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Canada Southern, Pressed by its Minority, Sues Penn Central over Asset-Stripping

Minority shareholders of Canada Southern Railway Company, alleging that successive US companies in the New York Central/ Penn Central group have stripped its assets, are agitating for the removal of Canada Southern's US-controlled Board of Directors, and the cancellation of its operating lease. Canada Southern's main asset is 200 miles of track between Windsor and Niagara Falls.

Throughout its history, which began in the 1880s, Canada Southern has leased its entire operation to successive companies in the Penn Central group, and it has been controlled, through the majority of its stock holdings, by the same companies who were, and are, successively the lessee. Present lessee and controlling shareholder, following a massive US bankruptcy reorganization, is Consolidated Rail Corporation (Conrail), which is a US government-sponsored company designed to take over the freight operations of the bankrupt Penn Central.

In agreement with some but not all of the minority's allegations, the present Conrail-controlled Canada Southern board is suing former lessees Michigan Central Railroad Company and Penn Central for an estimated $25 million for abuses of the lease.

However, Conrail is continuing to practise some of the operating and accounting practices it says were improper in its predecessors, pending the outcome of the suit.

One of the minority shareholders was unsuccessful in a court application to restrain Conrail from voting its shares at the annual shareholders meeting held earlier this month. Conrail holds about 107,000 out of 150,000 outstanding Canada Southern shares, and a minority shareholders committee headed by Albert D. Segal represents about 20,000 shares. So the Conrail nominees were re-elected.

As well, there are two applications pending before the Canadian Transport Commission, one by Conrail to confirm the transfer to it of the Canada Southern lease and stock-control, and one by Segal for a declaration the lease is breached and terminated.

Canada Southern, like the original lessee Michigan Central, was apparently part of the railway empire of Cornelius Vanderbilt, and like many of the Quebec and Ontario railroads of the time, it arranged a net lease of all its undertaking within the family, for reasons that are not entirely clear today. The lease, ratified by the Canadian parliament in 1904, calls for the lessee to operate the railroad, pay interest on the corporate debt and all taxes and assessments, and also pay rent equal to 3% on Canada Southern's $15 million of outstanding stock (150,000 shares of $100 per share value).

The setup is similar to the lease between the Ontario and Quebec Railway Company and Canadian Pacific, which was the subject of similar minority shareholder agitation and a lengthy court case decided last year by Justice Samuel Hughes, who held that proceeds from sales of O & Q lands by CP were to be held in trust for the O & Q company.

The Canada Southern claims are more complicated, and they include accounting for land sales, sales of rolling-stock and other depreciable assets, and tax and capital cost allowance issues.

Conrail, which took over Canada Southern on April 1, 1976, first served on the Penn Central trustees a demand for arbitration of the 1904 lease — something the lease provides for — but arbitration has been resisted by the Penn Central trustees, and now the Conrail-controlled Canada Southern has sued Penn Central in Supreme Court of Ontario on the same allegations as in the arbitration demand. The Ontario action was filed June 1, two days after Segal filed his (unsuccessful) action to have Conrail barred from voting its Canada Southern stock.

The minority shareholders say it doesn't make sense for Conrail to claim its predecessors abused the lease while Conrail itself continues to do so.

The problem with the lease is that although it clearly sets out the operating agreement by way of a net lease, it doesn't say much about the disposal of assets. Nothing in the lease refers specifically to land sales, and as to rolling-stock and other depreciable assets, it says the lessee will operate them, keep them in good condition, and at the end of the lease will restore them to the lessor in as good condition as they were originally.

