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Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial Group, Stanley Kugelmass at 416.593.3943 or skugelmass@blaney.com.

A NOTE TO OUR READERS

With this issue, *Blaneys on Business* celebrates its 10th anniversary of publication.

Blaney McMurtry's corporate/commercial practice group presents *Blaneys on Business* quarterly to alert you, our clients, colleagues and friends, to new statutes, regulations, cases, deals and other developments that affect your businesses and you as business people.

Over the last decade, our expert lawyers have covered a wide variety of subjects, including what government budgets mean for your business and you; what tax arrangements might be most efficient for your business; new avenues that may be open to you to finance your business; what business practices you want to embrace or avoid; how best to protect your firm's valuable intellectual property; what to beware of in letters of intent and restrictive covenants in employment and consulting contracts; your legal obligations in the collection and use of your customers' personal information; the rules of the game in telemarketing, online selling and securities registration; and your obligations as corporate directors.

We thank you for your positive feedback. It has been very gratifying and we look forward to continuing to bring you business law news, analysis and advice that you find interesting and that adds value to your enterprise.

Best regards,

Steven Jeffery
Editor

CASE UPDATE: Kipfinch Developments Inc. v. Westwood Mall (Mississauga) Limited

In our last issue, we discussed the Ontario Superior Court decision in *Kipfinch Developments Inc. v. Westwood Mall (Mississauga) Limited*. Kipfinch entered into an agreement of purchase and sale to purchase a shopping centre from Westwood, but the deal fell apart when Westwood refused to let Kipfinch carry out desired environmental testing. Kipfinch sued and the court found that by refusing the testing, Westwood had breached the agreement of purchase and sale. Kipfinch was awarded $330,000, based on a projected profit of $660,000 if the deal had closed and a 50% chance of the deal closing if Kipfinch had been permitted to carry out the environmental testing.

Interestingly, it was Kipfinch, not Westwood, who appealed, and asked for increased damages. The Ontario Court of Appeal released its decision this past January.

The Court of Appeal found that the trial judge had correctly assessed the chance of the transaction closing at 50%. The trial judge also correctly assessed the damages as of the date of the breach of contract, and not, as argued by Kipfinch, as of the date two years later when the leasing-up of the mall would have be completed. Kipfinch did succeed on one minor point – the trial judge erred when he excluded certain management expenses from the quantification of damages. A new trial was ordered on this issue alone. ■

Kelly J. Morris, a partner in Blaney McMurtry's Corporate Insurance Group who advises insurers, reinsurers, and insurance intermediaries, has substantial expertise in regulatory, compliance and market conduct matters; privacy law and money laundering issues.

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FIRST ADMINISTRATIVE MONETARY PENALTIES IMPOSED UNDER FEDERAL ANTI-MONEY LAUNDERING LAWS

Kelly J. Morris

Five Canadian "money services businesses" – businesses involved in foreign exchange dealing, electronic funds transfer, and issuing and redeeming travellers' cheques – are the first entities to be assessed administrative monetary penalties for serious or very serious violations of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the "Act").

Under amendments to the Act that became effective December 30, 2008, the Financial Transactions and Reports Analysis Centre of Canada ("FINTRAC"), the national financial intelligence unit that reports to the Minister of Finance, was given the power to assess administrative monetary penalties ("AMPs") for violations of the Act. Violations are classified as minor, serious and very serious, depending on the section of the Act that is contravened. FINTRAC is permitted to assess maximum penalties of $1,000 for a minor violation; $100,000 for a serious violation; $100,000 for a very serious violation committed by an individual, and $500,000 for a very serious violation committed by an entity. FINTRAC will make public AMPs imposed with respect to serious or very serious violations or where the total penalty assessed is $10,000 or more.

In determining what penalty is appropriate, FINTRAC will consider:

a) the fact that penalties are intended to encourage compliance with the Act rather than be punitive;

b) the harm caused by the violation; and

c) the history of compliance with the Act by the person or entity.

In November, 2009 FINTRAC assessed its first AMPs where the total penalty is over $10,000. It assessed a penalty of $12,750 against a money services business in Vaughan, Ontario that had committed eight violations of the Act, at least five of which were serious, including failure to develop and apply written compliance policies; failure to develop and maintain a written compliance training program for employees; failure to appoint a person responsible for implementation of a compliance program; failure to develop and apply policies and procedures to assess the risk of a money laundering or terrorist financing offence in the course of its activities; and failure to submit an application for registration to FINTRAC.

