Renewal of Aging Long-Term Care Homes: Public Private Partnership

In Ontario, the government and the private sector have a history of public-private partnerships, formed to build and redevelop the available supply of LTCHs. In July 2007, the MOHLTC announced its intent to establish a new capital cost funding initiative, aimed at providing incentives for owners of existing Class B/C LTCHs (at the time ~35,000 beds) to redevelop such properties to current design standards. In 2009, the MOHLTC unveiled the initial framework for the implementation of this initiative through an updated policy in respect of (i) providing capital grants to subsidize the construction of eligible redevelopment projects and (ii) the Long-Term Care Home Design Manual. In October 2014, the MOHLTC provided details of an enhanced capital grant program which increased the level of capital funding available for eligible proponents who committed to the redevelopment of the Class B/C LTCHs before the expiry of the license term in 2025. Separate from the Class B/C redevelopment initiative, announced as part of the 2018 Budget, Ontario is planning to build 5,000 net new long-term care beds by 2022, and more than 30,000 over the next decade[XI].

Capital Costs

Construction cost inflation has been a significant headwind for real estate developers as the current business cycle extends into the late stages of an extended market rally. The cost to develop a LTCH has escalated considerably over the past decade. While estimates vary, it has been observed within a professional practice context that greenfield project capital costs currently exceed an estimated $200,000 per bed, with regional premiums based on several factors including the price of land, municipal development charges and the availability of trades and labour. The increasing cost to develop an LTCH has been a key challenge for the MOHLTC's aforementioned plan to redevelop the Class B/C LTCHs in the province.

Business Risks

Owners of LTCHs are subject to general economic conditions as well as those specific to the sector. Risks associated with the ownership of real property are inherent in the seniors' housing industry. As an equity investment, real property is relatively illiquid, which can limit the ability of Owners to respond to changing economic or investment conditions. In addition, costs associated with repair, maintenance and renovation can be substantial. From a real property perspective, the greatest risks regarding seniors' housing residences are in the development phase, which includes land assembly, zoning approvals, construction and lease-up.

The ability to grow and expand operations in the LTC segment is determined by the Ontario government's willingness to approve new licenses, which is done through a request for proposal process and has resulted in limited new awards in the past decade. The province also regulates the way LTCHs are developed and redeveloped. As detailed above (see Licensing), all bed licenses are scheduled for expiry and there is no certainty of renewal. This is especially a concern for Class B/C beds and it represents a significant risk to cash flow streams beyond these expiry dates.

The labour-intensive nature of the sector exposes LTCHs to increased salary and wage costs, particularly given the prevalence of collective bargaining agreements. These costs are not easily passed through, since accommodation amounts are regulated. In addition, the health care industry continues to face shortages of nurses and other health care workers.

Frailty of the resident population implies health-related risks, such as disease outbreaks. In addition, vulnerability of residents is associated with risks of inappropriate or negligent acts by employees, and limited mobility of residents can amplify the consequences of catastrophic events such as fires. In recent years, reputational risks have become more prevalent for LTCHs, particularly with media coverage regarding incidents of neglect or mistreatment of residents.

LTCHs are subject to numerous regulations pertaining to the safety and security of residents, which are supported by inspections, audits and investigations. Non-compliance can result in severe penalties such as fines or other sanctions.

As indicated, competitive pressures for LTCHs are mitigated by occupancy rates close to 100%, throughout the sector, but competitive dynamics are susceptible to change in the mid-to-long term due to changes in government funding policies. For example, many RHs have overlapping care service offerings with LTCHs, and though RHs currently do not benefit from government funding, modifications to funding policy could occur. Alternatively, the introduction of self-directed care, now common in much of Europe, could alter consumption patterns by placing funding in the hands of seniors to choose their service provider, rather than having the funding flow from government only to designated providers.

Mitigating the risk profile of the LTCH sector are age demographics, which are largely predictable and provide some assurance of continued demand in the seniors' residential care sector. In addition, the funding stream for care services is principally from the Ontario government, which carries relatively low credit risk. As well, the LTCH sector has historically been fairly insulated from economic cycles. This can be attributed to several factors, including (i) the demand for LTCH housing being driven by need rather than discretionary expenditure; (ii) the stability of tenure, as seniors are less able to relocate to other accommodation after having moved into a facility; and (iii) the continual increase in the demand for LTCHs relative to the shortage of supply. All of these factors together help to reduce the risk of revenue fluctuations, though relatively narrow profit margins can have the effect of amplifying volatility in net cash flow should other risks emerge.

Valuation Methodologies

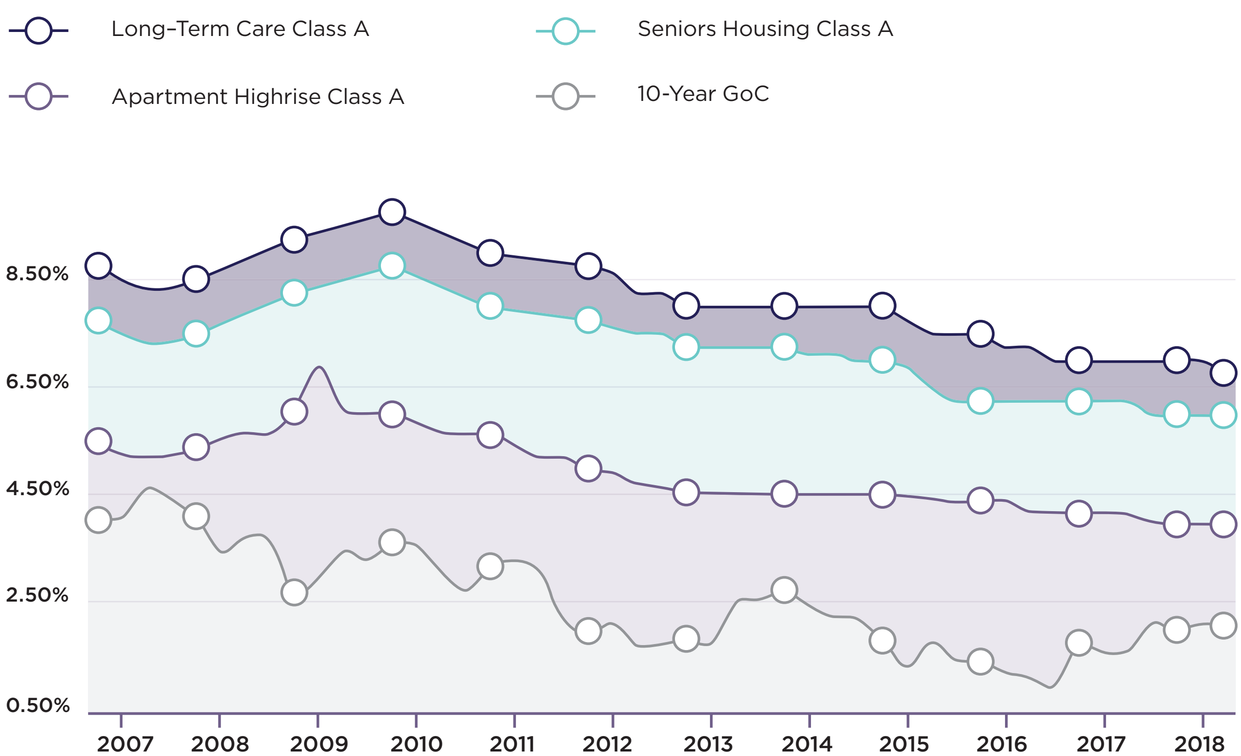
The valuation of LTCHs poses special challenges for business valuators given their capital-intensive nature and the fact that their value is closely linked to the value of the underlying real estate and other fixed assets. Additionally, these businesses are intrinsically tied to the value of the licenses to operate the LTCHs. As discussed, issuances of new licenses have been restricted in recent years and market liquidity has been limited.

Similar to other sectors characterized by capital intensity and regulation, business valuators tend to default to appraised values of the facilities prepared by qualified appraisers to determine the base value of the operations of business. It should be noted that these types of appraised values typically reflect the value of a "turn-key" long-term care facility, with all tangible assets (real property, fixed assets and working capital) and intangible assets (licenses and qualified workforce) available to generate the forecast earnings and cash flows. While technically an asset appraisal, this form of appraisal generates a value that corresponds closely with the operating value of the business. Business valuators would also consider any redundant assets relating to the operations as well as any debt associated with the business in arriving at the value of the equity of the operation. In addition, consideration should be given to any latent taxes associated with the underlying assets and any trapped-in capital gains that may exist within holding company structures, which are typical of real estate investments.

The primary methodology used by appraisers in determining the value of seniors' housing in general and long-term care facilities specifically, is with the application of a capitalization rate (cap rate) to the net operating income (NOI) of the business. The NOI represents a pre-tax return on the normalized operations of the business, irrespective of capital structure. This metric would be similar to a multiple method applied to Free Cash Flow or EBITDA, using a multiple that is the reciprocal of the Weighted Average Cost of Capital (WACC), adjusted for growth. These are metrics often favoured by business valuators. This method is reasonable when valuing facilities without significant capital expenditures, and would be appropriate for Class New/A LTCHs, which are compliant with current regulatory requirements and do not require significant capital expenditures to meet the new design standards. This method is also appropriate for long-life assets and can therefore be used on the assumption that Class New/A LTCHs are essentially evergreen businesses, with licenses that can be expected to be renewed on maturity. For Class B/C properties, where license renewal is less certain beyond 2025, other methods should be considered including a hybrid methodology consisting of a discounted cash flow for the remaining license term combined with a risk adjusted capitalized cash flow or sale of the assets thereafter, considering the redevelopment prospects at the terminal date.

According to CBRE's recent publication on the Canadian Seniors' Housing & Healthcare Industry[XII] the average cap rate for RHs was approximately 6% to 6.5% nationally, being approximately 200 basis points higher than the average yield on Class A apartment buildings and 400 basis points higher than 10-year Government of Canada bonds (see Graph 1). These unlevered yields and spreads represent historical lows over the past 10 years (see Graph 2). As compared with RHs, which are less regulated and have greater opportunity for revenue and profit expansion, Class New/A LTCHs typically tend to transact at cap rates approximately 100 basis points higher on account of the greater operational complexity and regulatory risks, with even higher spreads applicable to Class B/C LTCHs. As with all real estate cap rates, the above rates vary by location and are typically a function of real estate costs, construction costs, and in the case of LTCHs, the cost of regulatory compliance, which is quite significant in Ontario.

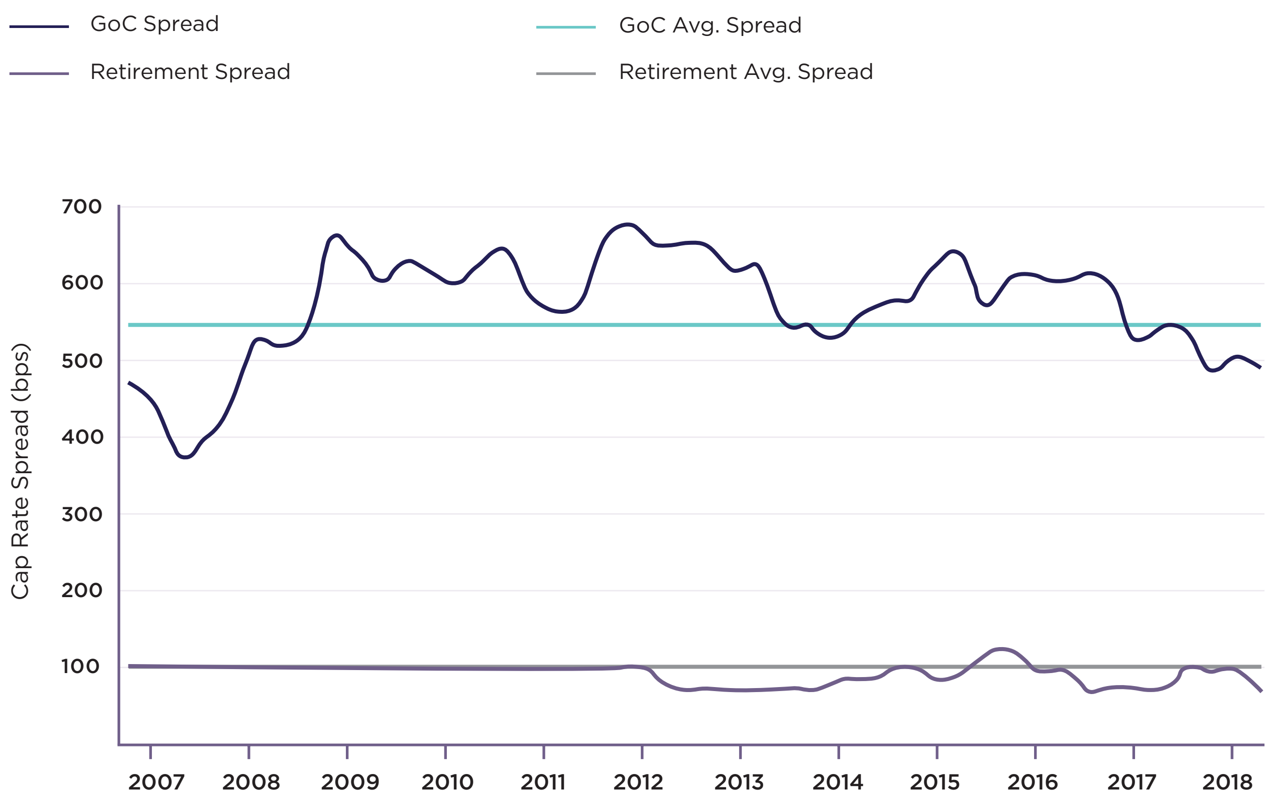
GRAPH 1 - NATIONAL SENIORS HOUSING AND CARE PROPERTY* CAP RATE VS. 10-YEAR GOC YIELD



* Class A seniors housing (IL/AL) assets. Stand alone property sales; not representative of portfolio transactions

Source: CBRE Limited

GRAPH 2 - CLASS "A" LTCH CAP RATE SPREAD VS 10-YEAR GoC YIELD AND RH CAP RATE



Source: CBRE Limited

In valuing the equity of the larger chains in the seniors' housing sector, valuators will often use market-based data, including implied earnings and cash flow multiples of comparable publicly-traded companies, as well as multiples implied by transactions involving comparable companies. However, these measures tend to reflect an underlying portfolio of assets, as opposed to an individual asset, may involve a combination of different types of seniors' housing assets (e.g., LTCHs and RHs) and other earnings streams such as home care or ancillary business ventures. These challenges are in addition to normal challenges a valuator faces in assessing comparability when implementing the market approach due to issues such as size, geography, growth opportunities and capital requirements, to name a few. Valuation metrics most often used by public company analysts include:

- EV / EBITDA (Enterprise Value / Earnings Before Interest, Tax, Depreciation + Amortization)
- P / FFO (Market Capitalization / (Earnings + Depreciation + Amortization – Gains on Sale of Assets)
- P / AFFO (Market Capitalization / (Earnings + Depreciation + Amortization – Gains on Sale of Assets – Maintainable Capital Expenditures)

These three valuation metrics differ in a number of ways. While the first arrives at the value of the enterprise (comprising all forms of capital), the second and third metrics value the equity of the business directly using a market cap as the indicator of value. In addition, while the first two metrics do not consider capital expenditures, the third metric does. This makes the third metric more relevant in situations where significant capital investment is expected, as would be the case with Class B/C LTCHs.

Conclusion

LTCHs represent a specialized market segment, even within the broader seniors' housing and residential care property sector, due to their particular licensing, funding and regulatory structures. These businesses are typically characterized by secure revenue streams, but profitability is limited in Ontario to the accommodation part of the business, while care funding is a pass through from the government. With revenues determined provincially by regulation, local real estate and labour markets can impact profitability substantially, as can economies of scale. Though licensing and regulation place high barriers to entry, they also present risks by imposing high standards on operators who serve vulnerable residents.

Given the sector specialization and the prominence of real estate in the value equation, valuators are well advised to work closely with appraisers with experience in the seniors' housing and residential care property sector. While appraisers employ valuation methods similar to those familiar to CBVs, there is no substitute for local knowledge of the real estate market in these types of valuations.

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03

FAIRNESS OPINIONS: THE NEW BEST PRACTICES

FAIRNESS OPINIONS: THE NEW BEST PRACTICES

Andrew Capitman[1], Paul Collins[2], Paul Davis[3], Uttaraa Diwan Talwar[4], David Lee[5], and Valenteena Samra[6]

Executive Summary

For several years in Canada, the use of statutory plans of arrangement has been the preferred method of acquiring public companies. In addition to obtaining the approval of the target's shareholders, completion of an arrangement requires that the Court (in the target's jurisdiction) approve the arrangement as being "fair and reasonable." Court approval involves a two-step process, with the Court initially being requested to grant an interim order relating to, among other things, the mechanics of calling and holding the shareholder meeting, as well as, subsequent to the shareholder vote, the Court being requested to grant a final order determining the arrangement to be fair and reasonable. At the hearing for the interim order, the Court is provided with a near final draft of the management proxy circular to be provided to shareholders and, at the hearing for the final order, the Court is advised of the results from the shareholder vote.

In November 2016, the Yukon Court of Appeal[7] overturned the ruling granted by the Supreme Court of Yukon[8] approving the proposed US$2.5 billion acquisition by Exxon Mobil Corporation (Exxon) of InterOil Corporation (InterOil) by means of a plan of arrangement. While the Supreme Court had noted a number of deficiencies in the fairness opinion provided by InterOil's financial advisor and the disclosure provided to shareholders, the Court approved the arrangement on the basis that, following a competitive process, the Exxon plan of arrangement had received overwhelming shareholder support (more than 80% of votes cast). The Court of Appeal overturned the lower Court's decision on the basis that the shareholder vote could not be viewed as a proxy for the arrangement's fairness and reasonableness where shareholders have not been provided with sufficient information to make an informed decision.