Successive lessees interpreted the provision about rolling-stock as follows: the lessee can dispose of such assets, keep the proceeds, and book an amount payable to Canada Southern of the amount of a 1928 appraisal of the assets, payable at the termination of the lease. And as controlling shareholder of Canada Southern, the lessee booked a corresponding Canada Southern receivable from the lessee. This was apparently based on interpreting the "as good condition" clause as being satisfied by a debt equal to the book value. The lessee was prepared to restore, not the assets in good condition, but instead their original book value in dollars, at the termination of the lease. Then as a set-off against these debts of lessee to lessor, the lessees charged to Canada Southern the cost of "additions and betterments" to the depreciable assets. In other words, if old stock was replaced, Canada Southern was debited with the present-day cost of the new assets, and credited with the 1928 value of the assets sold. And if assets were sold and not replaced, the lessee kept the proceeds and credited the Canada Southern account with their 1928 value, to be paid at the termination of the lease.

The Conrail-controlled Canada Southern claim is that it should get the proceeds of the sales (or book value if it happens to be higher than a sale for scrap value), and it shouldn't be charged with the cost of additions and betterments, since they are part of the lessee's obligation to maintain the railroad in good condition.

As a result of the improper practice, says Canada Southern, "Penn Central and Michigan Central have (a) disposed of and not replaced substantial amounts of Canada Southern's rail assets including rolling stock for undetermined amounts, and have retained the benefit of such proceeds at the expense of Canada Southern; (b) avoided their obligation to maintain Canada Southern's depreciables and rolling stock in good order during the continuance of the lease; and (c) saved maintenance, insurance and taxes."

Nevertheless, the Conrail board of Canada Southern is continuing to use the system it attacks, pending the outcome of the suit, and the 1978 Canada Southern statements say that from the beginning of the Conrail regime in 1976 until March 1979, the net effect of those procedures has been an amount of $2.1 million payable by Canada Southern to Conrail. That's more than the total rent payable by Conrail to Canada Southern for that period.

The claim also says land sales have been improperly handled, and in this case Conrail has corrected its procedures in line with its

Continued on page 2

Canada Southern

claim. What happened was that until 1963, all proceeds of land sales — made by Canada Southern at the behest of the controlling shareholder, the lessee — were paid to Canada Southern, or so Canada Southern says. But in 1963 a novel procedure was introduced under the Penn Central pre-bankruptcy regime. It decided in its double capacity it would place the cash proceeds of Canada Southern land sales in a Canada Southern "restricted account," treat the cash as a substitute asset for the real property, and in effect lease the cash as part of its overall lease from Canada Southern. The thinking was original, but the aim was simple: on that theory, the lessee, Penn Central, would be entitled to the interest income earned by the "restricted account," just the same as it had been entitled to earn income from the real property as part of the railroad lease.

Says Canada Southern: "Under this practice, which has no sanction in the lease, the lessor would be deprived of the use of such proceeds, or the earnings therefrom, until the termination of the lease. The entire benefit of such sales and abandonments was for Penn Central, which was relieved of its obligations under the lease to maintain the properties in good repair, and was relieved of its obligations to pay real estate taxes on such properties. Each such sale or abandonment required approval by the Canada Southern Board of Directors, which was obtained although Canada Southern did not receive any benefit."

Canada Southern also has a complicated tax claim against Penn Central.

It isn't clear whether Canada Southern will continue to pursue its claim through its demand for arbitration, or through the Ontario court action.

The minority shareholders aren't satisfied, but it is also unclear what they will do next, apart from maintaining the Canadian Transport Commission application to have the lease declared breached.

A major impediment in their efforts to remove the Conrail nominees from the Canada Southern board of directors is contained in an unnoticed section of the Hughes decision in the O & Q case. A section of the Railway Act says: "No person who holds any office, place, or employment in the company, or who is concerned or interested in any contract under or with the company, is capable of being chosen a director, or of holding the office of director." In the O & Q case, the minority shareholders said since the O & Q directors were also officers or employees of Canadian Pacific, and so were "concerned or interested" in the CP-O & Q lease, they were disqualified from being O & Q directors. But Justice Hughes said the statute and the cases cited to him were intended to cover cases involving possible "private advantage" of the director himself, and not the type of interlocking directorship in the case before him. Hughes said: "The situation (in O & Q) was almost, if not demonstrably unique, and the type of double-dealing which is the cause of disqualification when proscribed by statute and discountenanced in the courts was evidently absent."

