Court File No. CV-20-00637238-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

B E T W E N:

EMERALD CASTLE DEVELOPMENTS INC.

Applicant

- and -

FAAN MORTGAGE ADMINISTRATORS INC., in its capacity as the Court-Appointed Trustee of BUILDING & DEVELOPMENT MORTGAGES CANADA INC. formerly known as CENTRO MORTGAGE INC., and OLYMPIA TRUST COMPANY

Respondents

APPLICATION UNDER SECTION 37 OF THE *MORTGAGE BROKERAGES, LENDERS AND ADMINISTRATORS ACT*, 2006, S.O. 2006, C. 29; SECTION 101 OF THE *COURTS OF JUSTICE ACT*, R.S.O. 1990 c. C. 43, and *Rule 14.05(3)(d) of the RULES OF CIVIL PROCEDURE*, R.S.O. 1990, Reg. 194, as amended

JOINT SUR-REPLY FACTUM OF FAAN MORTGAGE ADMINISTRATORS INC. IN ITS CAPACITY AS TRUSTEE OF BDMC AND THE INVESTORS AND THE COURT-APPOINTED REPRESENTATIVE COUNSEL

October 26, 2020

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1. The Trustee and Representative Counsel file this Joint Sur-Reply to respond to Emerald Castle's Supplementary Factum. Emerald Castle emphasizes how it deftly avoided contact with the Investors who funded Emerald Castle's real estate enterprise based on the representation that their loan was fully secured. Emerald Castle implies that it is an innocent bystander who is entitled to keep both the Investors' money and Castlemore free and clear of the Investors' security. Emerald Castle says that this Court should enforce its commercially untenable interpretation of the bargain it struck with Fortress to the detriment of the Investors.

2. The Trustee and Representative Counsel do not accept the statements made in Emerald Castle's Supplementary Factum and file this Joint Sur-Reply to make two points:

(a) Emerald Castle is not an innocent bystander. Emerald Castle knew, ought to have known or was willfully blind to the fact that the loan was funded by the Investors and that the Investors received inadequate disclosure; and

(b) The law does not require Emerald Castle to have privity of contract with the Investors for this Court to find the End of Term Event and Waterfall clauses unenforceable. The law only requires manifest unfairness and lack of disclosure.

Emerald Castle Knew or Ought to Have Known that the Loan was Funded by the Investors Who Received Inadequate Disclosure

3. Emerald Castle asks this Court to believe that it "had no knowledge of, or involvement with, how or from whom [BDMC] were raising their funds for the Loan" (EC Supp. Factum, ¶10(b)). However, the evidence is uncontradicted that Emerald Castle knew or ought to have known that the loan was funded by the Investors. In addition to the facts identified in the Trustee's Factum ¶42-43 and the Representative Counsel's Factum ¶28-32, the Respondents note that:

(a) Mr. Auciello conceded on cross-examination that he knew it was "part of [Fortress's] business model" to "[go] to the public to raise those funds" and was aware that it was a "possibility" that "there would be salespersons helping raise the funds" (Auciello Cross, AR Vol. 3, Tab 12 p. 314 q. 276; p. 321 q. 373-375).

(b) The DCA, which was so heavily negotiated according to Emerald Castle, expressly states that fees "shall be paid to salespersons for commissions relating to raising Lender's funds" (1st Auciello Aff't, AR Vol. 1, Tab 2C p. 67).

(c) Although the Investors are not a direct party, the Loan Agreement states that BDMC is a party "in trust", although Mr. Auciello did not "know" (or ask) for whom BDMC was making the loan or holding the assets in trust (1st Auciello Aff't, AR Vol. 1, Tab 2B p. 33; Auciello Cross, AR Vol. 3, Tab 12 p. 309 q. 187).

4. Emerald Castle's Notice of Application also concedes that Emerald Castle owes obligations to the Investors, and not just BDMC. In the Notice of Application, at ¶1(e), Emerald Castle asks this Court to grant a declaration that upon payment of 1/3 of the amount outstanding, "BDMC's individual investors…and Olympia Trusts' individual investors shall be deemed to have released Emerald Castle from all obligations and security provided in connection with the Loan, including, without limitation the Security" (AR Vol. 1, Tab 1 p. 11).

5. Emerald Castle asks this Court to believe that only one investor – Dr. Pizzuto – received inadequate disclosure or is affected by this Application (EC Supp. Factum, ¶2). As the record makes clear, the Trustee is a Court-appointed officer whose role includes acting in the best interest of the Investors collectively. In fulfilling its duties, the Trustee received feedback from multiple Castlemore Investors (17th Report, AR Vol. 3, Tab 7 p. 15 ¶18, 20). Similarly, Representative

Counsel was appointed by this Court to represent the Investors' common interests. Emerald Castle's suggestion that this Court should require evidence from multiple Investors is inconsistent with the very reasons for which the Court appointed the Trustee and Representative Counsel.