While fairness opinions are not mandated by Canadian law, the Court of Appeal noted that the fairness opinion (which had been included in the management proxy circular) had been extremely limited in scope and had not included analysis to support its conclusion. Additionally the circular had not disclosed that a significant portion of the opinion provider's fee was contingent on the successful completion of the arrangement. Exxon and InterOil agreed to a revised plan of arrangement (which received approval by over 91% of the shares voted) and again sought the approval of the Supreme Court of Yukon[9], obtaining the approval in February 2017. In issuing its reasons for granting the interim and final orders approving the updated plan of arrangement, the Supreme Court of Yukon noted that a minimum standard for interim orders of any plan of arrangement should be a long form fairness opinion prepared by an independent financial advisor on a fixed-fee basis.

1 Managing Director, Duff & Phelps
2 Partner, McMillan
3 Partner, McMillan
4 Associate, Duff & Phelps
5 Director, Duff & Phelps
6 Associate, McMillan
7 InterOil Corporation v Mulacek, 2016 YKCA 14.
8 Re InterOil Corporation, 2016 YKSC 54.
9 Re InterOil Corporation, 2017 YKSC 16.

In this paper Duff & Phelps, LLC and McMillan LLP (We) provide an analysis of pre-and post-InterOil practice (in Canada) as it relates to obtaining fixed-fee fairness opinions on public company acquisitions. We conclude that the InterOil decision has had a significant impact in British Columbia and the Yukon with respect to boards of target companies obtaining financial advice on a contingency fee basis, as well as independent, fixed-fee fairness opinions.

Background

In July 2016, Exxon announced a proposal to acquire all of the issued and outstanding common shares of InterOil by way of a plan of arrangement for approximately US$2.5 billion, which represented C$45 per share plus a contingent resource payment (CRP) of approximately C$7.07 per share for incremental reserves - subject to a cap. The Exxon proposal was determined to be superior to the offer previously received by InterOil from Oil Search Limited. On September 21, 2016, the arrangement was approved by 80.57% of shareholder votes cast. InterOil's sell-side mergers and acquisitions (M&A) advisor was entitled to a fee for its services, a substantial portion of which was contingent on completion of the arrangement. As is customary in Canada, the structure and the amount of the advisor's fee were not disclosed in the proxy circular sent to shareholders. The advisor provided InterOil's board with a fairness opinion in connection with the transaction, disclosing that it was able to reach its conclusion (that the consideration was fair) based solely on the value of the stock consideration to be received by InterOil shareholders - without regard to the value of the additional CRP component.

The transaction was structured as a plan of arrangement, which required the determination of the Supreme Court of Yukon that the transaction was fair and reasonable. The application judge was critical of the fairness opinion, citing that it did not address the value of the CRP, that it lacked disclosure regarding the details of the advisor's success-based compensation, and that the opinion contained no valuation analysis so that a shareholder could consider the merits of the arrangement on an informed basis. Additionally, the judge also expressed the view that there should be "an independent flat fee Fairness Opinion to assist shareholders and the Court if [the board] wishes to comply with best practice corporate governance." Nevertheless, a fairness ruling approving the arrangement was granted by the Supreme Court of Yukon on October 7, 2016, with the Court attaching significant weight to the fact that a substantial majority of shareholders had voted in favor of the arrangement.

Philippe Mulacek, the former chairman and founder of InterOil (and owner of 5.5% of InterOil's shares), appealed the approval of the arrangement. Mr. Mulacek argued that the shareholder vote should not be relied on as a proxy for the determination of fairness and reasonableness where, among other deficiencies in the process undertaken by InterOil's board, InterOil had failed to provide sufficient information to allow its shareholders to make a fully informed decision on the arrangement. On November 4, 2016, the Yukon Court of Appeal, made up of judges from the British Columbia Court of Appeal, granted the appeal and overturned the approval ruling granted by the Supreme Court of Yukon. While receipt of a fairness opinion is not mandated by Canadian law, a key reason, cited by the Court of Appeal, in refusing to approve the arrangement was the fact that the fairness opinion was viewed as deficient for multiple reasons, including (i) the failure to disclose the success-based compensation that the advisor would receive in connection with the transaction, (ii) the failure to attribute any value to the CRP, and (iii) the failure to provide any discussion of the valuation process undertaken by the advisor.

Following the Yukon Court of Appeal decision, the plan of arrangement was amended. InterOil retained a different financial advisor to provide an independent, fixed-fee, and long form fairness opinion. On February 20, 2017 InterOil obtained approval from the Yukon Supreme Court for the updated plan of arrangement with Exxon. In issuing its reasons for granting the final order approving the updated arrangement, the Court stated: "It is not acceptable to proceed on the basis of a Fairness Opinion which is in any way tied to the success of the arrangement." In noting that the long form fairness opinion provided a useful template for the level of detail to be included in future fairness opinions, the Court made the following key observations: (i) the opinion was provided on an independent fixed-fee basis and the amount of the fee was disclosed in the proxy circular, and (ii) the opinion clearly set out the materials reviewed and the assumptions made, and provided a comprehensive explanation of the valuation methodologies used.

Following the release of the InterOil decision, in July 2017, the staff of the securities regulatory authorities in Ontario, Québec, Alberta, Manitoba and New Brunswick released Canadian Securities Administrators Staff Notice 61-302 – Staff Review and Commentary on Multilateral Instrument 61-101 (CSA Staff Notice 61-302) expressing staff's views arising from its oversight of transactions governed by Multilateral Instrument 61-101 – Protection of Minority Security Holders in Special Transactions (MI 61-101). MI 61-101 implements procedural protections where a related party of the issuer is involved in a material conflict of interest transaction, such as an insider bid, issuer bid, business combination, or related party transaction. In certain instances, MI 61-101 mandates that an independent formal valuation be conducted and disclosed in advance of completing the conflict of interest transaction. The guidance acknowledged that fairness opinions are not required under MI 61-101. However, in cases where a fairness opinion is obtained, the disclosure should:

- detail the specifics of the compensation arrangement of the financial advisor, including whether the fee be fixed or contingent;
- explain how the board or special committee considered compensation arrangements with the financial advisor when considering the advisor's advice;
- disclose any other relationship or arrangement with the financial advisor;
- provide a clear summary of the methodology, information and analysis underlying the opinion sufficient to enable a reader to understand the basis of the opinion; and
- explain the relevance of the fairness opinion to the board of directors and special committee in coming to the determination to recommend the transaction.

Research

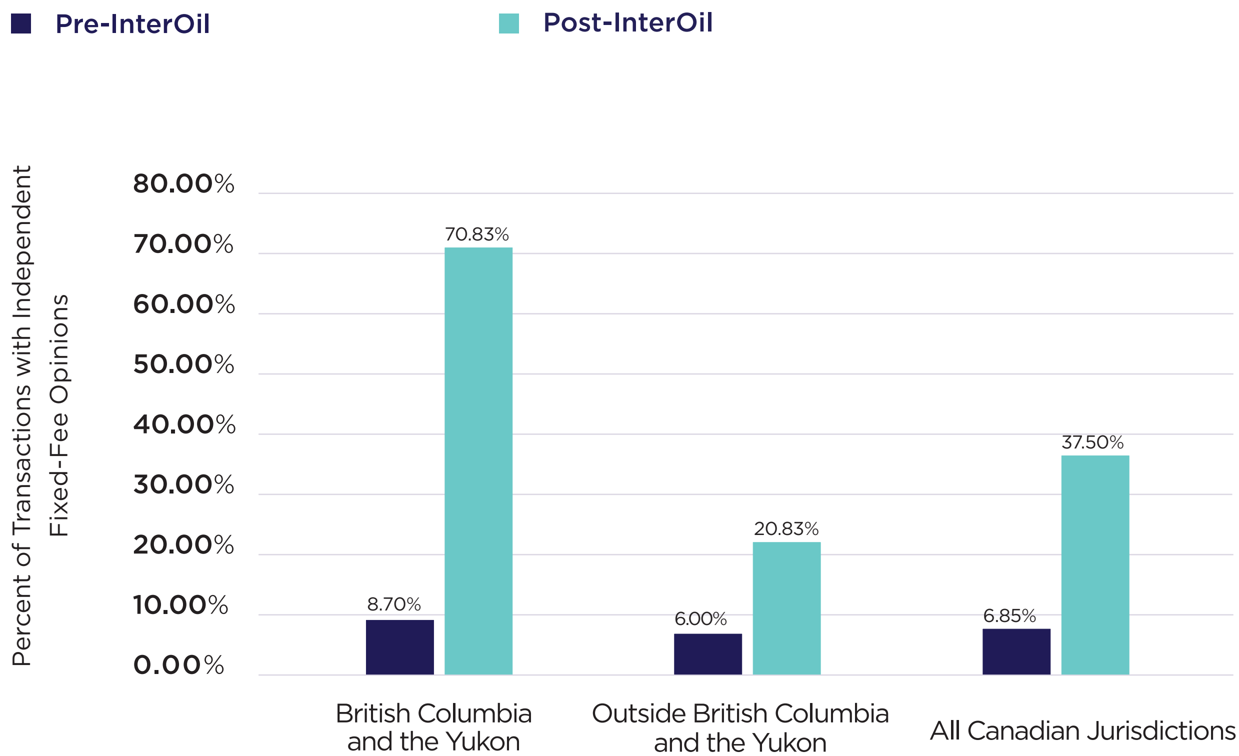
The Court's statement in the InterOil decision that an independent fixed-fee fairness opinion is a "minimum standard" would, if implemented by other jurisdictions, create a divergence from historical practice in Canada concerning fairness opinions. To assess the impact of the InterOil decision, we performed a statistical analysis of transactions involving the acquisition of Canadian public companies for a period of 18 months both prior to and following the InterOil decision.

Methodology

Our study relies on circulars we reviewed in relation to the acquisition of Canadian public companies (via a plan of arrangement or a takeover bid) available in the CSA System for Electronic Document Analysis and Retrieval (SEDAR) database during the timeframe of July 1, 2015 through June 30, 2018. In analyzing our results, we eliminated cases where there was no financial advisor advising the target and no fairness opinion obtained by the target. In addition, we excluded cases where a formal valuation was provided as mandated by MI 61-101.

Further, we distinguished transactions where the target retained a single financial advisor who provided a fairness opinion and who was compensated solely on fixed-fee basis. Our study revealed that there had been an increase in the number of instances where the target retained a single financial advisor on a fixed-fee basis, from 5 instances in the 18 months prior to the InterOil decision to 27 instances in the 18 months following the InterOil decision. Whether this increase reflects an impact on best practices following the InterOil decision or merely reflects the economic parameters of these particular transactions remains uncertain.

For the 18 months prior to the InterOil decision, 99 transactions were included in our final sample after eliminations, and 101 transactions were included for the 18 months following the InterOil decision. The following table summarizes our results where the target obtained a fixed-fee fairness opinion from an independent financial advisor in transactions and where one or more of the target's financial advisors also received a contingency fee.[10]



Summary of Findings

The InterOil decision has had a significant impact in British Columbia and the Yukon. Boards of target companies in those jurisdictions, in addition to obtaining financial advice on a contingency fee basis, have obtained an independent, fixed-fee fairness opinion in 70.83% of all transactions that were announced in the 18 months following the InterOil decision, compared to 8.70% in the same period of time preceding the InterOil decision. The impact of the InterOil decision has been less significant (although not insignificant) outside those jurisdictions. Boards of target companies in jurisdictions other than British Columbia and the Yukon, who received financial advice on a contingency fee basis, also obtained a fixed-fee fairness opinion in 20.83% of all transactions announced in the 18 months following the InterOil decision, compared to 6.00% in the same period of time preceding the decision. In all transactions announced in Canada, in the 18 months following the InterOil decision, where one or more of the target's financial advisors received a contingency fee, an independent fixed-fee fairness opinion was obtained in 37.50% of all transactions, compared to 6.85% in the same period of time preceding the InterOil decision.

Supplementing our statistical analysis, Duff & Phelps interviewed 25 M&A deal lawyers at 13 Canadian law firms to survey the legal community's reaction to the InterOil decision and its impact on transactions since then, both within and outside British Columbia/Yukon. The consensus view of Canadian M&A deal lawyers supported the results of our research and statistical analysis. M&A deal lawyers highly recommended obtaining an independent fixed-fee fairness opinion for transactions in British Columbia and the Yukon in the wake of the InterOil decision.

[10] A detailed overview of the underlying database, as well as the methodology and assumptions used in our analysis can be found [at the link below].

However, obtaining an independent fixed-fee fairness opinion is generally not strongly advocated in jurisdictions outside British Columbia and the Yukon unless there is good reason to expect opposition to the transaction.

Key Takeaways

While CSA Staff Notice 61-302 raises the bar on disclosing the specifics of the compensation arrangement of a financial advisor, a key similarity that remains between Canadian and U.S. practice is the lack of any requirement from securities regulatory authorities to obtain a second, independent fixed-fee fairness opinion from another financial advisor. Our research suggests, however, that the InterOil decision has had a significant effect on the boards of target companies existing in the Yukon and British Columbia because of the perceived heightened risk that, in the absence of compliance with best practices, as stated in InterOil, a court may refuse to grant the requisite approvals at either the interim or final order stage. While InterOil's statement of best practices has been somewhat recognized by target boards and their advisors in the balance of Canadian jurisdictions, it has yet to become the market standard in those jurisdictions except where participants contemplate a highly contested transaction.

About Duff & Phelps

Duff & Phelps is a global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues. Duff & Phelps is the #1 ranked fairness opinion provider in the U.S. and worldwide in Thomson Reuters' Mergers & Acquisitions Review Full Year 2017. Over the past 10 years, Duff & Phelps has provided more than 800 fairness opinions for deals aggregating over US$200 billion.

About McMillan

McMillan is a leading business law firm serving public, private and not-for-profit clients across key industries in Canada, the United States and internationally. With recognized expertise and acknowledged leadership in major business sectors, we provide solutions-oriented legal advice through our offices in Vancouver, Calgary, Toronto, Ottawa, Montréal and Hong Kong.

04

RECENT HOT BUTTON DAMAGES TRENDS IN LITIGATION CASES

RECENT HOT BUTTON DAMAGES TRENDS IN LITIGATION CASES

Richard Davies[1], CPA CA CBV CFE CFF

Daniel Ross[2], CPA CA CBV CFF

Introduction

This paper reviews three recent Canadian court decisions involving the quantification of damages while highlighting, for Chartered Business Valuators ("CBVs") working as experts, key takeaways from the Court's findings in these matters.

Specifically, this paper covers the following three cases:

Cases	Issues and Areas of Discussion
Case 1 : Grenke v. DNOW Canada ULC, *2018 FC 564*	Pre-judgment interest – Simple vs. Compounding
Case 2: Borrelli v. Chan, *2018 ONSC 1429*	Approaches to calculating damages involving alleged fraud and the issue of providing critique-only analysis
Case 3: Apotex v. Nordion, *2017 ONSC 1323*	Estimating "But For" Market Share

The summary provided herein is that of the authors, and does not necessarily reflect the views of their employer.

The cases discussed herein, as of the date of this paper, may be under appeal and/or subject to appeal.

CASE 1: GRENKE V. DNOW CANADA ULC, *2018 FC 564*

Case Overview

This case was bifurcated as between liability and damages. In the lability phase, Justice Phelan released his decision on June 3, 2010 in Weatherford Canada Ltd. v. Corlac Inc., 2010 FC 602 which found, among other things, that:

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"… Canadian Patent No 2,095,937 [937 Patent], relating to seals in stuffing boxes on oil drilling equipment, was valid and had been infringed;" [3] and, *"… that the Plaintiffs were entitled to an accounting or to damages to be assessed by the Court including claims for exemplary or punitive damages and pre and post-judgment interest as of June 3, 2010."* [4]

On May 31, 2018, Phelan J. released two decisions for the damages phase of this case. This paper focuses on the later decision pertaining to the damages awarded.[5]

The Parties in this action were as follows:

The Plaintiffs[6]	The Defendants[7]
• *Darin Grenke,* as personal representative of the Estate of Edward Grenke • *284949 Alberta Ltd.* (formerly GrenCo Industries Ltd.	• *DNOW Canada ULC* • *National Oilwell Varco Inc.* • *769388 Alberta Ltd.* (formerly Corlac Inc.)

For simplicity purposes, the Plaintiffs are referred to herein as either "the Plaintiffs" or "GrenCo", and the Defendants as either "the Defendants" or "NOV".

Background of GrenCo and the '937 Patent

Founded by Edward Grenke, GrenCo was a small family-run machine shop in Edmonton, Alberta - prior to the invention of the 937' Patent. Subsequent thereto, GrenCo became an industry leader in its market. Phelan J. noted in his decision that *"[t]he description of the introduction of the GrenCo Product as causing "a paradigm shift for the PC Pump industry" is an accurate one."*[8]

The 937' Patent was for a *"… seal assembly combination designed to fix a problem of leaking stuffing boxes on PC [progressive capacity] pumps. In simple terms, a stuffing box is the device which seals off the top of the oil well from the oil being drawn up by a turning rod. The 937 Patent was designed to limit leakage, which causes a loss of oil, environmental damage, and unplanned wellhead shutdown."*[9]

The stuffing boxes were attached to drives, which were then sold by GrenCo to its customers. GrenCo did not sell standalone stuff boxes (i.e., stuffing boxes which were not attached to drives), however NOV did.

Subsequent to the 937' Patent, the three main industry players which emerged were GrenCo, NOV, and Weatherford.