The same legislation was cited in the recent Canada Southern minority application, and the judge said he was bound by that section of the Hughes decision.

An Ontario court decision on another type of conflict allegation was released last August in a case in which Canada Southern sought to bar the Toronto law firm of Kingsmill, Jennings from acting for Penn Central in the proposed arbitration, on the grounds that predecessor Kingsmill firms had acted for over 100 years for Canada Southern, so they shouldn't now be acting for the opponent.

In fact, Nicol Kingsmill was a signing officer of Canada Southern along with Cornelius Vanderbilt when the lease was first entered into in the 1880s, and a year after his death in 1912 he was eulogized in Canada Southern minutes as a man who "took an important part in the construction and development of the Canada Southern Railway, and procured all the corporate legislation affecting it . . ." The successor firm continued to act for Canada Southern in the 1970s, including, Canada Southern alleged, several real estate transactions.

Kingsmill Jennings also acted for the lessees Michigan Central, New York Central and Penn Central during their respective periods of control, and they were refusing to turn over files to Canada Southern, claiming solicitor-client privilege on behalf of Penn Central.

Moreover, said a Canada Southern lawyer, it was the Kingsmill Jennings firm that gave its opinion on the legitimacy of the 1963 novelty that allowed Penn Central to get the interest income from sales of Canada Southern lands, one of the key issues in the arbitration.

Penn Central trustees had sought an opinion from Toronto lawyer John Robinette of the McCarthy and McCarthy law firm, and he advised by letter in 1977 that in his opinion in Ontario law no conflict existed. He said Kingsmill Jennings had really been acting for the majority shareholder and lessee New York Central/Penn Central, and not for Canada Southern, at least in recent times. Justice Southey, who was presented with letters by Kingsmill Jennings that explicitly said they acted for Canada Southern, ruled that even if Kingsmill was acting for Canada Southern, the law firm had no confidential information that wasn't already available to the controlling shareholder, since Canada Southern was in fact being run as an arm of the controlling shareholder.

"The officers of Canada Southern," said Justice Southey, "were all employees or agents of New York Central or Penn Central. Canada Southern had no employees of its own. And information received by the law firm from persons on behalf of Canada Southern must have been known to New York Central or Penn Central, of which such persons were officers, employees, or agents. During this period Canada Southern, rightly or wrongly, was being treated as a part of New York Central or Penn Central, despite the fact that it was not a wholly-owned subsidiary. It had no secrets from New York Central or Penn Central."

Southey concluded there was therefore no conflict.

In the overall picture, Conrail's position now is that its nominees, who are the Canada Southern board of directors, are acting independently, and although they were nominated by Conrail, a successful prosecution of their claims will eventually work to the detriment of Conrail as lessee. Their nominees, elected or re-elected earlier this month, are three Conrail officials, together with Brandon Sweitzer, and official of Wood Gundy Ltd, Toronto, and Ardagh Sidney Kingsmill, a partner in the law firm of Tilley, Carson and Findlay.

The Canada Southern situation has led to the freezing of about $10 million in funds acquired by Penn Central and Michigan Central in April 1976, including $5.5 million proceeds of a special Canada Southern dividend. All these funds are being held pending court determinations of what parties are entitled to them.

The "special dividend" of $60 per share was declared by Canada Southern March 29 1976, two days before the transfer of control from Penn Central to Conrail. About $6 million of the $9 million dividend belonged to the control block. It was declared payable to shareholders of record at April 9 1976, after the Conrail takeover, but Conrail agreed Michigan Central and Penn Central would be entitled to the dividend. However, the funds were frozen under the jurisdiction of the US bankruptcy court. The dividend wiped out $9 million of Canada Southern's $12 million of current assets.