6. Furthermore, Emerald Castle minimizes the inadequate disclosure to Investors by suggesting there was one "rogue broker" (EC Supp. Factum, ¶11). However, as the record makes clear, the inadequate disclosure occurred with more Investors than just Dr. Pizzuto. The representations are described in Representative Counsel's Factum ¶6-27. The representations were not made to only one Investor. They were contained in the pamphlets, project fact sheet, Form 9D and disclosure statement. There was no need to examine Fortress or the F Brokers in this Application: if Emerald Castle's interpretation is correct, then the misrepresentations are apparent on the face of the Loan Agreement and the documents provided to the Investors.

7. For example, Form 9D and the Disclosure Statement describe the key portion of the Waterfall on which Emerald Castle relies as follows: "Project revenue will be distributed in the following order: […] 5. Principal equity advances pari passu" (Pizzuto Aff't, AR Vol. 2, Tab 6F p. 259, Tab 6I, p. 308). Not only does this description fail to disclose the interpretation that Emerald Castle is urging this Court to accept, that distributions could be made at a time prior to the project generating any revenue, it also assumes that retail investors have sufficient legal training or knowledge of Latin to understand what "*pari passu*" means. This is not a case in which one "rogue broker" made one misrepresentation to one Investor.

8. Based on the evidence, this Court should conclude that Emerald Castle knew, ought to have known or was willfully blind to the fact that the loan was funded by the Investors and that the Investors received inadequate disclosure. It was not an innocent third-party bystander.

***MacQuarie* Does Not Require Privity of Contract to Find a Clause Unenforceable**

9. Emerald Castle argues that *MacQuarie*, 2020 ONCA 139 is distinguishable. It is not. *MacQuarie* describes when freedom of contract is limited to ensure that "harsh and oppressive terms" are not imposed on "unsuspecting part[ies]" (*MacQuarie* ¶33, quoting Professor McCamus). A party seeking to rely on such a "harsh and oppressive term" must take "reasonable measures" to draw such a term to the attention of the "unsuspecting party" (*MacQuarie* ¶36, quoting Dubin J.A. in *Clendenning*).

10. Emerald Castle is the party seeking to rely on the End of Term Event and Waterfall clauses. Those clauses, if enforced as Emerald Castle interprets them, will have the harsh and oppressive result of causing BDMC in trust for the Investors to lose more than $20 million, their security, and any chance at participating in the profits of Emerald Castle's development of Castlemore.

11. Emerald Castle had the right to draw to Investors' attention its interpretation of the Loan Agreement: Emerald Castle bargained with Fortress for the right to approve Fortress' marketing materials (1st Auciello Aff't, AR Vol. 1, Tab 2C p. 72 s. 8; Auciello Cross, AR Vol. 3, Tab 12 p. 327-28 q. 446-453). But like MacQuarie Equipment and Tilden Rent-A-Car, Emerald Castle did not draw to the Investors' attention the harsh clauses it now asks this Court to enforce.

12. Unlike in *MacQuarie* – where the Court concluded that the plaintiff had no intention to mislead Ms. Abdulaziz (*MacQuarie* ¶37) – Emerald Castle ought to have been aware of the red flags while it was negotiating with Fortress. For example:

(a) Emerald Castle "was not soliciting financing or intending to borrow funds for [Castlemore]" (2nd Auciello Aff't, AR Vol. 2, Tab 3 p. 10 ¶15) but could not turn

down the financing offered by Fortress and spent a year negotiating with Fortress to finalize the Loan Agreement (2nd Auciello Aff't, AR Vol. 2, Tab 3 p. 11 ¶17).

(b) Pursuant to the Loan Agreement, Emerald Castle materially improved its position by receiving $12 million in cash and by obtaining (under its theory) a mortgage *pari passu* with BDMC in trust for the Investors.

(c) Pursuant to the Loan Agreement and DCA, Fortress (and related parties) materially improved their position by receiving approximately $8 million in fees.

(d) Both of these improved positions were achieved without developing Castlemore. As a result, the arrangement was zero sum; on its face, someone was suffering a material detriment to fund Emerald Castle's and Fortress's improved positions.

13. This material detriment was highlighted by the loan amount and related security. Under Emerald Castle's theory, BDMC's in trust security was only worth $12 million. Emerald Castle calculates that value by starting with its $32 million "benchmark of value", subtracting the approximately $8 million first mortgage and dividing the remainder in half due to the purported *pari passu* security (Auciello Cross, AR Vol. 3, Tab 12 p. 316 q. 295, p. 324 q. 412-415).

