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FIDUCIARY DUTIES IN CORPORATE TRANSACTIONS: EXPANSION OF DIRECTOR'S DUTIES TO LIMITED PARTNERSHIPS & LIABILITY OF KNOWING (THIRD PARTY) ASSISTANTS

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The Ontario Court of Appeal ("**ONCA**") decision in *Extreme Venture Partners Fund I LP v. Varma*[1] ("**Varma**") examines the conduct of corporate directors and provides important guidance on acceptable standards of corporate conduct in Canada. Although the ONCA considered various legal issues in Varma, it reached two notable conclusions that are applicable to corporate law, particularly to corporate directors and anyone participating in corporate transactions: (1) the fiduciary duty owed by directors of a corporate general partner expand to include a duty to the underlying limited partnership; and (2) knowingly assisting a corporate fiduciary in breaching their fiduciary duties and benefitting from that breach could result in joint and several liability among the knowing assistant and the fiduciary.

Background

This case involved Extreme Venture Partners Fund I LP ("**Fund I**"), a venture capital fund and a limited partnership, and its corporate general partner, EVP GP Inc. ("**EVP**"), which was responsible for the day-to-day operations of Fund I. The board of EVP consisted of five individuals who were also the founders of Fund I. The specific actions of two of the directors of EVP, M and V (the "**Appellants**"), are the subject of this decision.

The first incident occurred in 2010 when the Appellants established another venture capital fund and obtained financing from a third party. The Appellants did not disclose their new fund to the other directors of Fund I. Not only did the investments of this new fund compete with those of Fund I, the Appellants also provided the third party investor with confidential information about Fund I's investment strategy, resulting in the new fund investing in six of Fund I's most successful portfolio companies.

The second incident took place throughout 2011 and 2012 when Fund I began exploring the sale of one of its investments, Xtreme Labs, a business that was co-founded and managed by the Appellants. In presenting the projections of Xtreme Labs to the board of Fund I, the Appellants disclosed understated projections that ran

contrary to the actual projected revenues being disclosed to prospective buyers. Unbeknownst to the board, the Appellants met with P, a friend and prominent investor, and assisted him in preparing an offer to purchase Xtreme Labs from Fund I. Notably, the Appellants never disclosed that they had assisted P in constructing the offer and presented the offer to the board as though it was unsolicited. Fund I subsequently completed the sale of Xtreme Labs to P's holding company for US$18 million.

In October 2013, P's holding company sold Xtreme Labs for US$60 million. As part of this deal, P and the Appellants again worked together to carve out certain assets that were held by Xtreme Labs, including a 13% equity interest in Hatch Labs—the developer of the popular dating app, Tinder. The Appellants did not disclose this interest in Hatch Labs to the board of Fund I in the previous sale and subsequently sold this interest for US$30 million. The remaining directors of Fund I and EVP brought actions against the Appellants, P and P's holding company, among others, for breach of fiduciary duty, breach of contract, conspiracy, inducing breach of fiduciary duty and inducing breach of contract.

At trial, the court found that the Appellants had conspired with P to facilitate the acquisition of Xtreme Labs at a discounted price by understating the company's revenue projections, advancing a low earnings multiple and concealing Xtreme Labs' equity interest in Hatch Labs, a finding for which P was also held to be jointly and severally liable. The court agreed that the Appellants had breached their fiduciary duties to EVP, and that Fund I had suffered harm as a result of the breach of fiduciary duty owed to its general partner, EVP, since EVP is responsible for managing Fund I's business.

Fiduciary Duty

On appeal, the Appellants challenged the lower court's finding, arguing that a fiduciary duty was only owed to the entity they were directors of, EVP, and not the underlying limited partnership who suffered the loss, Fund I. The ONCA disagreed, stating that the categories of a fiduciary duty are never closed[2] and a court may find that ad hoc duties may exist where:

1. the fiduciary has the discretionary power to affect the vulnerable party's legal or practical interests; and
2. the fiduciary has made an express or implied undertaking that it will exercise the discretionary power in the vulnerable party's best interests.[3]

The ONCA confirmed that both limited partners and limited partnerships constituted a class of vulnerable and defined beneficiaries with interests that were adversely affected by the actions of the Appellants. While the purpose of a corporate general partner is to (1) manage the business operations of the limited partnership, and (2) shield the limited partners from unlimited liability, it cannot be used to insulate individual directors who act in their own self-interest, breach their duties to the general partner and cause damage to the limited

partnership in dealing with its property or business. Rather, the fiduciary duty of directors of a corporate general partner expand to include a duty to the limited partnership.

In considering whether the lower court erred in making a disgorgement order (which is not discussed in this summary), the ONCA emphasized a fiduciary's duty of utmost good faith and the fiduciary's obligation to disclose information in order for the beneficiary to have the opportunity to make an informed decision about the best course of action. The Appellants did not disclose the Hatch Labs investment, resulting in Fund I losing the opportunity to participate in a profitable sale of that investment.

The ONCA also referenced the Limited Partnership Agreement of Fund I that explicitly stated that the officers, directors and shareholders of the general partner were liable to the limited partnership for any acts or omissions performed or omitted fraudulently, in bad faith, or that constituted willful misfeasance or negligence.

Standard of Business Conduct and Knowingly Assisting in the Breach

At the ONCA, P argued that his conduct was legal, consistent with Canadian business conduct standards and that he was no more than a knowing assistant to the Appellants in the matter and, as such, should not be held liable. In refusing this position, the ONCA outlined the test to be used in examining these instances as follows:

1. there must be a fiduciary;
2. the fiduciary must have breached that duty fraudulently and dishonestly;
3. the stranger to the fiduciary relationship must have had actual knowledge of both the fiduciary relationship and the fraudulent and dishonest conduct; and
4. the stranger must have participated in or assisted the fiduciary's fraudulent and dishonest conduct.[4]

The ONCA agreed with the lower court that P was a knowing assistant who was actively involved in the breach; he worked alongside the directors throughout the process, was acutely aware of the suppressed revenues and misrepresentations presented to the board and greatly profited from the Appellants' breach. In holding P jointly and severally liable and more than doubling the damages award (to capture the entirety of the profits gained by the Appellants and P), the ONCA clarified that its decision is not meant to establish a rule that liability between knowing assistants and faithless fiduciaries always be joint and several. Rather, courts should have flexibility to determine remedies on the basis of fairness in the particular circumstances of the case at hand.

Takeaways

The ONCA decision in Varma confirms important business considerations in Canadian corporate law. First, individuals who owe fiduciary duties to corporate general partners must be transparent in their dealings and

decision-making and ensure adequate consideration is given to the business interests of both the corporate general partner and the underlying limited partnership. The law surrounding fiduciary duties is not settled and courts may impose ad hoc duties where the requisite factors exist. Second, while parties to a transaction are not required to look out for the best interests of their competition, an individual who knowingly participates and benefits from a fiduciary or contractual breach may be subject to severe penalties depending on the extent of their knowledge and involvement in that breach.

For further advice on the duties of corporate directors or those engaging in corporate transactions, please contact any of the authors or another member of McMillan LLP's Business Law Group.

[1] *Extreme Venture Partners Fund I LP* v. *Varma*, 2021 ONCA 853.
[2] *Frame* v. *Smith*, [1987] 2 S.C.R. 99.
[3] *Galambos* v. *Perez*, 2009 SCC 48.
[4] *Air Canada* v. *M & L Travel Ltd*., [1993] 3 S.C.R. 787.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.