A few days thereafter, the new Canada Southern board authorized the sale of Canada Southern's shares in Toronto Hamilton and Buffalo Railway; and Penn Central and Michigan Central sold their TH&B shares as well. All the sales were to Canadian Pacific. The proceeds of the Michigan Central and Penn Central sales, totalling $4.5 million, the Canada Southern company says, "have been placed in excrow with a Canadian bank, pursuant to orders of Canadian courts which provide for release of funds upon further court order. Canada Southern sought to excrow the funds to retain them in Canada until its claims against Penn Central and Michigan Central have been resolved by way of arbitration, judgment, settlement, or otherwise."□

Rents: The Market Snubs Rent Review And Posts a Record 1978 Increase

Toronto year-to-year residential rent increases in 1978 were far in excess of what would be expected with an even moderately effective rent review program, according to figures in a recently-released Ontario government rental survey. The figures indicate the rent review program has become largely cosmetic, and an easing in rent increases when the program was introduced in 1976 has, in the market parlance, been "corrected."

The Ontario Housing Ministry's Rental Market Survey for 1978 indicated the average Toronto rent level rose by 10% during the twelve-month period to October 1978, which is higher than the average rate of increase in the four years prior to rent review. The survey results also show that a substantial majority of residential landlords are obtaining illegal increases and avoiding the rent review provisions entirely.

Considering first only those tenants who hadn't moved during the year, the survey indicates 32% of Metro Toronto tenant households had increases over the guideline rate of 6%. Under the rent review legislation, a landlord is required in such a case to apply to rent review and abide by a "rental determination." But a comparison of the 32% figure with the number of rental determinations processed shows at least half the over-guideline increases were done illegally. And that figure excludes the cases of the 33% of Metro tenants who moved during the twelve-month period, and whose average rent level at the end of the period was over the 1977 level by 16.8%, according to what the survey figures indicate.

This is the first time the Ministry has published survey figures that are comparable with the year-earlier survey, although such surveys of one kind or another have been done since 1975. The first survey was limited to Toronto, and the others cover eight Ontario cities. Officials aren't sure whether the Ministry will do another survey next year.

The defects in information available on residential rent levels and increases make the Ontario surveys of particular interest to observers of the rental market. Most such statistics are unsatisfactory, officials admit. The most unsatisfactory, and also the most widely-used figures are those of the Rent Index component of the Consumer Price Index. They understate the actual increase in cash rent levels by one-half and more. (For instance, the Rent Index indicated rent increases from 1961 to 1971 in Toronto of a mere 26%, while the decennial StatCan survey of cash rents showed an actual average rent increase for that period of 50%. Similarly, the Toronto Rent Index 1971-1978 shows an increase of 33%, while the Ontario survey compared with the 1971 StatCan cash rent figure — adjusted to exclude assisted housing, as the survey does — shows the increase to have been 72%. See box.)

StatCan Problem

StatCan people mention three reasons for what they admit is the substantial "downward bias" in the Rent Index component of the Consumer Price Index. One is that the sample is picked on the basis of labor characteristics as part of the StatCan Labor Force Survey, so it isn't designed as a random sample of the rental market, even though it is used that way.

Secondly, there is an elaborate system for adjusting reported cash rents downward to take account of physical improvements. This is a very sophisticated principle, designed to measure rent increases for the exact same unit. Unfortunately the implementation isn't as sophisticated as the theory, and the questionnaire apparently picks up all kinds of "improvements" that adjust the rent downward, but almost no cases of deterioration, even though the theory is that deterioration should result in an adjustment upward. The effect is a little like saying the lettuce keeps getting fresher every year, and price increases will continually be discounted to reflect the improvements to the same basic commodity.

The third reason for the peculiar behavior of the Rent Index is there is apparently some problem that occurs in the processing of the data when a tenant moves out and another tenant moves in. The problem has something to do with matching the data for the Labor Force Survey with the rent data.

The 1978 Ministry survey sampled 1,177 Metro Toronto tenants picked at random via their telephone number. It shows first of all that the tenants are essentially a nomadic people. During the twelve-month period, 33% of them had moved, while during the 12-month period in 1977 41% of the survey sample had moved. Rent increase information for 1978 was obtained from the 67% who did not move. Of these non-movers, 20% had no increase, 32% had increases up to and including 6%, and 48% of them had increases over the 6% guideline. So 48% of 67%, or 32% of the entire sample, had over-guideline increases. Rental units occupied before 1976 are subject to rent review, and there are about 300,000 of them in Metro Toronto, excluding public and assisted housing. That means there were an indicated 96,000 over-guideline increases.