3 Source: 2018 FC 564, paragraph 1.

4 Source: 2018 FC 564, paragraph 2; we note that the Plaintiffs elected damages (or "Lost Profits") instead of an accounting of the Defendants profits.

5 Grenke v. DNOW Canada ULC, 2018 FC 564.

6 Weatherford Canada Ltd. and Weatherford Canada Partnership (collectively referred to as "Weatherford"), who were the sole sub-licensee of the 937' Patent, were Plaintiffs during the liability phase. However, they were removed as Plaintiffs for the damages phase after they entered into a separate agreement with the Defendants on September 1, 2012 (Source: 2018 FC 564, paragraphs 15-17).

7 The specific infringers on the 937' Patent were as follows: Corlac Inc., Corlac Equipment Ltd., National Oilwell Inc. (now known as National Oilwell Varco Inc.), and National Oilwell Canada Ltd. (Source: 2018 FC 564, paragraph 1).

8 2018 FC 564, paragraph 21.

9 2018 FC 564, paragraphs 18 and 19.

Though we do not delve into market share for purposes of this paper, we note that the respective market share of GrenCo and its competitors was a contentious issue for this case.

The 937' Patent was licenced by Edward Grenke to GrenCo in December 1992, and subsequently transferred to GrenCo on June 3, 2010 (i.e., date of liability decision).[10]

Claim

GrenCo claimed for the following heads of damage from January 1, 2000 to June 3, 2010:[11]

Heads of Damage	Description
• Lost Profits	• GrenCo's "but for" market share of infringing drive sales (i.e., lost drive sales); and, • Other lost auxiliary income (i.e., lost drive service fees, drive rebuilds, and convoy products) on but for infringing drive sales.
• Reasonable Royalties	• On the remainder of infringing drive sales not attributed to GrenCo (i.e., the but for market share of other competitors); and, • Standalone stuffing box sales.
• Pre and Post-Judgment Interest	• Compounded interest to June 3, 2010 (i.e., approximate date GrenCo was sold to a third party); and, • Simple interest thereafter.

According to Phelan J's decision:

> *"The Plaintiffs originally sought an award of:*
>
> 1. *$13,118,000 in damages, including interest;*
> 2. *$1,882,000 in punitive and exemplary damages; and*
> 3. *Costs to be determined after written submissions of the parties."*[12]

10 Subsequent to the June 3, 2010 decision, GrenCo was sold to a third party.

11 GrenCo also claimed for punitive and exemplary damages which has not been shown in the illustrative chart above. We note that GrenCo did not receive an award for punitive and exemplary damages.

12 2018 FC 564, paragraph 5.

> *"As a result of evidence at trial, the Plaintiffs have reduced their damages claim to between $9,517,000 and $9,995,000. The difference depends principally on which royalty rate the Court accepts."*[13]

Court's Findings on Damages Issues

Phelan J. awarded damages of approximately $7.9 million (before pre and post-judgment interest) to the Plaintiffs made up of the various heads of damages.[14]

Of note in this decision, similar to a number of other recent cases, is that Phelan J. awarded pre-judgment interest on a **compounded basis** up to the sale of GrenCo (i.e., June 3, 2010), and on a simple basis thereafter.

The Plaintiffs argued for compounded interest on the basis that:

> *"… "[b]y being denied compensation it should have had at the time the Defendants committed the wrong, GrenCo lost the opportunity to use such compensation to pay off debts and/or for additional investment into equipment or research and development". Compound interest is an appropriate method of compensating the Plaintiffs for the loss of the "time-value" of money that the Defendants gained at their expense."*[15]

Conversely, the Defendants argued for simple interest, stating that:

> *"… simple interest ought to be awarded unless the Plaintiffs establish that compound interest is required to achieve full compensation. The Defendants submit that "[t]he most reasonable conclusion from Grenco's conduct in the real world is that Grenco would not have re-invested any additional profits earned into its business."*[16]

In discussing the relevant statutes with respect to whether compounded interest can be award, Phelan J. noted in his decision that:

> *"In Bank of America Canada v Mutual Trust Co, 2002 SCC 43 at para 38, [2002] 2 SCR 601, the Supreme Court noted that "[a]lthough not historically available, compound interest is well suited to compensate a plaintiff for the interval between when damages initially arise and when they are finally paid". Interest is available both at common law and at equity."*[17]
>
> *"Subsection 55(1) of the Patent Act, RSC 1985, c P-4, is also a statutory basis for the interest, as an element of compensation."*[18]
>
> *"Paragraph 36(4)(b) indicates that compound interest cannot be awarded under the Federal Courts Act. However, as discussed above, it is available through other statutory and equitable routes."*[19]
>
> *"In Eli Lilly and Company v Apotex Inc, 2014 FC 1254, 471 FTR 292 [Eli Lilly], Justice Zinn stated as follows:*

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13 2018 FC 564, paragraph 6.
14 2018 FC 564, paragraph 214.
15 2018 FC 564, paragraph 206.
16 2018 FC 564, paragraph 207.
17 2018 FC 564, paragraph 192.
18 2018 FC 564, paragraph 193.
19 2018 FC 564, paragraph 205; we note that this quote states "as discussed above" which is in reference to paragraphs 192 and 193.

"[116] Interest may be payable by a right under another statutory provision. Justice Gauthier implicitly recognized this when she wrote that Lilly could be awarded compound prejudgment interest "as an element of compensation." ***The source for "compensation" is subsection 55(1) of the Patent Act which provides that the infringer is liable to the patentee "for all damage sustained" by reason of the infringement.*** *If the patentee can establish that it lost profits as a result of the infringement and that those profits would have generated income on a regular basis over the period of deprivation of those profits, then the patentee has also sustained the damage of the lost income from those profits...* ***I would go further and say that in today's world there is a presumption that a plaintiff would have generated compound interest on the funds otherwise owed to it and also that the defendant did so during the period in which it withheld the funds.****"*[20] *[emphasis added by Phelan J.]*

Phelan J. ultimately concluded that GrenCo could claim for compounding pre-judgment interest, stating:

"I concur with Justice Zinn's comments that in today's world, compound interest is an accepted form of redress."[21]

"In Apotex Inc v Wellcome Foundation Ltd (2000), [2001] 1 FC 495 at para 123, 195 DLR (4th) 641(CA), aff'd 2002 SCC 77, the Federal Court of Appeal indicated that interest was an element of compensation: "I would adopt the longstanding principle in the Anglo-Canadian jurisprudence that interest should be used neither as penalty nor reward, but should stand as part of an award to make the aggrieved party whole."[22]

"... [t]he Defendants cite Janssen[23] *at para 138, wherein Justice Hughes considered that "[t]he decision of Zinn J. in Eli Lilly appears to consider lost profit arising from damages for lost sales is somehow reflected in an award of compound interest. Perhaps the Court of Appeal will clarify the situation."*[24]

"Although the jurisprudence is not entirely consistent on this point, I find the reasoning of Justice Zinn in Eli Lilly to be persuasive. This case was recently cited in Dow Chemical Company v Nova Chemicals Corporation, 2017 FC 350 at para 169, 279 ACWS (3d) 385, wherein the Court awarded compound interest in a case where the injured party elected an accounting of profits. Justice Fothergill found that "[t]he Court must decide the rate of interest to be applied and whether the interest should be compounded or not. The Court's jurisdiction in equity and s 55(1) of the Patent Act allow it to award compound interest."[25]

He further concluded that GrenCo was entitled to pre-judgment interest for a portion of the loss period, and noted the following case specific reasons which led to his decisions in this matter:

"The evidence indicates that GrenCo tended to pay bonuses and salaries out of its profits. However, there is also some evidence that profits were used to finance research and development (albeit in a limited manner). With additional profits, further research and development projects may have been undertaken. In Eli Lilly, Justice Zinn at para 118 indicated that "the patentee is not required to prove exactly what use it would have made of the profit it has lost as a result of the infringer's actions." In this case, there is sufficient evidence upon which to conclude that profit may have been used for research and development or for other useful business purposes."[26]

20 2018 FC 564, paragraph 193.
21 2018 FC 564, paragraph 194.
22 2018 FC 564, paragraph 195.
23 Janssen Inc. v. Teva Canada Ltd, 2016 FC 593
24 2018 FC 564, paragraph 208.
25 2018 FC 564, paragraph 209.
26 2018 FC 564, paragraph 210.

"As a matter of discretion taking into account the equities and the conduct of the Defendants, this also suggests that compound interest in respect of the period prior to the GrenCo sale is appropriate."[27]

"Therefore, I award compound interest on that basis and simple interest thereafter."[28]

CASE 2: BORRELLI V. CHAN, 2018 ONSC 1429

Case Overview

On March 14, 2018, Justice Penny of the Ontario Superior Court released his decision in this civil case, awarding a US$2.63 billion judgment to the plaintiff for damages suffered as the result of fraud and breach of fiduciary duty in its action against Allen Chan, the co-founder and former CEO of Sino-Forest Corporation. The decision is the largest judgment of its kind in Canadian history.

The Parties in this action were as follows:

The Plaintiff	The Defendant
SFC Litigation Trust (entity holding Sino-Forest's rights of action). Mr. Cosimo Borrelli was appointed Litigation Trustee.	*Mr. Allen Chan* ("Chan"), who was a co-founder of Sino-Forest and was, from 1994 to 2011, its chief executive officer and chairman of the Board.

Sino-Forest Corporation ("Sino-Forest") was a TSE listed public company, with businesses that were reported to include ownership/management of forest plantations, buying/selling of standing timber, and manufacturing of downstream wood products. At its peak Sino-Forest's market capitalization was approximately $6 billion.

From 2003 to 2010, Sino-Forest's reported annual revenues had grown from $266 million to $1.9 billion, its assets had grown from $418 million to $5.7 billion, and the company had raised approximately $3 billion through debt and equity financing in the capital markets.

In 2011, following the publication of a report by short-seller analyst firm Muddy Waters that accused the company of being a Ponzi scheme, Sino-Forest collapsed. Muddy Waters' report alleged that Sino-Forest did not hold the amount of timber assets reported on its financial statements, that they had overstated their revenues, and that Sino-Forest had undisclosed related-party transactions.

Following the release of the Muddy Waters report in June 2011, Sino-Forest's Board appointed an Independent Committee to investigate Muddy Waters' allegations. The Independent Committee released its final report in January 2012, finding that it was that unable to disprove Muddy Waters' principal allegations. As was noted by Penny J. in his decision:

"[The Independent Committee] was unable to establish that Sino-Forest held good title to $2.99 billion of standing timber plantations in mainland China which were recorded as assets in Sino-Forest's audited financial statements. It was unable to establish that Sino-Forest's counterparties in many standing timber and wood log trading transactions were arm's-length, partly because most of these counter parties disappeared or ceased to

27 2018 FC 564, paragraph 211.

28 2018 FC 564, paragraph 212.

exist after publication of the Muddy Waters Report. The Independent Committee uncovered evidence that Mr. Chan and other members of senior management were involved in the management and control of some of these counterparties."[29]

The Ontario Securities Commission (OSC) also commenced its own investigation of Sino-Forest following the release of the Muddy Waters report. In August 2011, the OSC issued an order that cease-traded Sino-Forest's securities and required Chan and other members of the company's management to resign. The OSC's order alleged that Chan and certain other directors and officers of Sino-Forest *"appear to be engaging or participating in acts, practices or a course of conduct related to its securities which it and/or they know or reasonably ought to know perpetuate a fraud."*

In March 2012, Sino-Forest filed for protection under the Companies' Creditors Arrangement Act (CCAA). The CCAA filing led to a plan of arrangement where the company's litigation rights were transferred to the SFC Litigation Trust to pursue for the benefit of Sino-Forest's creditors. In March 2014, the SFC Litigation Trust commenced an action against Chan in the Ontario Superior Court, claiming damages for fraud, breach of fiduciary duty and negligence.

Findings on Liability, Foreseeability and Causation

On the issue of liability, the Court found that Chan's actions constituted fraud and that he had breached his fiduciary duties to the corporation.[30] Penny J. found little credibility in the evidence from Chan and his fact witnesses. Their evidence was characterizing as being contrived, often evasive, and ever-changing (when confronted with inconsistencies):

> *"Their explanations were frequently implausible on their face, lacking any ring of truth, and/or unsupported by any contemporaneous documentary evidence. Mr. Chan's evidence, in particular, was frequently impeached by prior inconsistent testimony given under oath on discovery or in affidavits sworn in earlier proceedings in this case."*[31]

Central to the case were the Plaintiff's allegations that Chan had secretly controlled many of Sino-Forest's counterparties through a complex network of *"nominees"* that held positions as directors, officers, and shareholders on his behalf, and that Chan had defrauded Sino-Forest by causing it to fund deposits and advance payments to these secretly controlled entities.

Penny J. concluded that these allegations were true and that Sino-Forest's principal business model (termed the *"BVI model"*), which involved the purchase and sale of standing timber in China, was a fraud:

> *"The evidence, taken as a whole, overwhelming supports the conclusion that Mr. Chan established a complex network of relationships with third parties … in which they acted as his nominees, holding positions as directors and officers and shareholders in corporations beneficially owned or controlled by Mr. Chan."*[32]

> *"A critical component of the BVI model and Sino-Forest's wood log trading was that the transactions were at market value and represented the acquisition of valuable assets (in the form of standing timber and wood logs). This depended absolutely on the counterparties being bona fide arms' length entities. The conclusion that many of Sino-Forest counterparties were not bona fide arms' length entities, but were secretly controlled by Mr. Chan or other members of Inside Management working under Mr. Chan's direction, guts the*

29 Source: 2018 ONSC 1429, paragraph 3.

30 Source: 2018 ONSC 1429, paragraphs 911 to 925.

31 Source: 2018 ONSC 1429, paragraph 188.

32 Source: 2018 ONSC 1429, paragraph 342.

whole BVI model, as well as the wood log trading model, of any semblance of validity."[33]

On issues of foreseeability and causation of damages, the Court found Chan liable for all damages caused by his fraud and breach of fiduciary duty **[with emphasis added]**:

> *"In the tort of deceit (fraud)* ***the compensable results of the tort are not limited to results that are of the type that should have been reasonably foreseeable*** *by a person in the position of the defendant at the time the defendant committed the tort … Under this principle Mr. Chan is liable to pay damages for all losses caused by his fraudulent conduct, even if such losses were unforeseeable. The general principle in assessing damages in tort is the amount required to restore the plaintiff to the position the plaintiff would have been in if the tort had not occurred."*[34]

> *"As long as the* ***defendant is part of the cause of an injury, the defendant is liable for all loss suffered by the plaintiff even if the defendant's act alone was not enough to create the injury.*** *All that is required to establish "but for" causation is that the defendant caused or contributed to the plaintiff's injury … In this case, Sino-Forest's collapse was …* ***caused by the inability of the company to demonstrate that it owned BVI standing timber assets worth $2.9 billion*** *and … [had operations that were] bona fide, conducted with arm's-length counterparties at fair market value."*[35]

Turning to the quantum of damages, the Court considered a central complicating factor in this case to be that Sino-Forest's timber model was essentially cashless - i.e., little/no money came into or went out of Sino-Forest in connection with timber trading operations. When Sino-Forest bought a plantation from a "Supplier", it sold another plantation to an "Authorized Intermediary". Rather than paying Suppliers or receiving payments from Authorized Intermediaries, Sino-Forest directed its Authorized Intermediaries to pay its Suppliers. As a result, Sino-Forest's standing timber assets grew, but it ultimately received no actual cash flow from these transactions. As Penny J. noted:

> *"At one level, therefore, one could argue that, upon the collapse of the BVI standing timber model, Sino-Forest suffered no loss. It paid nothing for the asset so if the asset turned out not to exist, or to have no value, Sino-Forest suffered no damage."*[36]

> *"This approach would ignore, however, the effect of having carried the BVI standing timber assets on the books of the company – an asset which, by 2011, was valued at $2.99 billion."*[37]

> *"From a financial perspective, the largest impact of representing this value of Sino-Forest's principal asset in its audited financial statements was that it enabled Sino-Forest to go to the capital markets and raise money."*[38]

The parties' respective damages experts did not dispute that Sino-Forest had used its purported assets and profits to raise funds from capital markets. Rather, they differed in terms of their respective approaches to considering and quantifying damages in the case.

Plaintiff's Damages Expert

The Plaintiff's damages expert sought to quantify damages, not as a function of specific losses resulting from specific fraudulent activities or the tracing of funds into Chan's hands, but rather by considering the difference

33 Source: 2018 ONSC 1429, paragraph 344.

34 Source: 2018 ONSC 1429, paragraphs 928 and 929.

35 Source: 2018 ONSC 1429, paragraphs 936 and 937.

36 Source: 2018 ONSC 1429, paragraph 946.

37 Source: 2018 ONSC 1429, paragraph 947.

38 Source: 2018 ONSC 1429, paragraph 948.

between the purported values of Sino-Forest's assets (and the funds it had raised using those purported values) and their ultimate value achieved via recovery efforts following the various investigations and CCAA proceedings.

The Plaintiff's damages expert performed two alternative loss calculations:[39]

a. "Lost Cash Calculation" - reflecting losses suffered due to Defendant's malfeasance, calculated as the difference between:

   i. Total cash Sino-Forest raised from debt and equity issues (during the period from 2004 to 2010) that would have been available to invest in profit generating assets but for the Defendant's actions; less

   ii. The actual cash recoveries from the sale of Sino-Forest's assets.

b. "Write-down Calculation" - reflecting write-downs suffered due to false and inflated asset values perpetrated by Defendant's actions, calculated as the difference between:

   i. The reported value of Sino-Forest's assets of as of June 30, 2011; less

   ii. The net realized value of those assets following Defendant's departure.

