

CANADA / JUDGMENT

Culp v. KPMG et al.

2006 BCSC 1599

COURT

Supreme Court of British Columbia

DECIDED

30 June 2006

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2006 BCSC 1599 Culp v. KPMG et al

IN THE SUPREME COURT OF BRITISH COLUMBIA

Citation:

Culp v. KPMG et al.,

2006 BCSC 1599

Date: 20060630

Docket: S056713

Registry: Vancouver

Between:

Dr. Stephen Culp,

In Right of the Trustee in Bankruptcy of IC Creative Homes Inc., a Bankrupt

Plaintiff

And:

KPMG Inc., KPMG Management Services Inc., KPMG LLP,

Peter MacIntosh and MEJ Consulting Ltd.

Defendants

And:

Brian Grady and Kevin Grady

Third Parties

Before: The Honourable Mr. Justice Rice

Oral Reasons for Judgment

In Chambers

June 30, 2006

Counsel for Plaintiff

R.W. Taylor

Counsel for Defendants, KPMG Inc., KPMG Management Services Inc., and KPMG LLP

H.A. Mickelson

A.D. Gay

Counsel for the Defendants, P. MacIntosh and MEJ Consulting Ltd.

L. Broshko

Place of Trial/Hearing:

Vancouver, B.C.

- [1] THE COURT: This application arises from the bankruptcy of IC Creative Homes Inc., ("ICCH"). The principals of the company were two brothers, Brian and Kevin Grady. ICCH operated from early 2002 until mid-December 2004 when it became bankrupt pursuant to the Bankruptcy Act, ("BIA"). As of the date of its bankruptcy, ICCH had 200 creditors, about, including KPMG LLP and certain of its affiliates and also Culp Investments LC.
- [2] On July 19th, 2005, Dr. Stephen Culp, the principal of Culp Investments LLC obtained an order which I will call the first order pursuant to s. 38 of the BIA authorizing to commence a proceedings against KPMG, KPMG LLP, Peter MacIntosh and MEJ Consulting Ltd. In October 6th, 2005, Master Keighley, who had granted the first order, ordered a stay pending full hearing as to whether he should set aside or vary the first order. That full hearing took place in December 25th and on December 21st, 2005, Master Keighley dismissed the application on grounds that KPMG had no standing to challenge the first order and with that on December 21st, 2005, Dr. Culp commenced this action which we will call the action.
- [3] KPMG now appeals Master Keighley's decision of December 21st, 2005, the second order, pursuant to s. 192(4) of the BIA or in the alternative Rule 53(6) of the Rules of Court. KPMG further seeks an order pursuant to s. 187(5) of the BIA to rescind the first order and a further order striking out the writ and statement of claim in the action.
- [4] In its written argument, KPMG says that:

The core basis for the rescission is that at the time that the s. 38 order was sought and obtained, Dr. Culp's counsel was simultaneously counsel for Brian Grady, a likely target defendant, putting Dr. Culp and his counsel in a conflict of interest with participating creditors who would be invited by virtue of the first order to join in the proceedings and that Dr. Culp failed to disclose this to the court.

- [5] For the same reason, it is argued that KPMG was entitled to standing.
- [6] Alternatively, KPMG argues that the first order should be rescinded because Dr. Culp is not a creditor of ICCH. The proof of claim was filed by Dr. Culp on behalf of Culp Investments LLC and KPMG argues that the action should be dismissed at least against KPMG Inc. and KPMG Management Services since neither of them were named in the first order. Alternatively, KPMG argues that certain paragraphs of the statement of claim should be struck because they purport to advance personal claims of individual creditors rather than those of the bankrupt. Finally, KPMG seeks security for costs in the event that the written statements of claim are not struck.
- [7] The matter came before me and was argued for the three days commencing June 26th, 2006. After submissions Mr. Taylor on behalf of Dr. Culp gave assurances that the action against the KPMG defendants was not intended to include personal claims of the participating creditors. He maintained that references in that regard were intended as background to explain the circumstances of the claim; however, he conceded that some reduction of narrative was possible and he and Mr. Mickelson for KPMG agreed to adjourn that part of the application and confer. If the decision on this application is not to rescind the first order, then Mr. Taylor will seek to amend the statement of claim accordingly by consent. If they cannot agree, they may return to court for further argument and resolution of that issue before me.
- [8] As regards KPMG's application for security for costs, that will be adjourned generally by consent. Apparently now with more information than before on the participating creditors and with more to come perhaps, KPMG may be content to review that information and decide in due course whether the application is necessary. This presupposes that the first order will be rescinded.
- [9] Section 38 of the BIA provides as follows:
 - 1. Where a creditor requests the trustee to take any proceeding that in his opinion would be for the benefit of the estate of the bankrupt and the trustee refuses or neglects to take the proceeding, the creditor may obtain from the court an order authorizing it to take the proceeding in his own name and at his own expense and risk on notice being given, the other creditors of the contemplated proceeding and on such other terms and conditions as the court may direct.