Rent Review statistics chief Albert Wren says rental determinations have about levelled off at last year's level of under 50,000 for the province, with less than half of them in Metro. That's 25,000 rental determinations, as against 96,000 over-guideline increases, for which landlords are required to get rental determinations. Some of the over-6% increases were undoubtedly in new buildings not subject to rent review. But there weren't more than 9000 private sector rental units built in Metro each year since 1976, so at most they could possibly account for another 27,000 over-guideline increases. Allowing for 27,000 of such increases, and 25,000 as a result of rental determinations, that still leaves 44,000 illegal increases, just considering the non-movers.

There is an even more serious enforcement problem with rent review, and it too is reflected in the 1978 survey. The figures work this way: The non-movers, 67% of the sample, had an average increase of 6.8%, including those with no increase, while the total survey showed a year-to-year rent level that was up from last year by 10.1%. That means that those who moved, 33% of the sample, wound up with rents of 16.8% over the year-earlier average. The figure — even allowing for some new units coming on the market at higher rents — reflects the well-known fact that the rent review legislation does not work at all to control rent increases during an apartment vacancy. The 33% of the sample represents 100,000 private sector rental units, and the figures probably mean there were at least another 50,000 over-guideline increases levied without benefit of the statute.

"Vacancy decontrol" is illegal under the Ontario rent review legislation, but it is nevertheless a common practice.

In round figures, the survey results indicate some 150,000 over-guideline increases, of which 25,000 were the result of rental determinations, and another 27,000 could have been in units not subject to rent review.

In the four years before rent review was introduced, from 1971 to 1975, Metro Toronto rents were rising at an average year-to-year rate of 8.5%, probably lower than that in 1972-3, and higher in 1974-5. There are no figures available for rents in 1972-74; but the StatCan figure for average rents in Metro in 1971 ($151) can be adjusted by extracting the number and average rents for assisted housing provided to me by the Ontario Ministry of Housing, yielding the average private-sector rent for 1971 of $155. The Ontario Ministry's survey for 1975, the first year it was done, said the average Metro rent was $215 in that year, or an average year-to-year increase since 1971 of 8.5%.

Those figures are significant, because industry spokesmen and government policy-makers have maintained that rent increases in that period were "sluggish." An Ontario government discussion paper last year said that "In the past, capital gains (on the sale of apartment buildings) made as a result of the anticipation of higher levels of profits, have been substantial. Market value per unit of rental accommodation rose by 9.4% a year from 1967 to mid-1974 in

Continued on page 7

Mortgage News

Breach of Trust

Criminal liability in the deployment of mortgage funds by owner-builders, something almost unknown in Canadian law until recently, is becoming a topic of interest.

The Toronto conviction earlier this month of a developer, apparently the first Canadian conviction for criminal breach of trust in the diversion of building-mortgage funds, illustrates the present status of the law and its implications in the development field.

Herschel (Hershey) Rosen is a Montreal developer who initiated in 1973 a large condominium development in Oakville, Ontario. At the time, his Montreal companies, which had been involved in smaller projects, were in poor financial shape and they were experiencing cash-flow problems. Rosen obtained interim funds from the Bank of Nova Scotia, then bridge financing from Benjamin Pape and Associates Ltd of Toronto and Heller-Natofin Ltd of Montreal, which were supposed to lead to permanent first mortgage financing from Morguard Trust Company once two-thirds of the condominium units were sold.

Funds advanced by Pape to the Oakville building company were paid out of that company to other Rosen companies in Montreal to stave off overdraft problems at the bank there. Trades and suppliers on the Oakville project weren't paid, delays resulted, and ultimately Clarkson Co. was appointed receiver of the project under the Mechanics Lien Act.