14. However, the secured loan amount was intended to be $21.25 million plus accrued interest. Emerald Castle knew that if no development occurred, it would say that the Investors could only recover the value of its security. According to Emerald Castle, this result was a "fundamental term" of the Loan Agreement (Applicant's Factum ¶14).

15. It is telling that Emerald Castle would view the End of Term Event clause as fundamental. That clause (under Emerald Castle's interpretation) excludes the Investors from participating in an

increase in value of the Castlemore development and entitles Emerald Castle to escape fully repaying the loan and accrued interest. Yet just as Emerald Castle was content to allow Fortress to take approximately $8 million in fees from the proceeds of the loan, Emerald Castle is content to allow Fortress to participate in "all distributions of available cash flow" until "the earlier of the date of closing of the sale of the last housing unit" and the last distribution pursuant to the DCA (1st Auciello Aff't, AR Vol. 1, Tab 2C p. 72 s.7).

16. In the circumstances of this case, the principle in *MacQuarie* requires Emerald Castle to have taken reasonable measures (such as exercising its right to approve the marketing materials) to ensure that Investors understood Emerald Castle's interpretation of the "harsh and oppressive" End of Term Event and Waterfall clauses. Emerald Castle's failure to do so allows this Court to dismiss Emerald Castle's application for an Order that would let it rely on those clauses for its own profit to the detriment of the secured Investors.

17. The cases relied upon by Emerald Castle in its Supplementary Factum have nothing to do with the principle established in *MacQuarie*. In *Adamson v. Steed*, 2008 ONCA 375, the Court was asked to imply a term into a contract. In paragraph 60 of *JSM Corporation v. The Brick*, 2008 ONCA 183, the Court was commenting on the limits of the oppression remedy in the *Canada Business Corporation Act*, amongst other Acts. Neither case dilutes the principle articulated by the Court of Appeal for Ontario in *MacQuarie* that a party cannot rely on a harsh or oppressive clause unless it has taken reasonable measures to bring that clause to the impacted person's attention.

18. If Emerald Castle had taken reasonable measures to ensure Investors understood the End of Term Event and Waterfall clauses, then Investors would not have been told that their "principal amount is fully secured against the subject property (as a mortgage)" (Pizzuto Aff't, AR Vol. 2,

Tab 6 p. 158 ¶10 quoting from Tab 6D). Rather, Investors would have been told what Emerald Castle tells this Court – that the Investors' security was worth less than half of their investment. Such disclosure is precisely what the Court of Appeal in *MacQuarie* intended to occur to ensure that unsuspecting parties were not harmed by opportunistic entities seeking to rely on harsh terms.

Conclusion

19. Emerald Castle correctly states that the "Respondents are not claiming any relief" (EC Supp. Factum, ¶25). If this Honourable Court dismisses Emerald Castle's application, then the Respondents do not require relief because the Investors (through BDMC in trust) will still be owed approximately $30 million by Emerald Castle; the Investors (through BDMC in trust) will still have the benefit of their security on Castlemore; the Investors (through BDMC in trust) will still be able to participate in any increase in Castlemore's value; and the Investors in their personal capacity will not have been deemed by a Court order "to have released Emerald Castle from all obligations and security provided in connection with the Loan" (Notice of Application, AR Vol. 1, Tab 1 p. 11 ¶1(e)).

20. The Respondents ask this Court to dismiss this application, with costs on a full indemnity basis, on the basis that the End of Term Event and Waterfall clauses are not enforceable or, alternatively, that, properly interpreted, they do not entitle Emerald Castle to the order it seeks.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 26th day of October, 2020.

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SCHEDULE "A"
LIST OF AUTHORITIES

1. *Adamson v. Steed*, 2008 ONCA 375

2. *JSM Corporation v. The Brick*, 2008 ONCA 183

3. *MacQuarie Equipment Finance Ltd v 2326695 Ontario Ltd. (Durham Drug Store)*, 2020 ONCA 139

SCHEDULE “B”
TEXT OF STATUTES, REGULATIONS & BY - LAWS

N/A

EMERALD CASTLE DEVELOPMENTS INC. Applicant	and	**FAAN MORTGAGE ADMINISTRATORS INC., IN ITS CAPACITY AS THE COURT-APPOINTED TRUSTEE OF BUILDING & DEVELOPMENT MORTGAGES CANADA INC. FORMERLY KNOWN AS CENTRO MORTGAGE INC. ET AL. and OLYMPIA TRUST COMPANY** Respondents	Court File No: CV-20-00637238-00CL

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PROCEEDING COMMENCED AT TORONTO

JOINT SUR-REPLY FACTUM OF FAAN MORTGAGE ADMINISTRATORS INC. IN ITS CAPACITY AS TRUSTEE OF BDMC AND THE INVESTORS

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