FINTRAC had previously assessed four AMPs against money services businesses that had each committed one violation of failing to register with FINTRAC. The penalties imposed ranged from $3,000 to $4,320.

The amounts of the AMPs that have been assessed are quite low given the maximum penalties available to FINTRAC. For example, failure to register as a money services business is classified as a serious violation, so the maximum AMP that could have been assessed against each of the money services businesses that committed

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one violation was $100,000. The maximum penalty FINTRAC could have assessed against the money services business that committed eight violations was in excess of $500,000, far higher than the $12,750 imposed.

FINTRAC has made it clear, however, that the notion of proportionality is fundamental in assessing AMPs. In a speech in April, 2009, FINTRAC Director Jeanne M. Flemming described how FINTRAC will determine the amount of the penalty. FINTRAC will assess the "harm" for each violation, which will be measured by the "degree to which the violation would obstruct Canada's ability to detect and deter money laundering and terrorist financing." The level of harm will then be used to establish the base penalty amount, which will also reflect the entity's compliance history. The penalties are designed to be "non-punitive and proportional". Accordingly, it is likely that the AMPs assessed will continue to be in amounts that are far lower than the maximum permissible. ■

PATENTING YOUR BUSINESS METHOD TO PROTECT YOUR COMPETITIVE ADVANTAGE

Michael Schiff

Have you thought about patenting that clever system that your company has developed to provide services to your customers?

The good news is that if your patent is granted, you will have secured the advantage provided by your system for up to 20 years.

The other news is that winning the patent is likely to be far from straight forward because of recent developments in patent law. The game is afoot in the courts as to whether business methods and computer programs are even suitable for patenting.

In Canada, for instance, the patentability of Amazon.com's one-click ordering system is being appealed to the Federal Court. In the U.S., the patentability of a commodity transaction method (the *Bilski* case) has been appealed all the way to the Supreme Court, with a decision expected this spring.

Typically, the sorts of things that inventors usually take to the patent office are commercial products – new electronics, new medicines, mechanical devices, chemical formulae, and so on. The usual rule is that patent-eligible subject matter includes anything under the sun that is made by man.

But there are exceptions…

One thing that all major countries agree on is a prohibition against the patenting of thought processes or pure algorithms – things like schemes, business strategies, mathematical formulae, and equations that define laws of nature.

There are three reasons for this: (a) the difficulty in determining novelty (whether someone has had the same thought process before); (b) a concern that patenting algorithms will unduly block technological advancements and (c) an overarching principle that (if we can put it this way) the patent office has no business in the cerebra of the nation.

However, the U.S., Europe, and Japan have historically recognized that an implemented business method or a programmed computer is more than just a pure algorithm – and thus suitable for patent protection.

Amazon.com's one-click ordering system has allowed customers to turn on a feature where a single mouse click on a desired item will lead directly to their credit card being charged and the item being delivered to their house. The Japanese Patent Office decided that Amazon's system was obvious in view of some contemporaneous publications, and therefore not patentable. The corresponding case in Europe has been declared non-inventive and has gone on appeal, and the issued U.S. patent is currently being re-examined for obviousness as well. However, none of these jurisdictions has challenged the one-click method as being outside of the type of invention that would be suitable for patenting.

The Canadian Intellectual Property Office came to the opposite result on both points, putting it substantially out of sync with the rest of the world. In March of last year, the Patent Appeal Board decided that the one-click ordering system was inventive, but *non-statutory* (not patentable under Canadian law). The Board asked what had been added to human knowledge by the claimed invention, and decided that it was a set of rules for carrying out online orders. In a sweeping condemnation of business method patents, the Board said that when a claimed invention is neither a physical object nor an act to change an object, it cannot be patented. (It is tempting to speculate what the Board might have done if Amazon had claimed its process with a further step that involved wrapping the ordered item into a personally labelled package, and loading it onto a delivery truck, thereby giving it a real world effect).

So, what sort of inventions has CIPO's Appeal Board now effectively excluded from patentability? Computer software for sure, since software is just a series of electronic instructions. How about a product like a GPS mapping device, since the product just makes internal decisions about what to display. How about an assay kit used in medicine, since it involves correlating the level of a substance in blood with a disease condition. How about second medical use: when a previously known medicine is found effective in treating a different condition than what it was originally developed for. After all, the new use is really just a decision by the managing clinician to prescribe the medicine for a particular patient. Can you hear the technology and pharmaceutical companies down the block screaming? These things have been patentable in the past, and companies developing these technologies may rely on patents to protect the costs of beta testing or clinical trials.