Under the Lost Cash Calculation:[40]

a. The Plaintiff's damages expert calculated the amount of Sino-Forest's net proceeds raised in debt and equity markets from 2004 to 2010 to be $2.588 billion;

b. It was assumed that these debt and equity funds would have been deployed in a profit-making investment of some kind, at a rate at least sufficient to cover the cost of Sino-Forest's debt and its debt/equity issuing costs. The Plaintiff's damages expert estimated this "proxy" return to be an additional $477.8 million. Thus, the total cash assumed to be available to Sino-Forest but for the Defendant's fraudulent activity was calculated to be $3.065 billion;

c. The total amount recovered from disposition of Sino-Forest's assets was $438.5 million;

d. Based on this analysis, the Plaintiff's damages expert calculated Sino-Forest's loss at $2.627 billion, being the difference between total cash available of $3.065 billion less ultimate recoveries of $438.5 million.

As part of the analysis supporting the Write-down Calculation, the Plaintiff's expert showed that Sino-Forest's cash flows and accounting income were predominately on account of (i) the cash raised from the debt and equity markets, and (ii) paper gains on standing timber assets that were converted into ever increasing timber asset values.[41] Under this alternative loss approach, the Plaintiff's expert calculated the total write-downs suffered by Sino-Forest (on what he assumed, for purposes of his analysis, were false or inflated values of standing timber assets, receivables and wood log deposits) as follows:[42]

a. Sino-Forest's reported assets on June 30, 2011 were $3.8 billion, which included $2.8 billion of standing timber, $0.4 billion of receivables and $0.1 billion of log deposits;

b. The value of the company's assets transferred after the CCAA proceeding and upon its reorganization on January 30, 2013 was $565 million;

c. This reduction of $3.2 billion reflected write-downs to estimated net realizable values of Sino-Forest's assets.

39 The Plaintiff's damages expert recommended adopting the "Lost Cash Calculation" – a loss of $2.627 billion, rather than the loss under the "Write-down Calculation" of $3.244 billion.

40 Source: 2018 ONSC 1429, paragraphs 955 to 958.

41 Source: 2018 ONSC 1429, paragraph 961.

42 Source: 2018 ONSC 1429, paragraphs 959 to 965.

These write-downs pertained chiefly to the company's standing timber assets and reflected a conclusion that Sino-Forest did not own and could never realize economic value from these assets;

d. Based on this analysis, the Plaintiff's damages expert calculated Sino-Forest's loss at $3.244 billion.

Defendant's Damages Expert

The Defendant's damages expert prepared a report critiquing the analysis of the Plaintiff's damages expert, but not a separate loss quantification report opining on Sino-Forest's losses.

The Defendant's damages expert's primary criticism of the Plaintiff's damages expert was the latter's implicit assumption that all of the cash Sino-Forest raised in the capital markets from 2004 to 2010 was lost due to Chan's actions. The Defendant's damages expert said that this approach was too simplistic in the circumstances since, he argued, Sino-Forest operated legitimate businesses.[43]

In the Defendant's damages expert's critique, he argued that the Plaintiff's damages expert made five errors in his analysis. Specifically, he argued that the Plaintiff's damages expert:[44]

a. Used an inappropriate damages methodology given the facts and circumstances in this matter, thereby overstating damages (i.e., assumed Sino-Forest's operations were equivalent to a Ponzi scheme, measured damages as net cash losses realized by company's investors, and assumed Chan was solely liable for those losses);

b. Failed to investigate and quantify the damages contended to have been suffered by Sino-Forest that, "but for" the alleged actions of Chan, would not have been incurred;

c. Failed to identify specific frauds allegedly committed by Chan and to trace funds paid to Chan's benefit;

d. Calculated damages that duplicate those claimed by the group of debt and equity holder plaintiffs in a separate class action; and,

e. Unreasonably relied on the Plaintiff (Litigation Trustee Borrelli) for all of the significant aspects of alleged wrongdoing by Chan, and did not evaluate whether Borrelli had chosen to ignore contrary facts helpful to Chan.

Court's Findings on Damages Issues

The Court dismissed each of the Defendant's expert's criticisms and found in favour of the Plaintiff's damages expert on the quantum of loss. Penny J. concluded that most of the Defendant's damages expert's criticisms were unfounded and had:

a. Proceeded from a misconception of what the Plaintiff's damages expert was asked to do;

b. Proffered his own view that the Plaintiff's damages expert had not sufficiently considered certain evidence supporting the Defendant, which *"... exceeds the viable scope of the expert's role on damage quantification by getting into disputed facts going to liability"*[45]; and,

c. Been founded on legal argument, which again, is not an issue for expert opinion.

Penny J. addressed how the damages experts dealt with liability issues in their respective analyses, serving as a point of caution for experts to avoid overstepping into questions of legal issues in their work:

> *"[Plaintiff's damages expert] candidly admitted in his written and oral evidence that liability was assumed in his analysis. If liability were not proved, he said, his analysis of damages would have no application. [Defendant's damages expert]'s criticism on this point is, in my view, attacking [Plaintiff's*

43 Source: 2018 ONSC 1429, paragraph 968.

44 Source: 2018 ONSC 1429, paragraph 969.

45 Source: 2018 ONSC 1429, paragraph 975.

damages expert] for something he was not asked to do. It also assumes Mr. Chan's evidence and arguments on liability; this goes beyond the competence of a damages expert to address. In wading into this issue, [Defendant's damages expert] has, in my opinion, trespassed into questions of disputed fact on the issue of liability which are beyond the scope of a damages enquiry."[46]

"I have found that the essential factual underpinnings of [Plaintiff's damages expert's] opinion have been established on the evidence. I have found that most of the factual assertions pointed out by [Defendant's damages expert] have not been established."[47]

Penny J. also commented on the arguments proposed by Chan and his damages expert regarding who bears the burden of proof in respect of such evidence, and the possibility that other external factors contributed to Sino-Forest's losses:

"[Defendant's damages expert] also argues that [Plaintiff's damages expert] failed to eliminate the possibility of other market forces or industry factors that might have contributed to Sino-Forest's loss. To the extent this argument seeks to encompass the problem of fire-sale prices in a bankruptcy, it is again a question of causation, foreseeability and, ultimately, law. Who bears the risk of lower than market values in a bankruptcy scenario is not for the damages expert to decide. In the circumstances of this case, I find it is Mr. Chan who bears that risk. He knew, or must be deemed to have known, that the discovery of his conduct would send Sino-Forest into a tailspin."[48]

"To the extent [Defendant's damages expert's] argument contemplates completely external forces affecting market values in the forestry industry generally (such as typhoons or insect infestations), there is simply no evidence there were any external forces of this nature affecting value. It is not the plaintiff's obligation to exclude every possible contributor to a decline in value. The plaintiff has made his theory clear – the collapse of Sino-Forest was the result of Mr. Chan's fraud. The plaintiff has established there was a fraud and that over $2.7 billion in assets did not exist. It was for the defendant to show that there were other factors contributing to the loss. Mr. Chan failed to lead any evidence that any external factors contributed to Sino-Forest's losses."[49]

The Court's decision is also a valuable reminder for experts to recognize the inherent risks of adopting a critique-only approach without advancing alternative analysis:

"In my opinion, the defendant has improperly equated the need to prove a causal link between the loss and the defendant's conduct with the alleged need to prove damages on a "transaction by transaction" basis. [Defendant's damages expert] says it should be done this way but offers no basis for this; it is merely advanced as his opinion on how a proper loss calculation should be done. Counsel for the defendant have similarly offered no legal authority for this proposition. Importantly, [Defendant's damages expert] did not perform, try to perform, or even hint at the methodology one would use to perform the so-called "transaction by transaction" analysis, the absence of which he says so fatally flawed [Plaintiff's damages expert]'s approach." [50]

"It is clear that some transaction by transaction analysis has been done, for example with respect to the Greenheart and wood log trading frauds. But, as noted earlier, the BVI standing timber model was a cashless model. Even if the BVI standing timber assets were misrepresented and have no value, they were not bought

46 Source: 2018 ONSC 1429, paragraph 983.

47 Source: 2018 ONSC 1429, paragraph 985.

48 Source: 2018 ONSC 1429, paragraph 1012.

49 Source: 2018 ONSC 1429, paragraph 1013.

50 Source: 2018 ONSC 1429, paragraph 1017.

with cash. No amount of "transaction by transaction" analysis will produce any loss. Does this mean that the BVI standing timber fraud caused no loss to Sino-Forest? I do not think so."[51]

CASE 3: APOTEX V. NORDION, 2017 ONSC 1323

Case Overview

On December 22, 2017, Justice Pattillo, of the Ontario Superior Court, issued his decision in this case awarding Apotex $11.3 million plus pre-judgment interest for losses stemming from delays (in the regulatory approval of certain of Apotex's pharmaceutical products) that were caused by the defendant's contractual breaches and negligence.

The Parties in this action were as follows:

The Plaintiff	The Defendant
Apotex Inc. ("Apotex"), is a pharmaceutical manufacturer based in Ontario that supplies generic drug products. Apotex is the main operating company within the Apotex corporate group, which also includes Apotex Research Inc. ("Apotex Research").	*MDS Pharma Services Inc.* ("MDS"), who changed its name to Nordion Inc. in November 2010, is a life sciences company headquartered in Ontario providing products and support services for drug development, including clinical research and bioequivalence studies.

In 1999, Apotex Research and MDS entered into a Master Laboratory Services Agreement (MLSA) that governed their general relationship in respect of research studies. Subsequently, in the spring of 2003 and mid-2004, they entered into three additional separate agreements for MDS to carry out clinical bioequivalent studies to support Apotex's submission to the United States Federal Drug Administration ("FDA") for approval to sell two generic drugs in the United States. These two drugs were *amoxicillin-clavulanic acid* ("Amoxi-Clav") and *levodopa-carbidopa immediate release* ("Levo-Carb IR").

Apotex submitted its applications for Amoxi-Clav and Levo-Carb IR to the FDA for approval in April 2004 and May 2005, respectively. Apotex's drug submissions were supported by the three bioequivalence studies carried out by MDS.

In January 2007, following protracted dealings between the FDA and MDS concerning MDS' compliance with FDA regulations, the FDA refused to accept studies done by MDS at its facility between 2000 and 2004, including the three studies done for Apotex Research.

As a result, Apotex was unable to rely on the MDS studies and was required to repeat the studies and/or have them certified by an independent facility, which delayed them in bringing the two drugs to the U.S. market.

Apotex claimed that, as a result of the issues with the FDA, MDS was in breach of its contracts and/or negligent and sought damages that Apotex alleged it had suffered as a result.

Findings on Liability

Pattillo J. found that as a result of MDS' compliance issues with the FDA, MDS had breached the terms of the MLSA requiring MDS to comply with the applicable regulatory requirements and industry standards and practices in conducting projects for Apotex:

51 Source: 2018 ONSC 1429, paragraph 1019.

"I am satisfied from the evidence that, as a result of its issues with the FDA, MDS breached s. 8.1 of the MLSA in respect of each of the three Project Agreements. The evidence … was that MDS failed to comply with U.S. regulatory requirements as determined by the FDA at the Montreal Facility; that the lack of compliance was serious in nature; and MDS ought to have foreseen that its lack of compliance had the potential to cause damage to its customers including Apotex. Further, MDS failed to comply with U.S. industry standards and good practices in the manner in which it handled the FDA's concerns during the period."[52]

The Court also granted Apotex's claim of negligence and found that the damages suffered by Apotex were a reasonably foreseeable consequence:

"Given the sufficiently close relationship that existed between MDS and Apotex in respect of the Studies, I have no trouble concluding that MDS owed Apotex a duty of care in respect of them."[53]

"Further, by not complying with the FDA regulations which resulted in the FDA not accepting the Studies, I find that MDS breached its duty of care to Apotex which has resulted in Apotex suffering damages which were a reasonably foreseeable consequence of the breach."[54]

"In my view, therefore, Apotex has established a concurrent claim in negligence against MDS."[55]

Assessment of Apotex's Damages

Regarding the damages suffered by Apotex arising from MDS' contract breach/negligence, the Court concluded that these damages had two components:

a. The actual costs Apotex incurred as a result of having to repeat or certify the MDS studies; and,

b. Apotex's lost profits resulting from the delay it encountered in selling the two drugs in the U.S. market.[56]

In respect of the first damages component, Apotex's claim for reimbursement of costs was not significantly contested at trial, though MDS submitted that it was not liable for certain costs related to studies that were ultimately never used to obtain FDA approval.

In his decision, Pattillo J. awarded Apotex the full amount of its claimed reimbursement costs totaling approximately $3 million:

"… I consider Apotex's actions in pursuing both the repeat Amoxi-Clav studies and later certification to have been reasonable and a direct result of MDS' breaches. MDS is also responsible for the costs of the second repeat fed study. It was a risk of the study and a reasonable step for Apotex to take at the time. MDS is therefore liable for the costs incurred by Apotex for both the repeat studies by Anapharm and the certification by AccuReg in the total amount of $2,963,930.31."[57]

With respect to Apotex's lost profits claim, both experts addressed the relevant delay periods for the two drugs (i.e., the periods during which Apotex would have otherwise sold the two drugs in the U.S. market "but for" MDS'

52 Source: 2017 ONSC 1323, paragraph 160

53 Source: 2017 ONSC 1323, paragraph 181.

54 Source: 2017 ONSC 1323, paragraph 182.

55 Source: 2017 ONSC 1323, paragraph 183.

56 Source: 2017 ONSC 1323, paragraph 244.

57 Source: 2017 ONSC 1323, paragraph 252.

breach).[58] In addition, there was general consensus on the size of the U.S. market for the two drugs and the general approach used to calculate Apotex's lost net revenues.

Conversely, the damages experts disagreed significantly in their respective estimates of Apotex's "but for" market

share for the two drugs in the U.S. generic market, which was a key damages issue in the case, and also on the allowances that Apotex would have paid on its sales of these drugs.

In the balance of this section, we focus on the differences between the parties' damages experts in estimating Apotex's but for market share for the two drugs in the U.S. market by setting out the basis of each expert's method and the Court's view of their respective approaches.

In addition to a damages expert, MDS also retained a marketing expert with 40 years' experience in the drug industry (Mr. Harry Boghigian) to provide evidence at trial on issues of market share and the marketing of generic drugs in the U.S. The Court qualified Boghigian as an expert in pharmaceutical marketing, sales and business development including both branded pharmaceuticals and generic drugs in the U.S. market.

Apotex's Damages Expert – Estimated Market Share

Apotex's damages expert estimated Apotex's but for market share using what he referred to as a *"guideline molecule analysis"*, which was based on the observed penetration rates for other Apotex drugs in the U.S. generic market during the relevant time period.

Apotex provided its damages expert with information on 110 different drug products ("molecules"), which the expert then narrowed down to 25 "guideline" comparator molecules by excluding the following:

a. Molecules where Apotex was a participant in the market prior to 2005;

b. Molecules where the generic market was less than 65% of total market; and,

c. Molecules where there was incomplete or inconsistent data.

Apotex's damages expert then separated the 25 guideline molecules into two separate categories, as follows:

a. Molecules where Apotex was entering a market with only one large pre-existing generic manufacturer (i.e., similar to conditions for the Amoxi-Clav 125mg and 250mg dosage strengths); and,

b. Molecules where Apotex was entering a market with multiple large generic manufacturers, which was applicable to the other products and dosages.[59]

Apotex's damages expert then calculated the average and median market shares of the guideline molecules and, based on those calculations, exercised his professional judgment to create what he termed a *"smoothed ramp-up"* of the estimated but for market share over the Delay Periods for the two drugs.[60]

The expert estimated the but for market share for Amoxi-Clav and Levo-Carb IR during the Delay Periods to be as follows:

58 Pattillo J. determined the delay periods in U.S. market entry were 15 months for Levo-Carb IR and 24 months for Amoxi-Clav. Apotex had claimed the delay periods for these products were 26 and 30 months, respectively (Source: 2017 ONSC 1323, paragraphs 255, 256, 262 and 271).

59 Source: 2017 ONSC 1323, paragraph 289.

60 Source: 2017 ONSC 1323, paragraph 289.

(A) Amoxi-Clav 250/125 mg

Quarter	1	2	3	4	5	6	7	8	9	10	11
Smoothed Ramp-Up	2.5%	9.5%	19.5%	25%	25%	30%	35%	35%	35%	35%	35%

(B) All other Product Strenghts

Quarter	1	2	3	4	5	6	7	8	9	10	11
Smoothed Ramp-Up	1%	3.5%	5%	6%	7%	7%	7%	7%	8.8%	10%	10%

Based on these estimates of Apotex's but for market share, as well as other factors affecting Apotex's lost profits including the estimated sales allowances and Apotex's claimed delay periods, Apotex's damages expert estimated Apotex's total lost profits arising from the delay for the two drugs to be US$27 million.

MDS' Damages Expert – Estimated Market Share

In contrast to the method applied by Apotex's damages expert, MDS' damages expert estimated Apotex's market share for the two drugs by looking at the actual market share achieved by Apotex during the period it sold the two drugs in the U.S., and then applying a weighted average to impute Apotex's market share over the delay periods for the drugs.[61]

Based on this approach, MDS' damages expert estimated the but for market share to be constant throughout the entire delay period, as follows:

a. Amoxi-Clav: 7.99% (250/125 mg); 5.90% (500/125 mg); and 4.36% (875/125 mg); and,

b. Levo-Carb IR: 0.82% (10/100 mg); 3.93% (25/100 mg); and 1.87% (25/100 mg)

Using these estimates of its but for market share, alongside other factors that differed from Apotex's damages expert (including estimated sales allowances and assumed delay periods), MDS' damages expert estimated Apotex's total lost profits arising from the delay for the two drugs to be CAD$10.6 million.