2. On an order under subsection (1) being made, trustee shall assign and transfer to the creditor all his right, title and interests in the chosen action or subject matter of the proceeding, including any document in support thereof.
3. Any benefit derived from a proceeding taken pursuant to subsection (1) to the extent of his claim and the costs belongs exclusively to the creditor instituting the proceeding and the surplus, if any, belongs to the estate.
4. Where before an order is made under subsection (1), the trustee with permission of the inspector signifies to the court his readiness to institute a proceeding for the benefit of the creditors the order shall fix the time within which he shall do so and in that case the benefit derived from the proceeding if instituted within the time so fixed belongs to the estate.

[10] The court's jurisdiction to rescind the first order is stated in subsection 187(5) of the BIA:

The court may review, rescind or vary any order made by it under its bankruptcy jurisdiction.

[11] Reference to *Caisse Populaire Vanier v. Bales*.

[12] Before dealing with KPMG's chief substantive argument for rescission in the first order, I will address the defects alleged on the face of the order. Dr. Culp seeks orders to cure them by substitution. Mr. Mickelson for KPMG argues that it is uncertain that all of the defects are curable particularly the substitution of the Culp Investments LLC for Dr. Culp as the applicant which Dr. Culp seeks. Mr. Mickelson cites *Shaw v. Kocken*, *Volhoffer v. Volhoffer* and *Avco Finance v. Suppa*.

[13] I disagree that those authorities establish in this case that the first order is a nullity. It is settled law in this province that failure to comply or incomplete compliance with s. 38 of the BIA is to be treated in appropriate circumstances as an irregularity only. If it can be cured without prejudice to other parties and if there is no prejudice or injustice then that may be allowed by an order nunc pro tunc. That is with reference to *Jaston v. McCarthy*.

[14] Section 187(9) of the BIA provides as follows:

No proceeding in bankruptcy shall be invalidated by any formal defect or by any irregularity unless the court before which an objection is made to the proceeding is of the opinion that substantial injustice has been caused by the defect or irregularity or that the injustice cannot be remedied by any order of that court.

[15] In my view the amendments proposed to cure the defects are appropriate. First, there is the naming of Dr. Stephen Culp as the applying creditor in the order. It was Culp Investments LLC that filed a proof of claim and on the evidence the debt claimed was on behalf of Culp Investments LLC not Dr. Culp personally. Dr. Culp, in an affidavit, swore that he mistakenly thought that he had filed the proof of claim personally. The switch would not prejudice any other party and there is no other reason why the substitution should be disallowed and therefore it is so ordered.

- [16] Next KPMG argues that the form of the first order is vague and in a description of the proceeding to be assigned to the applying creditor it simply says "this court orders that that the applying creditor is authorized to commence and prosecute an action in contemplated proceedings wherein the applying creditor is the proposed plaintiff and KPMG LLP, Peter MacIntosh CA and MEJ Consulting Ltd. are the proposed defendants." There is no description of the nature of proceedings.
- [17] Mr. Taylor has not conceded that any change is necessary. The form is a standard form apparently used by trustees in bankruptcy; however, Mr. Taylor agrees that a brief general description of the nature of the proceeding would be appropriate. I agree that it is appropriate and by consent that issue will be adjourned for both counsel to fashion an appropriate amendment. If they cannot agree then either of them may apply before me at which point I will make a ruling on whether the current wording is defective and if so depending on my ultimate ruling on the application I will determine what the wording should be. Again, in my view, if this is the defect, it is one that may be cured by amendment and not one which necessarily renders the first order a nullity.
- [18] Next, there is the failure by Dr. Culp to name KPMG Inc. and KPMG Management Services Inc. in the first order so as to support their inclusion as defendants in the action. Mr. Mickelson offered no reason why this would be a prejudice to any of the other parties. It is appropriate therefore to add their names as parties against whom proceedings are authorized and I so order.
- [19] Of course in the action if there turns out to be no cause of action against any one or more of those entities, the appropriate application may be made for dismissal.
- [20] The conflict issue. The s. 38 application as provided in the BIA is procedural and it is in the nature of ex parte. An applicant need not notify other creditors until after the order is made and there is no provision in the BIA for any other party to be represented at the hearing. The learned master in his reasons given at the hearing of the second order first addressed the question as to whether KPMG had standing to impeach the first order. Mr. Culp contended that KPMG did not have standing based on the accepted authority of *Formula Atlantic Financial Corp. v. Canada (A.G.)*, [1994] B.C.J. No. 3253 (BCCA). In that case Taylor J. commencing at paragraph 8 stated:

I do not understand how such an argument could succeed. These decisions, taken together, seem to me to establish clearly that on a s. 38 application, such as that which resulted in the present order, neither the bankrupt nor any other proposed defendant in the intended action has a right either to notice or to be heard on the application, and that neither the bankrupt nor any other proposed defendant will have standing to appeal any order made on such an application, provided that it goes no further than to authorize action to be brought--this being for the reason that their rights will not be affected by a s. 38 order so long as it goes no further than that. The effect of the order is to transfer from trustee to creditor whatever right of action may exist--much, no doubt, as a chose in action may be contractually transferred from one party to another,

without adversely affecting the debtor. The order in this case imposes no liability on the appellant which did not previously exist, and leaves it free to assert in the action every defence it ever had.

The defendant in the action, of course, may move for summary dismissal of the claim if the plaintiff is unable to make out a prima facie case.

[21] Mr. Mickelson rightly submitted that unchecked, a s. 38 order could be obtained by fraud, with no way to impeach it.

[22] The learned master recorded KPMG's answers as follows:

KPMG says that at the hearing of the s. 38 application counsel for Culp failed to disclose to the court that he is also counsel for Brian Grady who was an officer and director and the controlling mind of ICCH and KPMG says an obvious target defendant for creditors. KPMG points out that not only is Culp's counsel acting for Grady in these proceedings, Grady is one of the participating creditors, but is also counsel for Grady's Texas company in other proceedings related to the failure of ICCH, proceedings in which the Texas company has instituted a third party claim against the bankrupt estate ICCH. It also appears, says KPMG, that Culp's lawyer was the advisor to Grady and ICCH prior to the bankruptcy. These material non-disclosures, says KPMG, require that without notice order be set aside as a matter of course. *Re Hoy*.

In addition KPMG says that the notice sent to creditors following my July 19th order did not disclose to them that counsel for the applicant was also counsel for Grady and that the decision not to name Grady in the action was made by counsel for Grady. KPMG also indicates that it intends should Culp's action proceed to issue third party proceedings against Grady which will then have the effect of underlining counsel's conflict of interest.

KPMG further says that the assignment of the subject claim to Culp in the circumstances where Culp's counsel is in conflict by virtue of his representation of Grady and the potential for prejudice to the participating creditor group creates a troubling appearance which should not be countenanced by this court. In the case of *MacDonald Estate v. Martin*, [1990] 3 S.C.R. 1235. The court recognized that the rules of professional conduct established by Law Societies across the country must be taken as the collective views of the profession as to the appropriate standards to which the profession should adhere.

As to the role of the courts in policing conflicts, Sopinka J. said at paragraph 18:

The courts which have an inherent jurisdiction to remove from the records solicitors who have a conflict of interest are not bound to apply a code of ethics. Their jurisdiction stems from the fact that the lawyers are officers of the court and their conduct in legal proceedings which may affect the administration of justice is subject to this supervisory jurisdiction.

[23] In his discussion of KPMG's argument the learned master stated that s. 38 of the BIA:

"Establishes a statutory mechanism whereby a creditor may advance a claim for the benefit of the bankrupt estate which the trustee declines to bring. On the hearing of the applicant's motion the court does not adjudicate the merits of the claim."

[24] The learned master went on to discuss authorities in regard to whether an applicant for a s. 38 order must prove a prima facie case. That issue is not raised in this appeal either with respect to the proposed defendants or the two new KPMG defendants.

[25] S. 187(5) of the BIA was not pleaded. The subsection permits a court to review, rescind and vary any order made by it under its bankruptcy jurisdiction. I am, however, of the view that the provision cannot be used to invoke any wider test for standing than would otherwise apply.