In the late 1990s, the Court of Appeals for the Federal Circuit (CAFC) in the U.S. issued two decisions that ushered in the recent history of business method patents. In *State Street Bank v. Signature Financial,* the Court upheld the patenting of a data processing system in which mutual funds pool assets for investment. In *AT&T Corp v. Excel Communications,* the Court upheld the patenting of a method for associating telephone messages with billing information. This led to an era in which most systems for data processing seemed to be patent-eligible as long as they were performed by a computer or recorded on a computer readable medium. The U.S. Patent and Trademark Office has over 300 examiners assessing business method patents, and over 1,600 such patents were issued last year to the likes of IBM, Microsoft, and J.P. Morgan Chase Bank.

In the last few years, the patentability requirements in the U.S. have become more focused. Methods of resolving arbitration or developing a vaccine are apparently not patentable. The case on appeal to the Supreme Court referred to earlier (*In re Bilski)* claims a method for managing commodity risks by initiating a series of market transactions. The CAFC ruled that a method had to either be tied to a particular machine or apparatus, or transform a particular article into a different state – and *Bilski* did not qualify.

While awaiting the ruling from the Supreme Court, the U.S. Patent and Trademark Office has adopted Interim Examination Instructions for its examiners, based on the machine-or-transformation test established by the CAFC in *Bilski.*

The first step is to examine whether the claimed method needs to be implicated by a particular machine. The particular machine must impose a meaningful limitation (rather than a general purpose computer). In the alternative, the Office asks if the claimed method transforms a particular article. Again, the transformation must be meaningful (more than an insignificant post-solution activity, such as a general limitation to a particular area of use).

In the unlikely event that the U.S. Supreme Court uses *Bilski* to sweep business methods off the table, we can expect that Congress will step in if necessary to make business methods patentable at some level.

We can also hope that Federal Court of Canada will align this country's patentability standards with the rest of the world by reversing the CIPO Appeal Board's decision in the Amazon one-click case. Whatever the outcome, because of the commercial importance of business method patents, Canada will ultimately be pressured to comply with the standards in place in other major jurisdictions – and Parliament may be recruited into the fray.

In the meantime, all of this rethinking of the standards of patentability has sensitized companies everywhere to the idea of protecting the methods they have developed to provide goods and services to their customers.

The opportunity to protect the key features of your system may create a long-term business opportunity: having a patent application on file potentially affixes a technological advantage in place for the 20-year term that the patent remains enforceable. ■

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She was assisted in the preparation of this article by Rafal Szymanski, an articling student at Blaneys.

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DEFRAUDED LENDER LOSES TO INNOCENT PURCHASER FOR VALUE

Laura McLennan

Who wins when two innocent parties are the victims of fraud?

The Ontario Court of Appeal had to answer this question in *Bank of Montreal v. iTrade Finance Inc.*

Both the Bank of Montreal and iTrade Finance Inc. were the victims of a fraud perpetrated by Webworx Inc. and its principal, Mr. A. Webworx had induced iTrade into financing phony contracts payable to Webworx. By the time the scheme was uncovered, iTrade had lost more than $5 million.

iTrade successfully sued Webworx and Mr. A, and was granted a tracing order against Mr. A to help it determine whether any of the iTrade funds could be traced to assets in the hands of persons "other than bona fide purchasers for value without notice" – bona fide buyers who had provided something of value in exchange for the assets and didn't know that the assets had been obtained fraudulently.

iTrade was able to trace some of the funds to a BMO Nesbitt Burns investment account in the names of Mr. A and his spouse, Ms. R. Unfortunately for iTrade, BMO claimed it was entitled to the funds held in the investment account.

Mr. A and Ms. R had a line of credit with BMO. The bank had agreed to raise their credit limit upon the spouses granting a pledge of their investment account to BMO. All parties agreed that BMO had no notice that the shares in the investment account had been purchased with proceeds of the iTrade fraud.

Despite some documentation being executed in connection with the pledge and increased credit limit, the bank never obtained a written security agreement pledging the investment account assets from Mr. A or Ms. R. Perhaps even more surprising, BMO did not register its security interest under Ontario's *Personal Property Security Act* (PPSA). Mr. A and Ms. R did, at a later point, sign a "Notice and Direction" which confirmed that they had granted a security interest in the investment account to the bank. Regardless, BMO argued that it had a security agreement with Mr. A and Ms. R, one that was partly written and partly oral.