Court's Findings on Damages Issues

In his decision, Pattillo J. preferred the 'actual results' method applied by MDS' damages expert in estimating Apotex's but for market shares over the 'guideline molecule analysis' method used by Apotex's damages expert, stating **(emphasis added)**:

> *"I recognize that estimating market share is a difficult task. As Mr. Boghigian points out, it is dependent on a number of factors including the size of the market overall; the number of generic manufactures in the market at the time of entry; the length of time they have been in the market; and, importantly price."*[62]
>
> *"While neither is free from criticism, I prefer [MDS' damages expert's] opinion as to market share to that of [Apotex's damages expert].* ***By using the actual market share that Apotex achieved during the periods it***

61 Source: 2017 ONSC 1323, paragraph 291.

62 Source: 2017 ONSC 1323, paragraph 293.

sold Levo-Carb IR and Amoxi-Clav in the U.S., it is based on actual results."[63]

Pattillo J. noted that the marketing expert's analysis had identified various issues regarding the guideline molecule analysis adopted by Apotex's damages expert, including that it did not sufficiently consider relevant market factors and the specific indicators or characteristics of the "guideline" molecules versus the two molecules in question:

> *"Mr. Boghigian, whose evidence I accept, testified that in his opinion, [Apotex's damages expert's] 25 molecule guideline approach was an unreliable method for calculating market share in that it failed to consider a number of factors including market dynamica and order of entry; drug class and dosage forms; individual drug dosage strengths; and price."*[64]

> *"As Mr. Boghigian points out, the 25 molecule guideline also does not compare apples to apples. Amoxi-Clav is an antibiotic, used … for short periods. Levo-Carb … is used in the treatment of Parkinson's which involves long term, repeat usage. The molecules (except for one) in the 25 molecule guideline were not in the same class and therefore not comparable. Nor did [Apotex's damages expert] do any analysis of the price at which the molecules were being offered at or any incentives that were offered which are important considerations for obtaining market share on late entry. All of that information could have been obtained from Apotex."*[65]

Pattillo J. also addressed certain areas of the evidence where he thought Apotex's damages expert's had strayed outside his expertise, and the question of market share estimates derived from a "smooth ramp-up" compared to a "weighted average":

> *"[Apotex's damages expert] said that he did not use Apotex's actual market share for Amoxi-Clav or Levo-Carb because, in his opinion the time periods were too short to develop meaningful penetration rates. But [Apotex's damages expert] is not an expert in market penetration. Mr. Boghigian on the other hand, testified that the use of actual market share in this case could be justified and was reasonable."*[66]

> *"Apotex submits that [MDS's damages expert's] weighted average does not take into account the "smooth ramp-up". In effect, however, I consider that it does. A weighted average is an average computed from a series of items where each item has first been multiplied by a factor indicative of its importance to the total value of the series. A weighted average therefore takes into account the initial lower market share as well as the subsequent increases."*[67]

The Court also expressed its general concern with the lack of information that was provided by the plaintiff Apotex during the case with respect to its market share data, and how this impacted the Court's view of the respective estimates provided by the damages experts:

> *"The one issue that troubled me during the trial and continues to trouble me is the failure of Apotex to produce during discovery any documentation concerning its estimates of market share for the two products. Apotex is a large, highly sophisticated and very experienced generic drug manufacturer … one would have thought, given the expense involved in obtaining FDA approvals, that before deciding to proceed with both Amoxi-Clav and Levo-Carb IR, it would have conducted a thorough analysis of the markets and costs."*[68]

63 Source: 2017 ONSC 1323, paragraph 294.

64 Source: 2017 ONSC 1323, paragraph 295.

65 Source: 2017 ONSC 1323, paragraph 297.

66 Source: 2017 ONSC 1323, paragraph 298.

67 Source: 2017 ONSC 1323, paragraph 306.

68 Source: 2017 ONSC 1323, paragraph 300.

"Yet it was only on the eve of trial that it produced a few documents from Apotex Corp. relating to Amoxi-Clav market share. Then again, at trial, it produced a few more … MDS didn't object to the documents being admitted because they wanted to rely on them."[69]

"Apotex's failure, in my view, to be open and transparent as to what it estimated the market to be for both Levo-Carb and Amoxi-Clav at the time it decided to enter the market for each of those products is another reason why I have a concern about [Apotex's damages expert's] estimate of market. I am not satisfied it is an accurate estimate. I consider it to be high, especially given the actual results Apotex achieved."[70]

"As MDS points out, what Apotex's few marketing documents indicate is that what happened in the real world is what Apotex initially forecasted would happen. [MDS' damages expert's] 4.74% market share for Amoxi-Clav is consistent with its initial 5% forecast. Further, Apotex Corp.'s own 2009 forecast for Amoxi-Clav, a seasonally adjusted forecast, shows no increase in market share over the first 12 months."[71]

69 Source: 2017 ONSC 1323, paragraph 301.

70 Source: 2017 ONSC 1323, paragraph 304.

71 Source: 2017 ONSC 1323, paragraph 305.

05

THE CANADIAN ECONOMIC & FINANCIAL OUTLOOK: GETTING TO THE NEW NORMAL

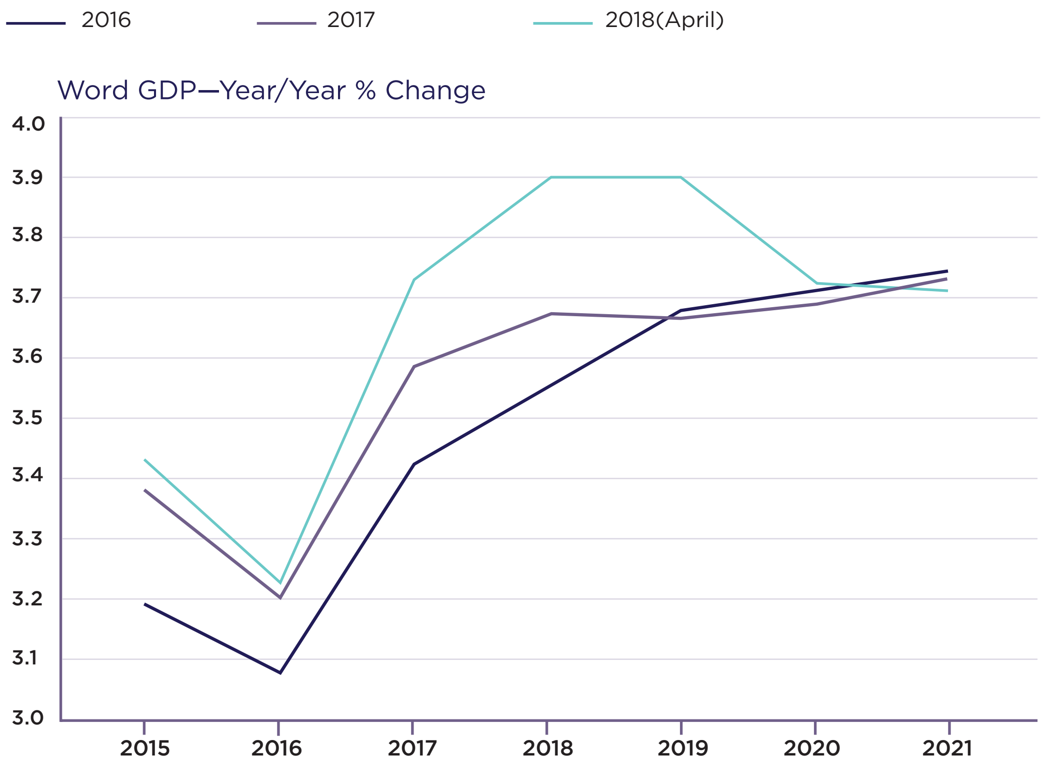
THE CANADIAN ECONOMIC & FINANCIAL OUTLOOK: GETTING TO THE NEW NORMAL

Brian De Pratto

This is a transcription of a presentation delivered at CBV Institute's 2018 National Business Valuation Congress

Globally, economic growth is beginning to be visibly synchronized. The United States is currently strong; while Canada, as always, moves steady yet strong. There have been emerging trends, however, in Canada and globally, which should be noted. With global protectionism emerging, the uncertainty in the U.S.A, and high Canadian household debts, there is currently great economic risk overall. In starting with the global backdrop, the theme has been sequential growth. The International Monetary Fund (IMF), since 2016 (see figure 1), has continuously forecasted reasonable outgrowth. Canada keeps receiving stronger and stronger forecasts, with more potential growth, and with projections seeming to synchronize globally.

FIGURE 1



Source: IMF World Economic outlook, TD Economics

For an economy, growth involves labour and the productivity of said labour. Essentially, if you put together labour and productivity you can track a countries longer-term performance. Using this benchmark, we can see that 2017 was a strong year - well above what economic fundamentals would suggest. This has not just been the case for Canada. According to National Statistic Agencies Europe, Japan and the US have also had robust performances to close 2017, and (with the exception of Japan), a strong start to 2018.

In regards to Europe specifically, the European Central Bank has decided to end its Quantitative Easing policy at the end of 2018. Europe no longer needs to increase liquidity because its economy is able to sustain its capital demands, so they can again normalize interest rates (i.e. the emergency asset purchases by central banks are no longer needed). After a bit of struggle for the EU, this is a big change. The US however, from a Canadian perspective, is a more interesting and compelling story - since 75% of exports head there.

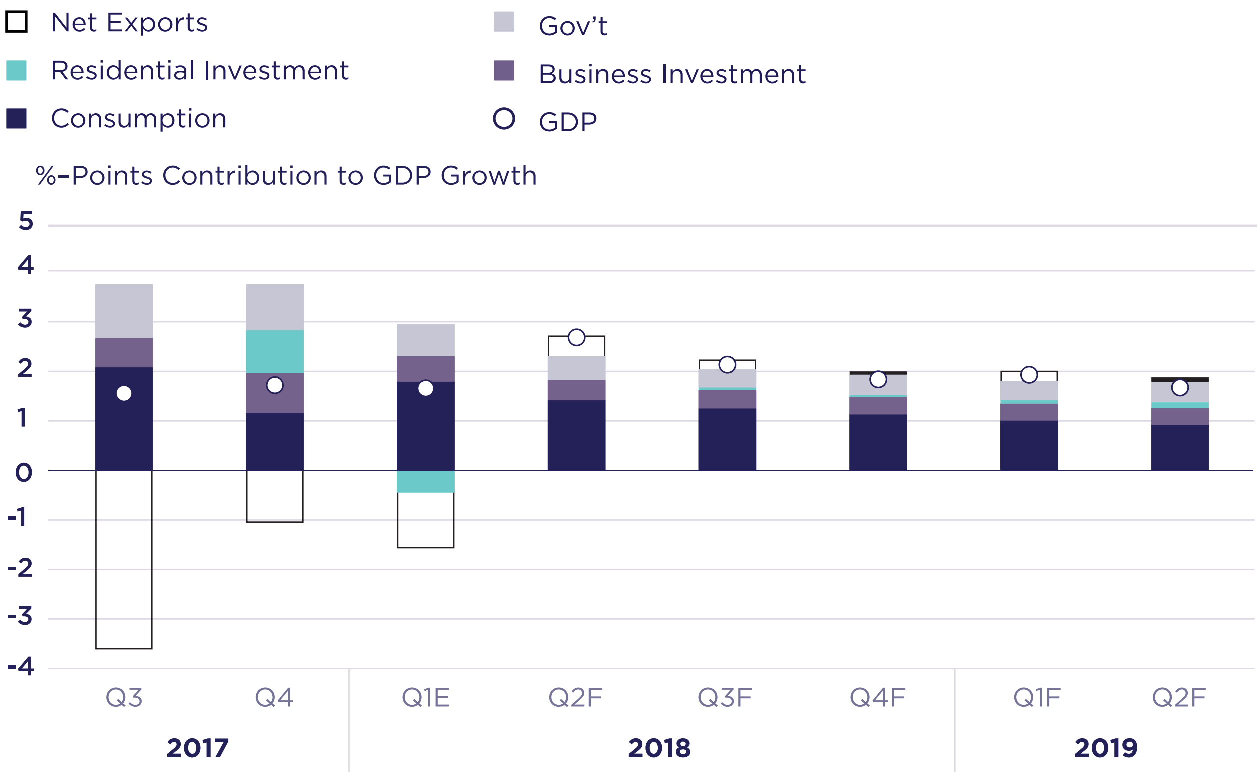
The US economy grew steadily in the fourth quarter of last year, and into the beginning of 2018, but as of today, growth seems to have plateaued. Growth in the U.S. has been significantly boosted in the near term by government policy, to the tune of about half a percentage point. To those outside the financial industry a half-point increase seems nominal, but for economists its rather unusual. For a 10+ trillion-dollar economy, a half point is about 50 billion dollars in extra output, with much of this growth being attributed to the Presidents tax cuts and stimulus package. The forecast has since shifted to even stronger growth, with an even larger deficit; this shift is unusual because a large deficit near full employment lacks precedent. Normally, in a recessionary type scenario, when unemployment rates start rising, a government starts spending more to (hopefully) balance the economic fortunes of the country. As things get worse a government is expected to plug the necessary leaks - to weather the storm. It can be beneficial in a recession: cutting rates and boring costs helps a business manage the dip in growth - whereas raising costs during these times puts an unnecessary strain on businesses. Governments worldwide, since the 1970's, have been following this logic. Now, America has arrived at a place where the country has followed said logic, found itself in a position of growth, but, unlike past recessionary cycles, the US is positioned with large deficits; while large deficits near full employment lacks precedent, it also has proven to drive near-term growth.

The US has a solid growth forecast for this and next year's GDP - almost reaching 3.0% - however, as 2020 approaches, there is a potential fiscal cliff - which may be the result of short-term policies harming long-term forecasts, along with all the usual variables which the future entails. For example, at lot of government spending is set to expire around 2020. Additionally, American politics will be playing musical chairs again in 2020 - which builds risk. In the near term the U.S will be economically solid and continue to grow. With economic growth brings a reaction to interest rates, and in the past year, with all this stimulus, the US has raised its interest by a half-point or so. This increase has made things challenging for Canada, because the US increases drag borrowing costs here higher as well.

Turning to Canada, the outlook is best described as an economy threading the needle to normality. The Canadian economy has been solid but with a few disappointing areas; the challenges are apparent but the outlook is better than the media conveys. As outlined in Figure 2, net exports have been dragging since the end of 2017, and, with B20 mortgage rules putting a stress test on potential borrowers in Ontario and BC, residential investment has expectedly slowed. Otherwise, as figure 2 shows, business investments have been consistent - around 1% of GDP growth. In terms of business investment, Canada has seen a positive story, especially machinery and equipment. To some extent, these returns explain the softer trader numbers in 2018 because most of the capital goods that go into business investment are imports. While imports may often be considered a loss, this is a shortsighted view; if an import contributes to the long-term economic benefit of Canada than it is also a gain. Either way, economists do not expect the 3% growth of 2017 to persist; economists expect a very solid, and normal, 2% growth in Canada's GDP.

While, if compared to 2017, Canadian growth has seemed to slow down, and proved to be more volatile than expected, Canada has still seen strong economic growth in most major sectors. According to Statistics Canada, other than residential construction (which is projected to experience negative growth in 2018-2019), all other major industries are still expecting positive growth into the future. Industries like Transportation & Warehousing are expected to stay strong because of changing consumer needs and demands; the market now necessitates retailers to participate online now that Amazon style business models are flourishing. Outside major cities, Canadians are seeing less housing developments and seeing more warehouses and more logistics operations. These changes, under the influence of Amazon, evidence a transition in Canadian shopping patterns as well as a transition for the Canadian economy

FIGURE 2



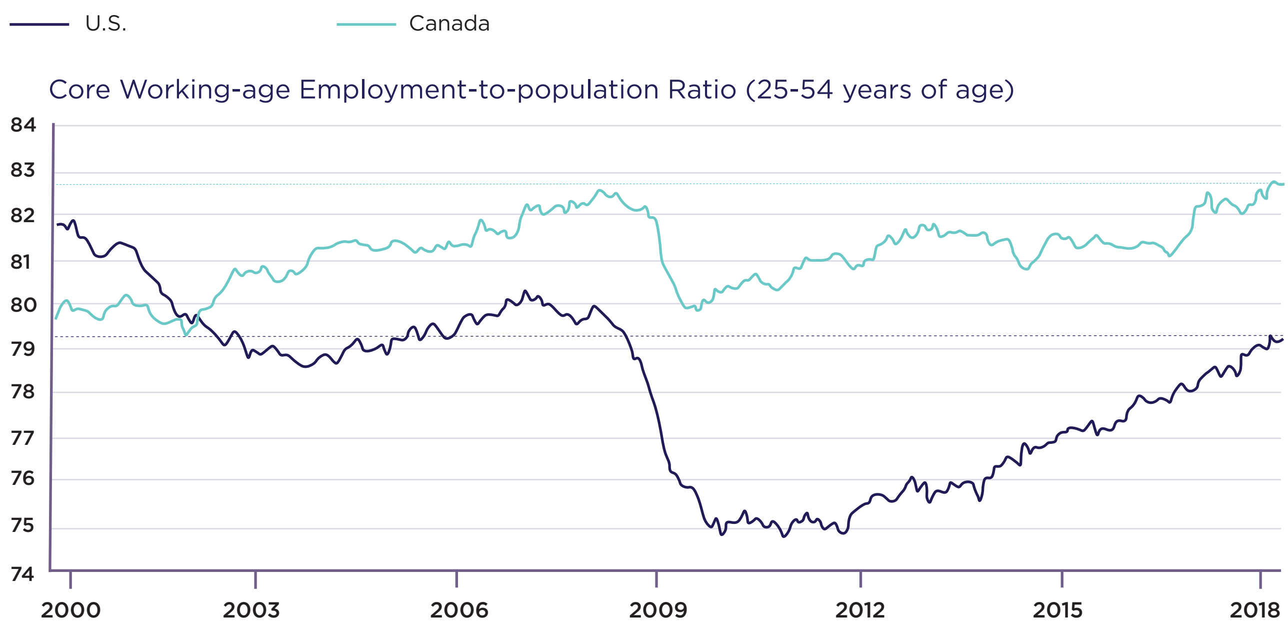
Source: TD Economics

Currently, growth has leveled off, with the rest of the economy remaining stable, in part, because of declining residential investment. Growth is also is projected to be moderate because the Canadian economy is currently running at full capacity. According to the Bank of Canada, unemployed resources are at a modern low; the output gap is minimal and there is little to no economic slack. Of course, there are some regional exceptions, like Alberta, who are feeling the aftermath of 2015-16's oil price adjustments. Nationally, however, most of what happened in the most recent recession has subsided - leading to the nation’s output catching up, and the economy running at cruising speed. Overall growth proves to be a nuanced and complex concept to forecast. As always, when particular area's boom others will subside, and, as always, Canada is at the whims of the global climate - but especially the climate in the USA. This article will continue to explore the Canadian economy's projected outlooks through a variety of economic measures, elucidating the good, the bad, and the bottom line for the Canadian forecast.