[26] The master concluded as follows:

It seems settled that *Formula Atlanta*, supra, decision that KPMG has no standing. In the absence of fraud to impeach a s. 38 order which is essentially a matter between the trustee and the applicant creditor, fraud is neither proved nor alleged. What is alleged is evidence of circumstances suggesting present or potential conflict which justify the intervention of the court to protect the integrity of its own processes. I am not, however, satisfied that this is presently necessary. The issues of conflict may be dealt with in the action itself and it is at that stage at which the court may determine to play a role in regulating the conduct of the action and counsel. KPMG will remain free to assert any defence it may have to the claim advanced by Culp and others.

[27] Mr. Mickelson for KPMG argues that the master erred in law in stating that from *Formula Atlantic* KPMG "has no standing in the absence of fraud to impeach the order." The court in *Formula Atlantic* did not say that fraud alone would suffice to permit standing. It provided only that a court would not allow its process to be used to perpetrate a fraud. In fact, there are other circumstances that the courts have intervened to protect the integrity of their processes and Mr. Mickelson cited several examples for instance, *Chien British Columbia Supreme Court 2005* and *Shaughnessy Brothers Ontario High Court of Justice 1985*.

[28] In *781332 Ontario Inc. v. Mortgage Insurance Co. of Canada* the court confirmed that counsel as an officer of the court had standing to raise an issue where there are circumstances casting a shadow on the integrity of the administration of justice which in that case was opposing counsel's conflict of interest. Mr. Mickelson argued and I agree that it is settled law that the courts have inherent jurisdiction to remove from the record solicitors in conflict of interest positions. For instance, *MacDonald Estate v. Martin*, (supra) and *Mara v. Blake* [1996].

[29] Mr. Mickelson also cited *Laser Works Computer Services Inc.* That concerned the conduct of a solicitor gathering proxies for a creditor on a vote on a proposal in bankruptcy. It was found that the creditor was a competitor of the debtor and had undertaken a campaign of gathering votes in order to defeat the proposal for the dominant purpose of putting the

debtor into bankruptcy in order to lessen competition noting that the courts will not grant a petition in bankruptcy where it has been felt for an improper purpose. The court acknowledged its responsibility to prevent abuse under the provision was the BIA and ruled that the proxy votes could not stand.

- [30] Neither side in this application cited cases where the courts have considered intervention in a s. 32 matter where conflict of interest is alleged. By Mr. Mickelson's reckoning, Mr. Veinotte, a solicitor with the firm acting for Mr. Grady and then Mr. Culp, which I will call the firm, were in an impossible conflict of interest that very seriously jeopardized the interests of the participating creditors. By having acted for Mr. Grady, the firm was bound not to use confidential information gained from working for Mr. Grady either in order to fully inform the participating creditors or to advise and take instructions to sue Mr. Grady rather than KPMG. This problem, Mr. Mickelson pointed out, was not unknown to Mr. Veinotte when he took steps on behalf of Mr. Culp to engage the support of the other creditors. In an e-mail dated September 20th, 2005 to one of the creditors, Mr. McCan, he wrote:

Brian Grady is in and you will have to make your own decision whether that is acceptable to you. As I said, I cannot defend the guy against other clients but what will be necessary in my view however is cease fire. If Brian gets anything out of this claim well I guess there will be money there and people can sue his ass off.

- [31] Mr. Taylor argued that the conflict was only a potential one until the event of Mr. Grady being joined in the proceeding. He argued that the firm's engagement on behalf of Dr. Culp was limited to securing the s. 38 order and pursuing KPMG and that the firm had resigned from all services provided to Grady.
- [32] My conclusion is that Mr. Mickelson is right about the existence of the conflict and right that Mr. Veinotte failed to recognize it. It was not potential. It was already in play when he took instructions to seek the s. 38 order for Mr. Culp's company/creditor. It was a serious conflict and it was not resolvable by purporting to limit the retainer or by disclosures indicated in the materials. Indeed, the evidence showed that some creditors like Mr. McCan and a Mr. Hinkson were unaware that Mr. Veinotte had acted for Mr. Grady and Mr. Mickelson described several allegations of wrongdoing against Mr. Grady that could have persuaded them to want to take action against him rather than KPMG.
- [33] Further, Mr. Mickelson points to the failure of the firm to disclose the conflict when it applied for the first order on behalf of Dr. Culp. The proceeding being by nature *ex parte*, there was a duty, argues Mr. Mickelson, of full and frank disclosure in the absence of which the court ought to exercise its discretion to dismiss.
- [34] In *Hoy*, Wallace J. said in those circumstances the setting aside of the *ex parte* order follows as a matter of course.