Now about 90% sold, the project will realize enough to pay the Clarkson fees, the first mortgage principal and some of the interest to the Pape and Heller-Natofin companies, nothing for a second mortgage also held by them, nothing toward a $1.6 million third mortgage to the Bank of Nova Scotia, and nothing for about $1.4 million in mechanics lien claims by trades and suppliers.

Following the receivership, Rosen was charged in connection with the diversion of funds from the Oakville mortgage advances to his other companies. Three charges were all based on the same facts: Theft from the Oakville building company; fraud as against the mortgage lenders; and breach of trust. All the charges dealt with the same sum of about $1 million allegedly misappropriated.

The breach of trust charge is based on a section of the Mechanics Lien Act, an Ontario provincial statute, which says that funds advanced under a building mortgage constitute a trust fund in the hands of the builder for the benefit of the tradesmen and suppliers. The statutory establishment of this trust, according to the crown's allegation, brought Rosen within the scope of the Criminal Code section dealing with breach of trust.

The trial was held before County Court Judge Hugh Locke in Toronto last month, and Rosen was found guilty on all three counts June 5. In his argument, crown attorney Norman Chorney said there is a choice between laying a charge under the offence section of the Mechanics Lien Act itself, and the more serious criminal charge. He said the decision how to prosecute depends on the scale of the alleged offence.

Jack Biddell of Clarkson Co., which happened to be the receiver in this case, told me most if not all of the insolvent owner-builders his firm administers have adopted the same pattern of using building mortgage advances to satisfy unrelated obligations, in contravention of this trust, and in a recent speech he warned that criminal charges could be laid in such cases.

Before Judge Locke, defence lawyer Robert Carter argued it was the building company, and not Rosen himself, who held the funds. Consequently, he said, Rosen himself wasn't the trustee and wasn't subject to the criminal code breach of trust section. However, Judge Locke ruled that since, on the evidence, Rosen alone was the "controlling mind" of the building company, they were "one and the same." "A judge in a criminal trial," he said, "may properly step behind the corporate veil."

Legal argument on the fraud count was significant as well. Carter's defence argument on the fraud count was that Rosen didn't make any false representations to the lenders, and that in any event they paid out the mortgage advances, not on the basis of any representations at all, but on the basis of architects' certificates on the amount of work completed. He said it must be proved that the lenders parted with their money on the basis of false representations made to them by Rosen.

Judge Locke, in his judgment, said that for a fraud conviction, it isn't necessary for there to be proof of falsehood or deceit. Citing the recent Supreme Court of Canada *Olan* decision, he said the Criminal Code phrase "by deceit, falsehood, or other fraudulent means" can include "any means which can properly be stigmatized as dishonest." And that, Judge Locke said, can include the deliberate failure to disclose information. Rosen knew when the loans were arranged, the judge said, that he intended to use substantial moneys to provide "fiscal transfusions" for his other companies, and he failed to disclose this to the lenders.

As well, Rosen's conduct in supplying cost projections and so on to the lenders led them to believe he intended to use the funds for the building project. Proof of a specific false statement, the judge said, isn't necessary.

On the theft count, Carter argued that the re-direction of the funds was not hidden but clearly set up in the books of the building company as loans, and Rosen intended they would eventually be repaid. On this point, Judge Locke said the financial condition of Rosen's other companies, to which he transferred the funds, was such that he couldn't have entertained an honest belief that he would later be able to "sort it out" and repay the funds. Crown attorney Norman Chorney had cited a list of cases on this point to the judge, indicating that a judge may infer an intent to commit theft or defraud from a course of conduct, including the financial condition of the borrower.

Both points — the proof of fraud without an actual false statement to the lender, and the probative value of circumstances like the financial condition of the borrower — were summarized and established in the *Olan* case, which has apparently broadened the sphere of transactions that can be the subject of fraud or fraud-related charges.