The Good Part 1: Employment

Nationwide, unemployment rates are at historic lows. Again, there are exceptions (oil prices issues are still hurting Alberta as well as Newfoundland and Labrador), but employment is generally healthy - with unemployment rates being at a national 40 year low. If comparing the Canadian unemployment rate (of 5.8%) to the US unemployment rate (of 3.9%), one could worry and assume the US labour market to be discernably healthier than Canada, however, this discrepancy has less to do with general economic health and more to do how certain statistics are measured by certain entities. According to the working age employment-to-population ratio (see figure 3), a measure which captures the core working population only, Canada, since 2009 especially, has had a greater percentage of its workforce employed than the US. This ratio is a better measure of employment because general unemployment rates are easily skewed. When a person is called up by their government’s statistics bureau, and asked about their current work situation, they respond with an assortment of answers which will place a person as either employed or unemployed (responses like: I work part-time, I work full-time, I have been searching for six months, I was recently laid off, I am retired, I recently graduated school, and so on). Certain responses can, however, leave room for interpretation; meaning, for example, a retired person can be considered unemployed or out of the workforce - depending on how a government interpret that person's current state. These interpretations can skew the actual economic forecast, like in the case of the US. The US does not consider those who have been out of work longer than three years to be unemployed because they interpret their state as being out of the workforce entirely. Meaning, these people, according to the US government are recognized as neither employed nor unemployed -driving the unemployment rate down. Simple employment rates can be misleading, so economists also use the working age employment-to-population ratio (which documents the portions of the population who are in their most productive years). According to the working age employment-to-population rate, with 83% of Canadians between 25 and 54 years of age employed in 2018, Canadian employment rates are at an all-time high. The US, at the epicenter of the housing crash, is recovering well, however, simply put, the scaring down south is much deeper. Many challenges faced by the US are not necessarily faced in Canada -for example, Canada seems to utilize its labour more efficiently.

FIGURE 3



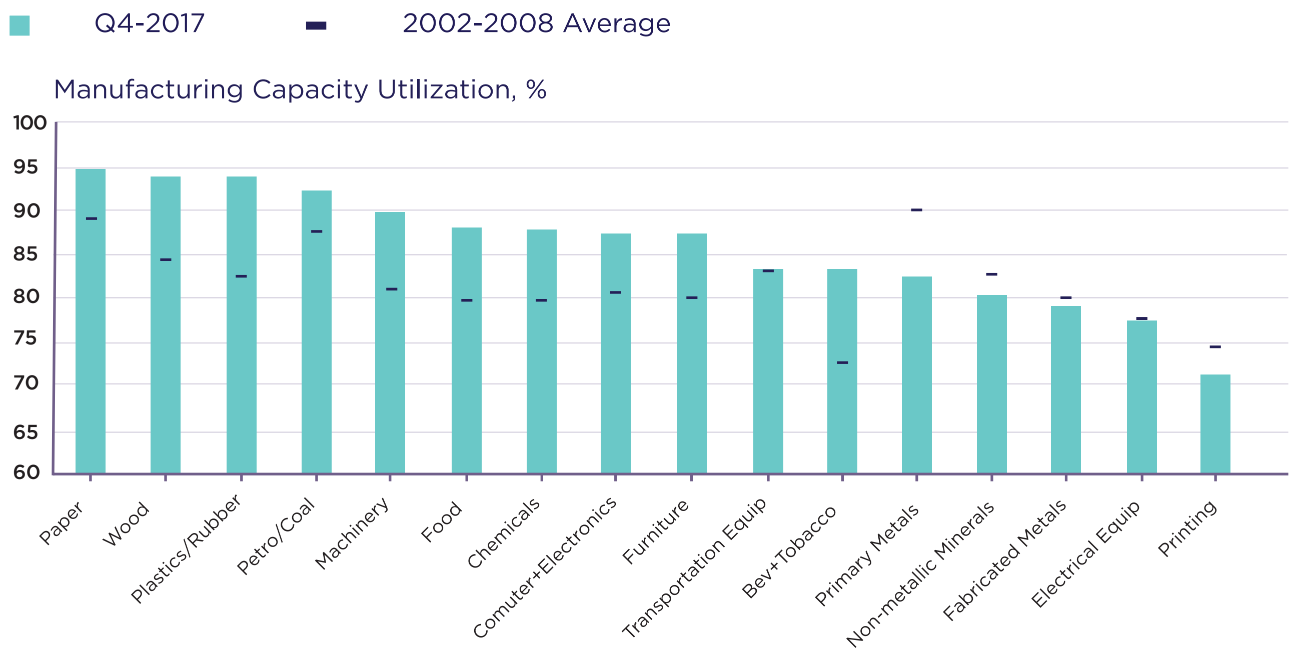
Source: Bureau of Labor Statistics, Statistics Canada

Additionally, in relation to labour, while often the public correlates raising minimum wages with employment rates, minimum wage increases (traditionally) tend to effect other areas more impactfully; minimum wage increases usually tend to impact inflation and therefore impact costs and pricing for consumers and businesses alike. Usually minimum wage increases are nominal (raising in small increments, as cost-of-living adjustments), however, Ontario for example, has recently raised the minimum wage from $11.60 to $14.00 an hour. While this is an unprecedented move, and may prove volatile, the economy seems to have responded typically. According to Statistics Canada, childcare, housekeeping, food, and energy prices (since 2017) have been gradually rising. Here is where Canadian's see the impact of minimum wage increases, most notably in the cost of housecare services or the price of a meal at a food court or other food away from home. This year's marked increase in the minimum wage increases lead to the increased costs being passed along onto the consumers, while the labour market has continued to grow robustly.

The Good Part 2: Business Investment

In relation to Canada's economic and financial outlook, Canadian business investment has been solid. The outlook is cautiously optimistic. According to Statistics Canada, Canada is utilizing its manufacturing capacity better than past averages (see figure 4). 2002-2008 is considered a strong point for the Canadian economy, and in 2017, most Canadian industries eclipsed that period's average capacity. Granted, some industries have seen a decline, most notably printing and primary metals; however, this decline can be more easily attributed to a transitioning global economy. Yet other industries, most notably machinery and equipment investment, have bounced back since the recession. Overall, Canada is seeing manufacturing capacity stretched to relatively historic levels, meaning, firms must continue to expand capacity and keep up with demand - this is a positive signal for business investment in Canada. With factories running at capacity, and business looking to expand their reach, logistic challenges and capacity limitations are inevitable; yet, as long as businesses are investing in their businesses, Canada's investment forecast should remain stable.

FIGURE 4



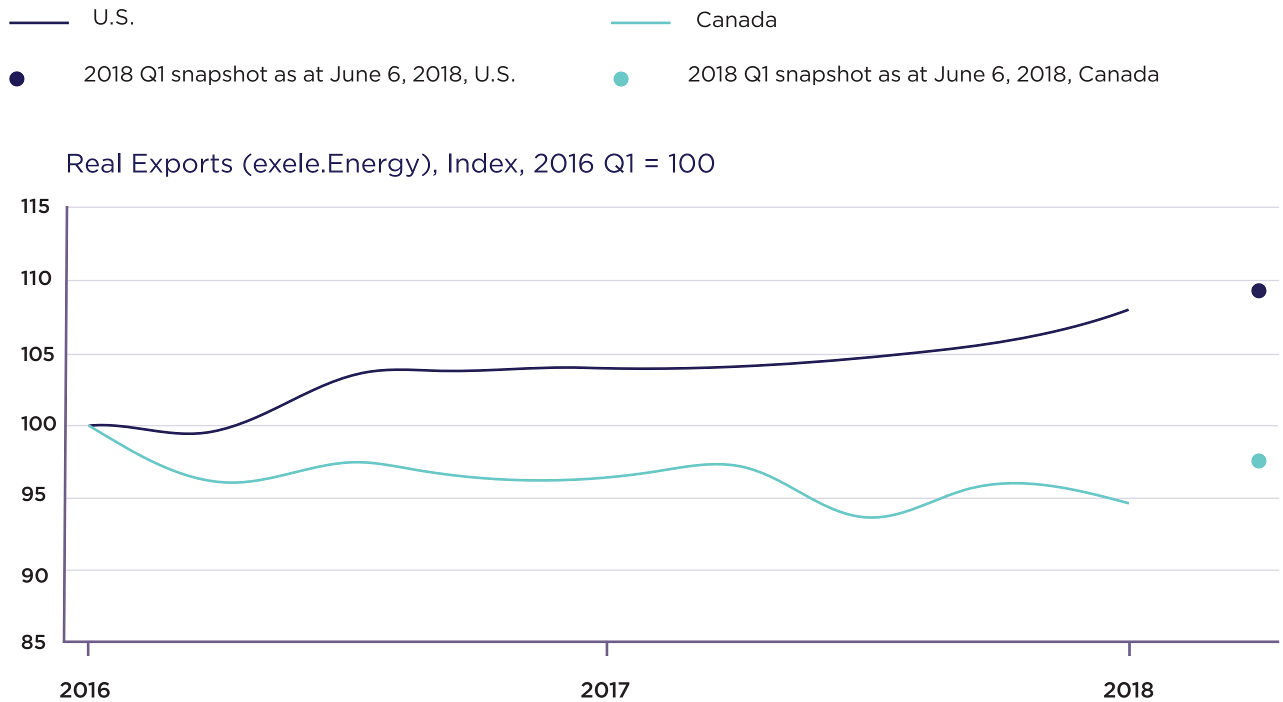
Source: Statistics Canada, TD Economics

The Canadian economy will see challenges, no matter how prosperous the outlook. The growth in business investment is particularly positive, as it can serve to ease the burden from consumer spending. Furthermore, Canadian exports are down. Point being, there are always fluctuations in an economy, and there are always events which have the potential to change the forecast - currently a wave of protectionism is on the horizon. In summation, consumer debts, coupled with declining exports (and a global wave of protectionism) do suggest some vulnerabilities in the Canadian economy.

Part 3: The Bad

Beginning with exports, since 2016, Canada has seen serial disappointments. There have been a number of issues for Canadian manufacturing, with retooling and adjusting for technological advancements as well as mass auto plant closures. Generally speaking, pure exports have been disappointing. As seen in figure 5, the US economy has out performed Canada, which historically, is a bit of an aberration - yet still noteworthy. Because the US is such a large economy, their trade value will always be high, however, they are considered a relatively closed economy. The US does not export many goods to the world; proportioned appropriately, the US exports about a third of Canada's output. Nevertheless, the US has recently outperformed Canada for a variety of reasons. In part, the US outperforming Canada does relate to the bounce back from the most recent recession. Machinery & Equipment industries were one of the hardest hits, and, as mentioned earlier, demand has returned, however, Canada needs to be able to meet that demand. While investment has been strong, Canada will not see that economic lift until demand is able to be met.

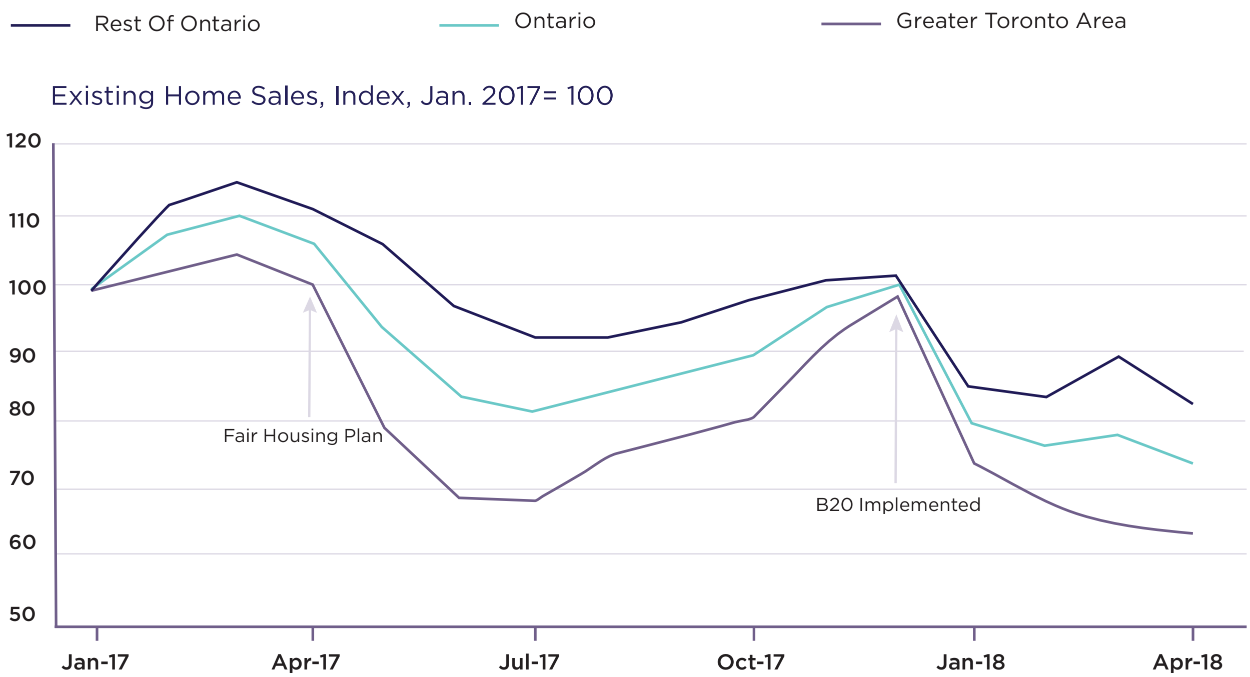
FIGURE 5



Source: Census Bureau, Statistics Canada, TD Economics

Another area of concern for the Canadian economy is the housing market. Volatility has been the climate, with a lot of apprehension in Ontario and BC housing markets (due to the new B20 mortgage rules) - Ontario's climate is evidenced in Figure 6. A lot of media attention has been here, since Ontario is also absorbing the impact of prior policy change. In early 2017 the market dipped (especially in the Greater Toronto Area) after the fair housing plan. While the market did recover by the fourth quarter, the implementation of B20 mortgage rules has since provided another sharp decline in housing sales. This decline has been especially concerning in the Toronto area. If one resides in a smaller market with a reasonable income, say one resides in Leamington Ontario, there will be reasonably priced housing available. In addition, the consumer is more likely to pass stress tests because the price of the home is not likely to be a significant multiple of their income. In Toronto, Vancouver, and the areas surrounding these metropolises, house prices are upwards of six times higher than the average income rate of households. This makes buying a house difficult for many, with those who do pushing into the Gross Debt Service limit. The new B-20 policy does enters into a consumer's equations at this moment; meaning, a buyers maximum borrowing capacity has now been lowered so that a buyer is protected against economic stresses. The new policy, essentially, puts a limit on the amount one can borrow; it chops about 15-20% off one's potential budget. This is a big change, it means someone who could (before) afford an $800, 000 house can (now) only afford a $650,000 house. This change has shown up in the existing home sales index and the housing market overall. In Toronto and Vancouver sales have plummeted and prices are decreasing, however, it has not been enough for anyone to make any fundamental adjustments to the housing market dynamics - yet.