- [35] Without authorities from counsel in this proceeding I do not take Hoy to mean that any of the court's discretion is reduced or overridden in such circumstances. The court is not obliged absolutely to set aside an order for material non-disclosure.
- [36] I am persuaded by Mr. Mickelson's argument that the learned master expressed himself so as to restrict standing and rescission of an s. 38 order to cases where fraud is alleged. It was a question of law and the test is not as narrow as that on a fair reading of *Formula Atlantic*. There is room for the court to allow access in other circumstances where the administration of justice is abused or brought into disrepute.
- [37] I am less sure, however, that the learned master's restrictive interpretation made a difference to the decision he made. His conclusion on the facts was that it was presently unnecessary for the court to intervene to protect the process. At any rate, it is possible that the learned master did not apply his mind to the submissions and evidence upon conflict of evidence because of the acknowledged absence of fraud. It is appropriate therefore that I examine those facts and decide for myself whether the conflict in this case rises to an abuse of the process calling for rescission of the order.
- [38] As I said, there was no case known to either counsel where the court has rescinded a s. 38 order on the grounds of alleged conflict of interest. Not that a conflict of interest such as the facts portray in the case ought to be trivialized. On the contrary. However, there is a difference in the effects and the accepted means of dealing with lawyer's conflicts compared to the case of fraud. Compared to the case of fraud, a conflict of interest of counsel is typically resolvable and is resolved by application to the court for removal of counsel in the action in question. In this case the action has been commenced and it is open for KPMG at any time to apply for the firm to be removed as counsel. In the meantime, there is little prejudice evident, real or potential to other creditors if they are obliged to follow that course vis-à-vis having to start all over in the event that the first order is rescinded.
- [39] KPMG's arguments to the effect that the participating creditors have been virtually duped and are at peril is denied strongly by Mr. Taylor who reminds us again that no fraud is alleged. There is nothing alleged in the conduct of Dr. Culp himself or his company in the nature of fraud or acting for an improper purpose or any other irremediable wrongdoing. There is in the case of conflict of interest every means within the action to end and to rectify any prejudice caused by the conflict and although as I have said *Formula Atlantic* probably offers a broader range of exceptions than fraud in order to establish standing, it remains fairly exceptional and I do not see why an extraordinary adjudication of the conflict issues in this case is in order in this s. 38 hearing. In short, I agree with the learned master's reasoning that the intervention by the court in this case was presently unnecessary.
- [40] Neither is it advisable in my view. The s. 38 process is intended to be procedural only, a means of providing access to the court.

- [41] As for lack of comment by the master in his decision as to why he did not rescind his order because of the non-disclosure, it seems to me implicit from his decision and from the fact that he heard the submissions on that very point that he decided on the whole of the circumstances that non-disclosure was not material or in any event did not justify dismissal of the application. He was not clearly wrong in other words, or wrong at all in my opinion.
- [42] My review of the material and consideration of the submissions made in this hearing persuade me for that same reason not to rescind for non-disclosure. It is evident that Dr. Culp and his counsel did not recognize an existing conflict. They acknowledge that they would have to resign if and when one arose and given that there has been no precedent for dealing with this issue at the s. 38 application stage it was not unreasonable for them to believe it was not an issue that required disclosure.
- [43] At this point it is appropriate for me to clarify the standard of review in this court. On appeal from a master's order the question is whether the order is clearly wrong but there are two exceptions; one is with respect to orders characterized as being vital to the final issue, and the other is where the appeal is based on a point of law. In those two circumstances my review is by way of re-hearing unfettered by any deference to the order under appeal. The Stoneman case.
- [44] Accordingly, the clearly wrong test is not appropriate on the question of the master's interpretation of the decision in Formula Atlantic and I must re-hear it and make a fresh decision and I have done so. The question of whether or not to dismiss based on the failure of full and frank disclosure and whether the intervention of the court was not presently necessary. I agree with the Master's findings.
- [45] The application to set aside the first and second orders of the learned master are therefore dismissed. Arguably there is a divided result and I invite counsel to speak to costs either now or at some other time. Is there anything I haven't covered?

(Submissions re costs)

- [46] THE COURT: Costs for the plaintiff of \$2,000 for costs and disbursements for all aspects of the applications that have been heard.

"E. Rice, J."

The Honourable Mr. Justice E. Rice

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