A further *Olan* principle is that actual economic loss is not a necessary ingredient for a fraud conviction. The word "deprives" in the fraud section can include "detriment, prejudice or the risk of prejudice," according to that decision. This branch of the fraud law wasn't applied in the Rosen case, because the victims did in fact lose money.□

Westbury Bankruptcy

Arthur Zimet, a residential developer in the Toronto area since the building boom of the 1950s, is facing questions about operations of the two companies he assigned in bankruptcy last March 28. They are A. Zimet Ltd and Woodbine-Summit Ltd, carrying on business together as Westbury Developments.

At the first creditors' meeting held May 3, a statement of affairs was distributed showing real estate assets with $13.86 million book value, and secured liabilities, being mortgages against that real estate, of $13.56 million. That figure doesn't include mechanics lien claims by subcontractors and suppliers, which are substantial. They are included under unsecured liabilities of an amount, from the debtor companies' books, of $1.67 million. The figures are only preliminary, and lien claims are expected to be much higher. Jerry Friedman, partner in Laventhol and Horwath Ltd, the trustee, estimated that the trade liabilities on Westbury's Malvern condominium project alone will be between $1.5 and $2 million.

The companies' books were last audited as at August 31, 1977, and Friedman filed an affidavit in court in which he said the books were not sufficiently up-to-date to enable him to obtain the necessary information for the first creditors' meeting in the time required. He said he had retained staff members of Westbury to help up-date the records.

As well, the Laventhol company prepared an "asset summary" in which market values of the real estate are estimated at figures about 10% below their values shown on the companies' books. This would indicate realizable value of the real estate of less than the outstanding mortgages, and it would indicate nothing left over for

the lien claimants.

The real estate consists of unsold houses in the Erin Mills, Heart Lake, and Caledon developments west of Toronto, and a 300-unit condominium project, partly completed, in the Malvern area of Scarboro. But in addition, listed but not included in the statement of affairs, there are about 12 joint venture projects, in most of which the major partners are Westbury and a company called Hillcrest General Leasing Ltd, controlled by developer Harry Hershoran.

One of the areas the trustee is investigating is the application by Westbury of monies advanced by the first mortagee of the Malvern project, Ontario Development Corporation. Funds advanced under this mortgage were apparently used for other purposes than the Malvern project, on which Friedman estimates there are $1.5 to $2 million unpaid trade creditors.

In his examination by the Official Receiver, Zimet was asked whether the Malvern mortgage advances were used to repay loans due to his wife. He said: "Due to the nature of the accounting system used at the company, I am unable to say whether or not payments made to Mrs S. Zimet were made from mortgage advances made to the Malvern project. Payments to Mrs Zimet were made from the company's general account; most mortgage advances relating to all projects were also initially deposited into this general account."

Zimet was asked what was the authority for transferring mortgage funds from this project to other Westbury projects, and the amount of such transfers. "No specific authority was needed," Zimet said, "to transfer mortgage funds from this project to other Westbury projects. As noted... most mortgage advances were deposited into the company's general account and then allocated to the various projects as demands were made. I do not know what amounts were transferred from mortgage advances re Malvern to other projects."

Zimet says the causes of the bankruptcy were "introduction of the Land Speculation Tax Act and its subsequent effects; competition." He says the corporations first became aware of their insolvency in the first week of March 1979. He said the companies showed profits through 1976, and losses in 1977 and 1978.

Faced with unsold inventory, it isn't unusual for owner-builders to use mortgage advances on a current building project to meet carrying costs on their unsold inventory from earlier projects, and for other purposes not related to the project for which the funds are being advanced.

But section 2 of the Mechanics Lien Act, an Ontario provincial statute, appears to say that building mortgage funds, except those necessary to pay for the land, constitute a trust fund in the builder's hands, to be used to pay for the work on the project. So if the practice is common, it is also questionable.

In addition to the mortgage-funds issue, various inter-company loans and transfers of property, queried by a lien claimant at the creditors' meeting, are also being checked by the trustee, both within the group of Zimet-controlled companies, and between those companies and Harry Hershoran's Hillcrest General Leasing.