FIGURE 6



Source: CREA, TD Economics *

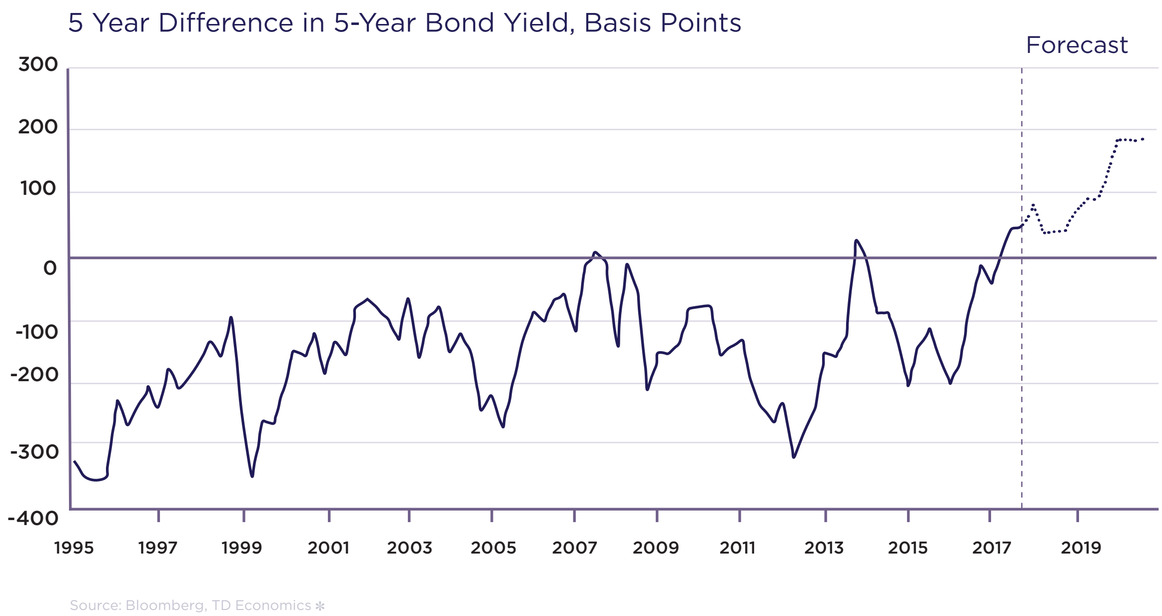
Historically, policy changes have never hindered but, always impacted the housing market. In the past one could get a 30-year mortgage with zero down payment, than mortgage insurance was introduced and the market was impacted and eventually adjusted. Ultimately, the fundamental demand for housing in these metropolises remains, so the markets balance with time. Currently, even with the lack of activity, Toronto is still not moving into a buyers' market - there is still too way too much demand for housing in the area. Much of the same can be said for Vancouver, who, like Toronto, still average 100,000 annual immigrants; these constant arrivals will continue to create a lot of demand for housing in these two still growing cities. Prices will adjust and level out in the short term, and economists still expect housing prices to grow. Yet, compared to the growth last year or two years prior, the leveling off of major housing markets is disappointing. In recent years there would be 10% price growth, this will no longer be the case.

For the average consumer, interest rates are up, houses are less affordable and therefore Canadians' budgets are tighter. This all factors into potential price growth, and while the market is not booming, the housing economy is healthy and stable. The economy is adjusting to new policy, which usually brings about conservative forecasts. Additionally, the government, when they believe necessary, is prone to applying measures which cool off demand; British Columbia, for example, has increased their foreign buyer taxes and are also thinking of adding a wealth tax for homes valued above $3,000,000. Housing markets are fickle ecosystems, and the long-standing issue may remain to be supply. In BC there are a lot of restrictions as well, builders are facing licensing issues, there are utilities issues and now more taxes are being bored by the consumer. Nationwide, market supply is not appearing to be an issue, however, some metropolises are proving there are just not enough homes being built.

In terms of getting these markets to bounce back, focus on the supply side is warranted. This is where interests' rates enter the fray as a potential risk or limiting factor. Rising interest rates are natural, but currently the dynamic is unprecedented for borrowers. Or at least, unprecedented for many borrowers for there has not been a period where the change in the mortgage rate at renewal were persistently positive since 1982 - so there is effectively an entire generation who have only known falling rates.

As evidenced in the following chart (figure 7), through the five-year bond yield (which can be used as a proxy for mortgage rates), in recent history homeowners have rarely seen higher renewal rates. Homeowners have continuously been seeing mortgage payments lower, with exceptions in 2009 and 2014, however generally, visiting one's mortgage lender has been a positive experience. Now, for the first time since 1982, homeowners are projected to see rates continuously rise at renewal. In addition to the economic effects of this trend, it may prove to be psychologically challenging for consumers and mortgage lenders alike. Usually, when costs are up, the markets price demand slows. There are potential economic challenges on the rise, depending on how the public reacts to their mortgage payments rising annually, moreover, in these situations the government is often unable to interfere because these rates are determined nationally as well as internationally.

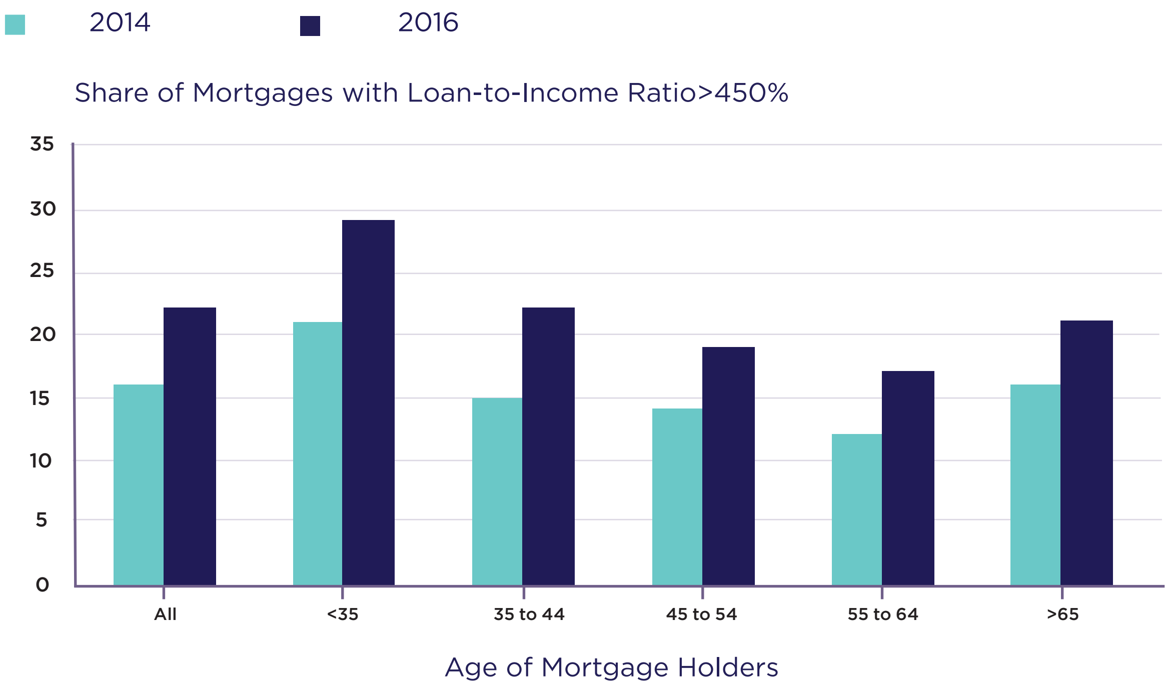
FIGURE 7



In terms of pricing, Canada is experiencing challenges with regards to household spending as well as household debts - Canadians are basically as highly indebted as they've ever been. The price of debt (the interest rate) had been flat - after a long period where people borrowed with low interest rates. These periods are both over, economists will watch closely as individuals with high debt levels react to rising interest rates. The healthy labour market is key to Canadians reacting well to these rates, nevertheless, Canadians across all ages are experiencing high debt loads.

This next graph is worrisome (see Figure 8), this graph tracks the percentage of mortgages, sorted by age, with loan-to-income ratios greater than 450%. Furthermore, percentages seem to be rising. Certain demographics are understandable, but, some are disheartening; it is understandable that younger Canadians have more difficulty acquiring a more manageable mortgage and it is disheartening that many won't even own their house until they are 60 years old. Another concerning trend evidenced here is the debt levels among older Canadians. It seems the debt levels among older Canadians is actually rising significantly; those over the age of 55, and especially those over 65, are in mortgages which owe at least four times their income. Going into retirement, this is a scary thought for any Canadian. While some may be left unaffected by such debts, a large portion of people carrying debt into their 70's is concerning and will only be more concerning as borrowing costs rise on those with such a fixed income.

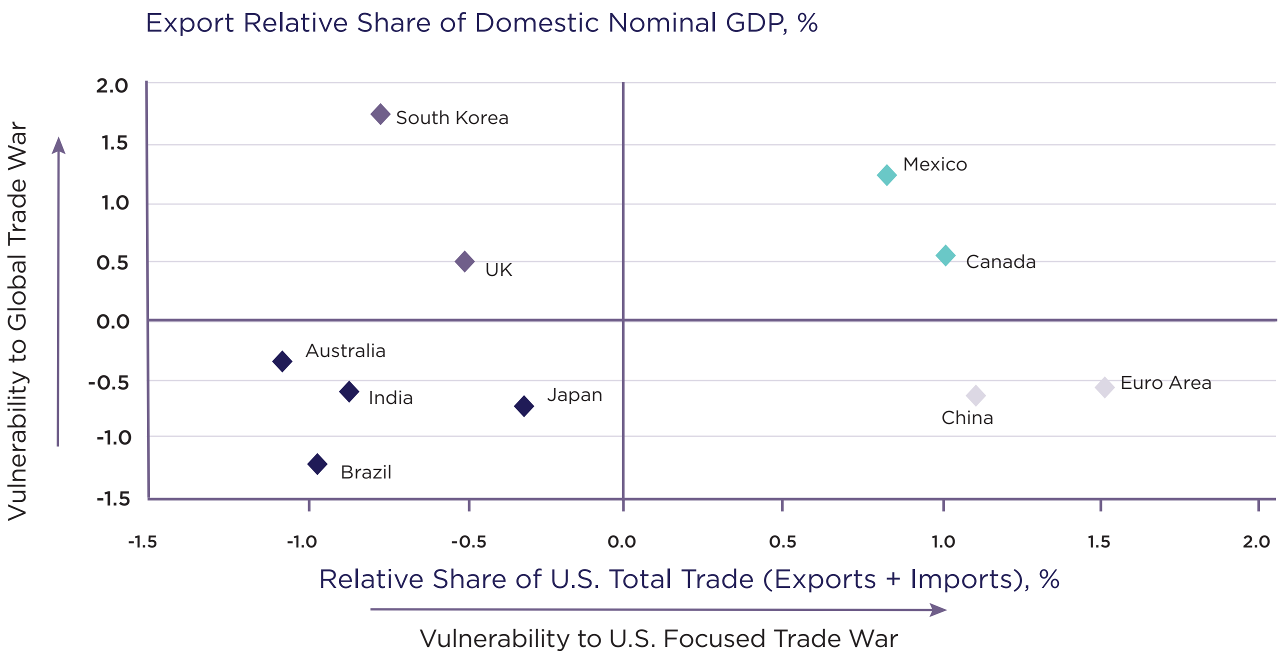
FIGURE 8



Source: Bank of Canada, TD Economics *

And finally, the elephant in the room - pun intended. Now it is time to address the biggest risk to Canada's bottom line. While Canadian debt is a concerning issue, it tends to be a slow-burning fire trumped by America leading a global protectionist movement. With American Protectionism global trade and growth is at risk. Canada is reliant on trade as a whole, so any global trade disruption is likely to impact Canadian growth, however, Canada is highly reliant on trade with the US. Trade disruptions with them are potentially precarious. Figure 9 presents particular nation's vulnerability to a global trade war, along with their vulnerabilities to a US focused trade war - in relation to particular countries relative share of US total trade as well as their total share of exports (in GDP %). Globally, the model shows the issues particular countries will have with the Presidents threats and potential policies. South Korea and the UK are among the nation’s most vulnerable to global protectionisms. South Korea's industrial base, and their advanced manufacturing base makes them a likely candidate for such vulnerabilities. The UK are in a similar situation to Canada, but they have the EU providing alternative support as a general buffer from the US market. While China does a lot of trading with the US, overall, they are not huge traders. It is Canada and Mexico who are the nation’s most vulnerable to both Global and US focused trade wars. Canada is highly reliant on trade for growth, with prosperity often reliant on economic trade with America. The tariffs have been well publicized, as have been the threats to withdraw from NAFTA. If protectionism was to continue Canada could end up in a recession, but Canada also has a fair bit of leverage with America (particularly in the auto industry). In the end, the new deal looks eerily similar to the old deal (but with the America's name getting first billing), and all parties agree it would be tragic to discard two generations of economic integration between three countries. That is not to say absolutely nothing happened, the new deal does have a few differences, the tariffs did affect the aluminum industry, and US tax reform may pose a medium-term competitive challenge in attracting capital to Canada.

FIGURE 9

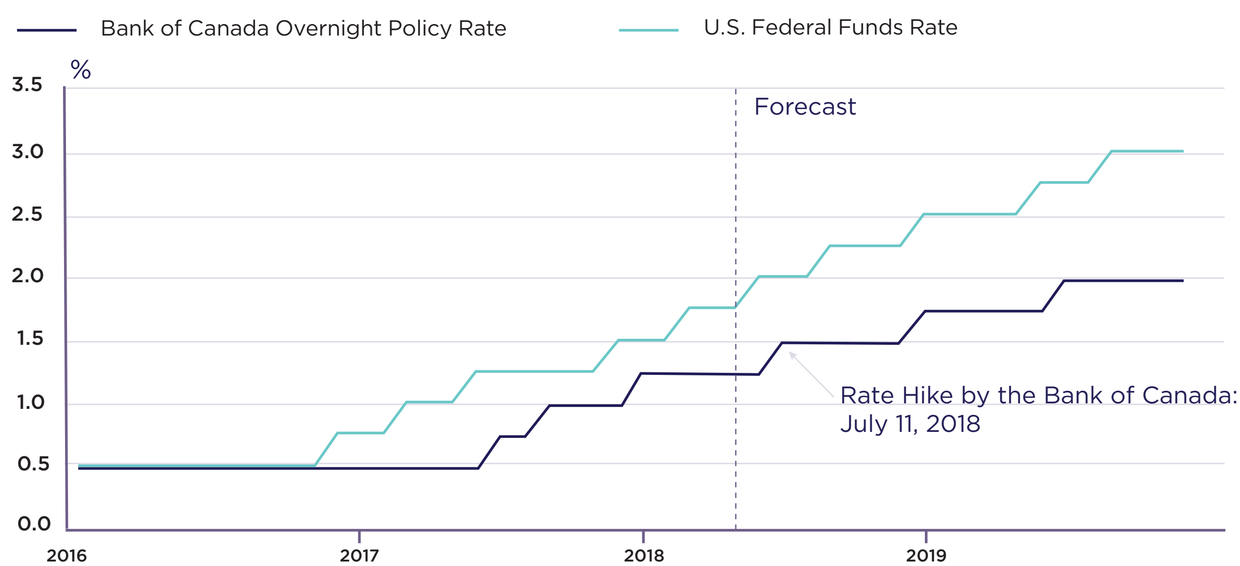


Source: National Statistical Agencies via Haver Analytics, TD Economics. Normalized trade shares calculated from 4-qtr moving average of latest available data as of March 12, 2018 *

The Bottom Line

Overall, the current American economy has produced volatility in all markets, yet, Canadian businesses, and by extension the Canadian economy, remains stable. The Global economy is always transitioning and a transitioning global economy will always bring challenges; however, Canada is notoriously stable it is expected to find a new normal. While global companies may no longer see Canada as a prime location for their next factory or facility (as they did two years ago), domestic investment has been steady. Less economic slack has led to higher interest rates. Interest rates are forecasted to reach 2% in 2019. Despite the negative clouds swirling, investment is strong, inflation is coming through, unemployment is at forty-year lows, and Canadian incomes are rising.

FIGURE 10



Source: Bank of Canada, Federal Reserve Board, Forecast by TD Economics *

As long as incomes are rising, the economy will be able to offset past challenges (like the emergency level interest rates of the past recession). Economists are forecast rising interest rates (see figure 10), and the Bank of Canada has been clear, in that, they will continue to raise rates. Though economists expect them to continue to be cautious and gradual with their approach, cognizant of high debt levels and external uncertainties', rate increases about every two quarters is the current forecast. The US, on the other hand, is dealing with a much stronger economy, therefore their interest rate is closer to 3%; they have already seen their price pressures rise, and have already raised interest rates this year. Based on the information received, from the US Federal Reserve System, economists are expecting rates to increase quarterly - maybe even faster. Economists forecast the Canadian Dollar to continue to sit around 78¢, and, in 3-5 years, gradually increase to about 80¢. Fundamentally, the loonie is driven by oil prices and interest rates, and currently, the global economy is expecting to continue to see high oil prices (applying upward pressure) with aggressively rising interest rates (applying downward pressure). This results in the Canadian dollar continuing on as it has; ultimately, the current global political climate has the loonie muted.

06

THE NEW ONTARIO CONSTRUCTION ACT– WHAT CBVs SHOULD KNOW

THE NEW ONTARIO CONSTRUCTION ACT – WHAT CBVs SHOULD KNOW

Keith Bannon, Glaholt LLP   Andrew Cochran, EY   Carolyn Scott, EY

As of July 1, 2018, new legislation regulates the payment of contractors, subcontractors, and suppliers in Ontario's construction industry. After an in-depth consultation process, the legislature implemented most of the suggestions contained in an expert review while replacing the 35-year old *Construction Lien Act* with the *Construction Act*. In addition to modernizing the lien process, the Act introduces prompt payment and adjudication to Ontario.

The need for some form of legislative intervention was shown in an Ipsos Reid survey on payment security and late payment in the industry. The Ipsos Reid survey, which was considered by the expert review, showed that the average age of current receivables in the construction industry was 61.3 days. The report also showed that, approximately, 84.7% of the participants current receivables were more than 30 days old, and that 18% were carrying receivables of an average age of 90 days or more. To contextualize, over the previous three years, 67.6% of overdue invoices that were outstanding for 30 days, were also outstanding for over 45 days. Between 2002 and 2013, the average collection period in construction increased from 57.3 days to 71.1 days, while that period in all the other considered industries remained stable at about 47 days (see Prompt Payment Ontario, *Trade Contractor Survey Results,* Ipsos Reid, November 2015, cited in Bruce Reynolds, Sharon Vogel, *Striking the Balance: Expert Review of Ontario's* Construction Lien Act, April 30, 2016).