The case boiled down to determining which party was entitled to the funds in the investment account, iTrade or BMO? Despite all of the shortcomings in the BMO pledge arrangement, the Court of Appeal ultimately found that BMO was entitled to the assets in the account.

The Court did not rely on priorities granted by the PPSA to resolve the dispute and even questioned whether the PPSA applied in light of section 4(1) of the PPSA which states that the PPSA *does not* apply to a lien given by statute or by rule of law. iTrade's claim of a constructive trust (a trust imposed by a court in cases of unjust enrichment) over the investment account funds was arguably a lien given by rule of law.

Nevertheless, the Court found that if the PPSA did apply, BMO had an enforceable security interest in the investment account assets. Although BMO had not registered a financing statement under the PPSA, the Court found it had perfected its security interest by possession of the collateral (the investment account). [It should be noted that facts in the case arose before amendments to the PPSA permitting a secured creditor to perfect its security interest by "control" came into force.]

iTrade had argued that BMO could not have a security interest in the investment account assets because, since the assets in the account were obtained with funds fraudulently obtained from iTrade, Mr. A could not have sufficient rights in the assets to create a security interest in favour of BMO.

The Court of Appeal disagreed. iTrade, although induced to do so by fraud, intentionally transferred its rights in the funds to Webworx/ Mr. A. At the time of the transfer from iTrade to Webworx, iTrade was in a position to void the transfer of the funds. However, once a fraudster (Mr. A) transfers such property to a bona fide purchaser for value without notice of the fraud (BMO), the original transaction can no longer be voided and the bona fide purchaser takes the property free of the fraud.

BMO was a bona fide purchaser for value without notice. All parties to the case agreed that BMO had no notice that the shares in the investment account had been purchased with funds fraudulently obtained. In exchange for the pledge of investment account assets, BMO gave value by increasing Mr. A and Ms. R's credit limit. [The Court stated that the fact that BMO purchased from Mr. A personally and not Webworx directly (to whom iTrade had advanced the funds) was immaterial. There was to be no distinction between the fraudster and the corporate vehicle he used to perpetrate the fraud.]

Lastly, the Court rejected iTrade's claim of a constructive trust over the assets in the investment account. In order for a court to grant this equitable remedy, there must be (i) a benefit to or enrichment of one party, (ii) a corresponding detriment suffered by the other party, and (iii) the absence of a juristic (recognized in law) reason for the enrichment. BMO conceded that iTrade suffered a detriment, and the Court proceeded on the assumption (but not the determination) that the bank had been correspondingly enriched.

The Court found that there were valid juristic reasons for the enrichment, namely, that, (i) there was a valid contractual agreement between BMO and Mr. A and Ms. R, (ii) Mr. A and Ms. R had sufficient rights in the investment account property to transfer that property to BMO, and (iii) BMO was a bona fide purchaser for value without notice of the fraud.

BMO had entered into a valid and legitimate contract with Mr. A and Ms. R without any knowledge that the assets in the investment account had been purchased using monies that were fraudulently obtained from iTrade.

While BMO ultimately succeeded in keeping the assets in the investment account, lenders in their position would be well advised to always obtain a pledge agreement in writing and to register their security interests under the PPSA, and, where appropriate, obtain control of the pledged securities.

In addition, it is critical that parties in iTrade's position be aware that even when the proceeds of fraud can be traced, recovery is rarely possible once the ill-gotten property has been purchased by an innocent third party.

iTrade may have succeeded if it had taken valid security from Webworx and Mr. A – including a security interest in any investment accounts in Mr. A's name – and registered their security interests under the PPSA. But it didn't and, as is inevitably the case when fraud is involved, innocent parties will rarely ever be made whole.

Blaney McMurtry LLP is pleased to announce

Tammy A. Evans

has joined the firm as a Partner in our Real Estate/Leasing and Architectural/Construction/Engineering Services (ACES) groups.

Tammy's practice is focused in all aspects of condominium development and construction law. Tammy has extensive experience in property development acting for owners, developers, landlords and financiers.

Prior to completing her law degree, Tammy spent over 15 years in the land development industry working closely with developers to coordinate the creation and completion of a range of commercial, residential and industrial developments, from hotels to business centres to condominiums and residential subdivisions.

Tammy was called to the Bar of Ontario in 2002.

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Blaneys on Business is a publication of the Corporate/Commercial Group of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com.
Legal questions should be addressed to the specified author.

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