A standard construction project is often depicted in a pyramidal form, with the owner at the apex and subcontractors and suppliers at the bottom. Money then flows down the pyramid, and given that most construction contracts do not contemplate payment in advance of performance, subcontractors often have to carry the cost of their work and wait for payment - until well after their work is done. If that payment is delayed enough, subcontractors may find themselves in a situation where they struggle to keep their businesses running. As a result, the expert review recommended a scheme of prompt payment reforms, supported by a summary adjudication process, new to Canada, but well known in the rest of the common law world. While most of the Act is currently in force, the adjudication and prompt payment provisions come into force on October 1, 2019. They will not apply to contracts and subcontracts entered into before October 1, 2019, or contracts and subcontracts entered into on or after October 1, 2019, if the procurement process was commenced before that day.

Prompt Payment

The new Act applies a prompt payment regime to all public and private sector construction contracts and requires payment within 28 days between the owner and general contractor upon submission of a "proper invoice", i.e. a "properly documented invoice". "Proper invoice" is defined as:

> a written bill or other request for payment for services or materials in respect of an improvement under a contract, if it contains the following information and, subject to subsection 6.3 (2), meets any other requirements that the contract specifies:

- The contractor's name and address.

- The date of the proper invoice and the period during which the services or materials were supplied.
- Information identifying the authority, whether in the contract or otherwise, under which the services or materials were supplied.
- A description, including quantity where appropriate, of the services or materials that were supplied.
- The amount payable for the services or materials that were supplied, and the payment terms.
- The name, title, telephone number and mailing address of the person to whom payment is to be sent.
- Any other information that may be prescribed.

Proper invoices must be given to an owner on a monthly basis - unless the contract provides otherwise.

Upon receiving full payment from the owner, the general contractor has seven days to pay the subcontractor(s) that were included in the invoice, submitted to the owner, for the services included in the invoice.

Upon receiving partial payment from the owner the general contractor must pay its subcontractor(s) that were involved in the submitted invoice, from that payment, on a rateable basis. Where the money withheld by the owner relates to the work of a specific subcontractor, the money paid will be distributed rateably among the other subcontractors.

However, the owner, the general contractor, and/or other payer will be allowed to set off against invoices by submitting a "Notice of Intention to Withhold Payment". This notice will be submitted within 7 days of receipt of a "proper invoice", specifying the amount that is not being paid and detailing the reasons for the non-payment.

Adjudication

The Act creates an efficient adjudication process to implement its prompt payment regime. As a last resort, a contractor or subcontractor can legally suspend work until paid - with mandatory interest rates applying. Reasonable costs incurred during the delayed payment must be reimbursed, a reasoned adjudicator's determination can be filed with the court once obtained, and then enforced like any other court order. Parties who disregard the adjudicator's determination may become subject to garnishment, seizure of property, invasive examinations in aid of execution and other judgment creditor's remedies.

As of October 1, 2019, parties to Ontario construction contracts will have a right to refer certain disputes to interim adjudication. This is referred to as "targeted adjudication." The parties are free to create their own contractual adjudication regimes provided that they are consistent with the Act. If an agreement falls below the requirements of the Act, the Act governs.

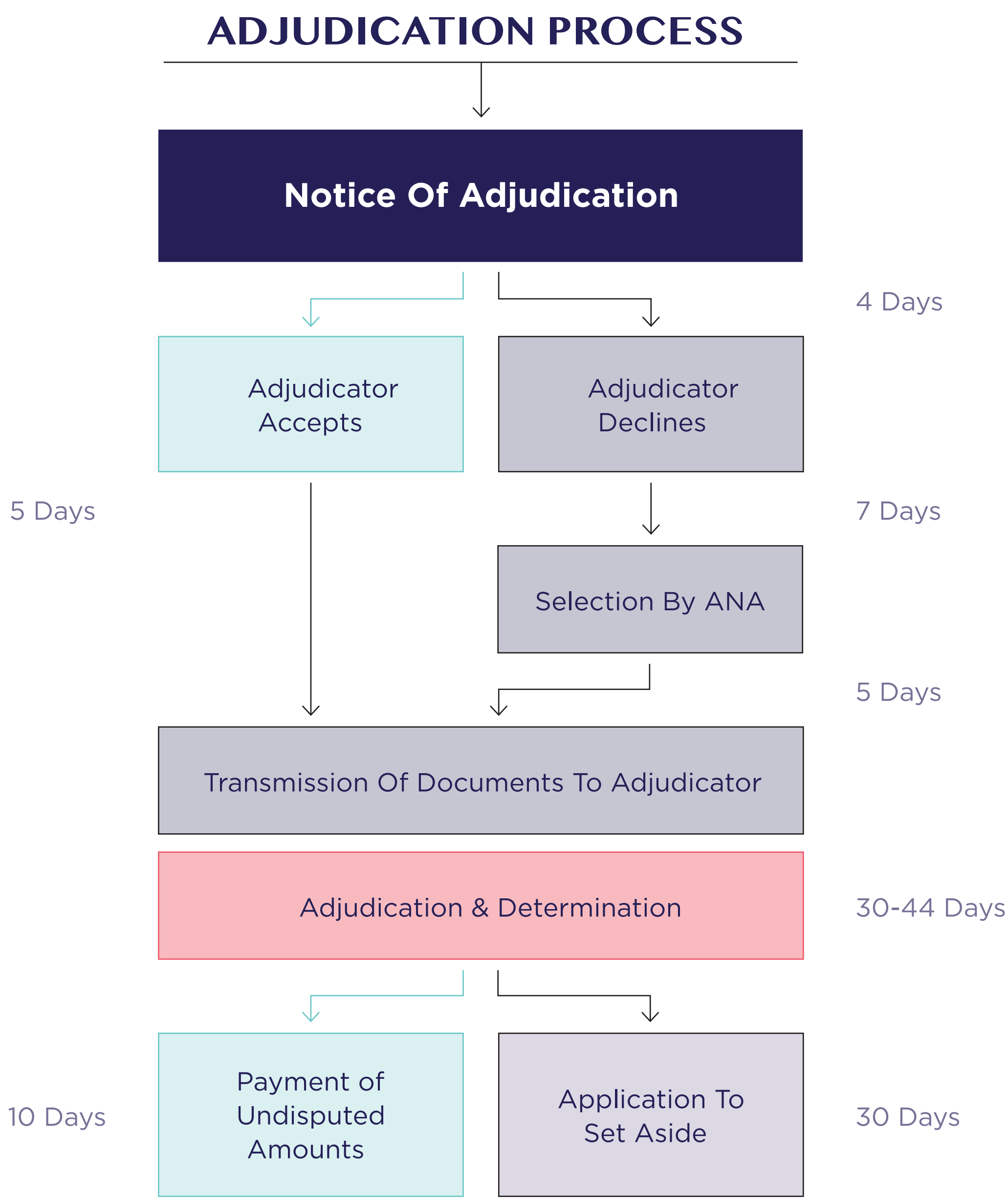
The following types of disputes may be referred to adjudication:

- The valuation of services or materials provided under the contract.
- Payment under the contract, including in respect of a change order, whether approved or not, or a proposed change order.
- Disputes that are the subject of a notice of non-payment under Part I.1.
- Amounts retained under section 12 (set-off by trustee) or under subsection 17 (3) (lien set-off).
- Payment of a holdback under section 26.1 or 26.2.
- Non-payment of holdback under section 27.1.

- Any other matter that the parties to the adjudication agree to, or that may be prescribed.

An authorized Nominating Authority has been established to create, educate, and maintain a roster of qualified adjudicators. With lien rights maintained during the adjudication.

Statutory adjudication is a highly streamlined process, in which an binding interim decision is rendered within roughly 2 months from the initial notice of adjudication. International experience with this procedure has been generally positive. A table summarizing the timeline is provided below:



Section 13.12 provides an adjudicator with broad powers, some of which are decidedly more inquisitorial than those of a common law judge:

- Issuing directions respecting the conduct of the adjudication.

- Taking the initiative in ascertaining the relevant facts and law.
- Drawing inferences based on the conduct of the parties to adjudication.
- Conducting an on-site inspection of the improvement that is the subject of the contract or subcontract, subject to the prior consent of the owner, if he or she is not a party to the adjudication; and any other person who has the legal authority to exclude others from the premises.
- Obtaining the assistance of a merchant, accountant, actuary, building contractor, architect, engineer or other person in such a way as the adjudicator considers fit, to enable him or her to determine better any matter of fact in question. The adjudicator may fix a fee for any such assistance and direct payment thereof by the parties.
- Making a determination in the adjudication.
- Any other power that may be prescribed.

It is important to note that the adjudicator's determination is binding on an interim basis only, i.e. it is binding and enforceable as if it were an order of the court, unless and until overturned by some judicial or arbitral decision on a more complete record.

While an application to set aside a determination will only rarely succeed, based on the very strict test stipulated by s. 13.18, nothing in the Act prevents a party from commencing proceedings in court or before an arbitrator to finally determine the matter.

CBV's role(s) within Construction Litigation

Compared with other litigation matters involving CBVs, construction litigation tends to be multi-faceted. It is not uncommon to be faced with multiple heads of damages. A large construction project can give rise to any of, but not limited to, the following types of claims:

- Delay
    - critical path delay
    - concurrent delays
    - acceleration
- Disruption / loss of productivity
- Differing site conditions
- Different quantities
- Changes in scope or variations to existing scope
- Wrongful termination
- Lost profits
- Extended overhead
- Misrepresentation
- Professional negligence (incl. gross negligence)
- Breach of standard of care
- Labour inefficiency claims

Among the costs typically claimed in construction litigation are:

- costs associated with additional scope not included in the contract;
- costs associated with increases from estimated quantities in a contract
- time-related costs associated with a delay to the project, including project staff/supervision, equipment and running costs; or
- additional labor and equipment costs

While many of these claims and costs clearly fall outside the scope of a CBV's expertise, and will require input from other specialists, some of these categories may well benefit from a CBV's input. Construction litigation requires a mix of detail-oriented expertise along with big picture expertise. The data held by construction clients is often far from ideally organized. In construction litigation, maybe even more so than in other litigation, organization is key - which may make a CBV's expertise in organizing and analyzing data crucial.

Changes to the CBV's role subsequent to change in Construction Act

While there have always been significant opportunities for CBV's in construction litigation, the new adjudication regime creates a number of additional opportunities for CBVs.

A CBV can serve as an expert, or claims consultant, who assists parties in developing and responding to claims. CBVs, however, should familiarize themselves with the markedly different processes and timelines now involved in an adjudication, as noted in the table above.

CBVs may also be interested in acting as adjudicators. The kind of expertise CBV's already provide, will be as crucial in preparing for adjudication, as it is in litigation. Regulation 306/18, the regulation governing adjudications under the Act, requires adjudicators to have "*at least 10 years of relevant working experience in the construction industry*". The regulation provides that "*examples of relevant working experience in the construction industry may include experience working in the industry as an accountant, architect, engineer, quantity surveyor, project manager, arbitrator or lawyer*".

A large number of disputes that may be referred to adjudication is anticipated to involve the **valuation** of **services** or **materials** and **quantification of damages**. Where the dispute involves money, the party will ideally require an valuations expert with a background in construction litigation.

Adjudicators will be chosen exclusively from a registry established by the Authorized Nominating Authority. In addition to satisfying the experience threshold, adjudicators must have completed a training program developed and administered by the Authorized Nominating Authority.

In the end, adjudication will spawn a whole new industry. If CBVs want to get involved now is the time to position the profession, and become a part of this new process.

Given that the changes to the Construction Act have expedited the time in which new construction litigation is being adjudicated, other opportunities have also arisen where a CBV can be a strategic member to the construction litigation process. Opportunities which include:

- CBVs acting as a trusted advisor in an "on call" roll;
- CBVs proactively consulting on accounting systems, accounting processes and record keeping; and
- CBVs assisting clients in preparation prior to filing the dispute.

07

WORKPLACE HARASSMENT IN A POST #METOO ENVIRONMENT:

HOW EMPLOYERS CAN RESPOND TO MEET THEIR OBLIGATIONS

WORKPLACE HARASSMENT IN A POST #METOO ENVIRONMENT: HOW EMPLOYERS CAN RESPOND TO MEET THEIR OBLIGATIONS

Michael Horvat

The #MeToo movement has shed a tremendous spotlight on harassment, particularly that which has and can occur in an employment relationship. Employers can no longer risk ignoring matters of harassment, bullying, violence and/or threats within their workplaces or amongst and between their managers and employees. Employment law has re-focused, both legislatively and through the courts, on how not to just identify past breaches, but to address and compensate victims and act as a deterrent. Imposing these legal obligations (as well as the associated cost risks to employers) have impacted management directly, to develop human resource policies that not only address the consequences of harassment in the workplace, but also serve to educate, warn and ultimately prevent such incidents from occurring.

While businesses now have the legal obligation to implement policies, training and investigation processes to satisfy new legislative requirements, the focus for the employer must remain on how to create a safe and inclusive work environment for all employees. Failing to have proper protocols in place to prevent, investigate and address harassment and violence in the workplace (when they do occur) can be costly to a business. But the failure to develop a safe and harassment free culture, in addition to avoiding government sanction and an ever-increasing risk of significant monetary damages, can assist in reducing the other human resources costs associated with such behaviour, including turnover, loss of talent and long-lasting damage to the company's reputation. Beyond the immediate hit to the bottom line, the losses associated with departing talent and a tarnished reputation can take years to repair.

#MeToo has instilled an expectation, amongst both management and individual employees, that complaints will be accepted and investigated. Consequentially, with the resulting legislative changes, employees who are subjected to harassment have the following rights: 1) The right to complain without fear of reprisal (unless the complaint itself is malicious); 2) The right to have the matter investigated (without management acting as a "gate-keeper"); and 3) The right to be informed of the results of the investigation and the actions taken by the employer.

Harassment (as well as violence or a threat of violence) typically requires an action which subjectively impacts the target of that action and affects how they view their ability or inability to interact at the workplace. Safety can be a very personal calculation, with the employee internally questioning "Do I feel that I am being harassed?" The analysis also considers whether the accused objectively should have known the action was unwelcome. This second question is often a misunderstood and difficult component and consideration in harassment cases. The alleged harasser may be inclined to state that he/she did not intend their comment or action to be improper (potentially coupled with a clichéd non-apology apology – "I am sorry that you were offended or felt harassed"). When conducting their investigation, employers should not lose sight of a key employment concern, which is, what was the impact of the misconduct on the victim and, in that context, consider whether the harasser knew or should have known that their actions and misconduct would cause harm. This allows for an adaptable process, allowing the victim to express fully his/her concerns relating to the alleged conduct, and can better reflect societal evolution, which changes over time, as to what is considered to be permissible or impermissible in the workplace.

When you couple the legislative progress made, which now requires matters of workplace harassment to be addressed, with a #MeToo public understanding that complainants must be heard, the new environment permits more open discussion, and generally greater acceptance and understanding, of, not only, what is and is not objectionable behaviour (and what individuals "ought" to know is acceptable), but also, the likely consequences of engaging in such behaviour. This new environment is likely to empower individuals who have felt harassed to come forward, armed with the knowledge that they have the legislative and human resources support to have their complaint heard. For employers, it is imperative that they create and support an environment where such workplace dialogue can take place. Safety begins with understanding and accepting what may constitute harassment and/or discrimination, and it is only with a common base line that human resources can move from just imposing penalties, after the fact, to education and prevention.

The #MeToo movement has also focused on management's obligation to report, investigate and confront allegations and incidents of harassment in the workplace. Individuals with authority, if they are witness to an incident, should not wait for the victim to speak up or file a "formal" complaint. Management itself has a renewed responsibility to its own policies and processes. This does not mean, however, that every complaint must or can be investigated. It is inherently difficult to pursue an investigation when the individual considered to be the victim of the harassment doesn't object to the conduct or does not wish to participate in the investigation. Similarly, complaints which appear to be malicious or are at risk of being abusive (particularly anonymous complaints), or those which simply object to supervisor or management direction are inherently problematic - the complaint process can be abused by all parties.

As the obligation to investigate complaints/threats has expanded, so too have the interactions and relationships which are considered to fall within the ambit of workplace policy and protections. For all practical purposes, technology has changed what individuals perceive to be part of the workplace, which now can extend past the four walls of the office or factory. Workplace connections, particularly on social media, blur the line between workplace and private interaction. The ability to constantly interact with work colleagues, seamlessly, can drag along with-it company policy relating to harassment and discrimination. By necessity (and not to create a false gap) online interactions with and within one's "workplace network" must still abide by workplace policy regarding harassment and discrimination when the nexus between "off duty" conduct and the workplace is sufficient.

As noted, and regardless of the legislative changes, management has a growing self-interest in addressing internal complaints of harassment and discrimination, as well as promoting a culture of safety and prevention. As unresolved claims reach human rights tribunals and the courts, there is growing evidence that these adjudicative bodies are increasing the quantum of damages to affected employees. The risk of damages, previously limited, generally, compensating the victim for the loss of employment (or employment opportunities) related to a harassment event, are now being regularly augmented with damages to compensate such employees for the pain and suffering caused by the harassing conduct and/or the company's failure to act, investigate and respond adequately.

Finally, the #MeToo environment has encouraged companies to consider and promote diversity in their workplaces, particularly amongst management. Having the benefit of different life experiences and differing viewpoints obtained from a more diverse cross-section of society increases communication and expands the understanding of conduct and comments which ought to be known to be abusive, harassing or discriminatory. A management group of likeminded, similarly aged, racially, sexually and ethnically congruous people may be less likely to identify and/or develop a culture that acknowledges and identifies behaviour that is no longer acceptable in the workplace. This makes diversity an important added step towards prevention. If an organization does not understand what is or isn't harassment or discriminatory conduct, how can that organization identify the need for training, investigation and potential penalties as the required steps to prevention?

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