Among other areas, the trustees are looking at Allenwood Investments Ltd, a company owned by Zimet family trusts, which has a contractual agreement, Zimet says, with Westbury for management fees.

The trustees expect their preliminary investigation of these and other areas will be completed in July, at which time, if they have found irregularities, they will report them to the Superintendent in Bankruptcy.□

Lumsden Holds the Fort

A Clarkson Co. veteran who spent several years administering Rochdale College was called in last month to try to obtain control of the office building at 67 Richmond Street West from Mark Stein's Lumsden Building Corporation Inc. on behalf of Great West Life Assurance Company, whose first mortgage, with about $950,000 owing, had come due. But he met with physical resistance and threats of trespassing charges, and he was unsuccessful. Notices to tenants to attorn their rents to Great West were contradicted the next day in letters from the Lumsden company.

The Clarkson Co. official said in an affidavit he found litter and garbage in the basement, dirty floor and cracked mirror in the lobby, and "the directory board located in the lobby was of little or no assistance in determining what tenants are occupying the building by reason of many missing letters from the names of tenants and by missing numbers listing the suites. The directory board appeared dirty and there was no way of knowing whether or not it had been kept up to date." He said it appeared to him the premises are between 25% and 40% rented.

"The present condition of the building is such that in my opinion there is no inducement for prospective tenants, and the entire building will require a general cleanup and regular maintenance. It is my concern that the present conditions of the building have created a fire hazard, and the present conditions existing in the building are such that it might well result in a cancellation of the fire insurance or forfeiture of the fire insurance should a fire occur."

He said unauthorized renovation work is being done which "is not being inspected by the Municipality and there is no way of ascertaining whether or not it is in conformity with the Building Code or the Electrical Code."

Among the tenants in the building is the Ontario Ministry of the Attorney General, which operates a Small Claims Court on the second floor.

Myron Stein, identifying himself as a consultant to Lumsden, said the company barred Clarkson because it would have obstructed them from seeking a sale or new financing. He said the Clarkson allegations about the state of the building are exaggerated and misleading; work is being done in conformity with requirements; and "no objections have been voiced by any governing authority." Stein said the property is almost fully leased.

The seven-storey structure, apparently built in 1946 by the legendary Principal Investments Ltd, was owned after Principal's 1963 ljquidation by Lawrence Manor Investments Ltd, a company associated with Avram Bennett of the Principal Investments Bennetts, then by J.V. Franciotti Realty Ltd, who sold their one-half interest in it to the Lumsden company, who are now the owners along with Elaine Kamin and Mary Chapman.

Following their unsuccessful sortie under the terms of the mortgage, Great West then applied in court for an order whereby the court would appoint Clarkson Co. as interim receiver of the building. The judge hearing the case said he was reluctant to incur the costs of the full Clarkson Co. routine if the owners were going to be successful in a proposed sale of the building. Lumsden produced an offer to purchase by Rudy J. Wolfinger of Mississauga on behalf of an anonymous German group.

On the other hand, the judge said, "These people's track record isn't the greatest... these people have been fiddling around for some considerable period of time... I'm concerned it might just be a stall." Told by the Lumsden lawyer that the rents since the April due date have been used to make renovations, he smiled and said, "We don't know that, do we?"

He ordered Lumsden to direct the June rents be paid to Great West, and that it produce the rent roll to Great West. The application for a receiver he stayed until June 25 to allow the Wolfinger deal, if there is to be one, to come to fruition.

An appraisal of the property was submitted by Lumsden. It says the replacement value of the building is about $970,000. Comparable market data for the area show sales anywhere between $107 and $237 per square foot; at an estimated $155 per square foot for this property, the appraiser said the indicated market value is $1.1 million.

But he derived a much higher value based on possible income. Current rents in the building, the appraiser said, are below market, with some as low as $3 per square foot. But based on $300,000 worth of renovations, he said, net income could be $237,000 for a capitalized value of $2.1 million. That is the amount of the Wolfinger offer.

The appraisal, and the offer, indicate a per square foot land price of $294, substantially higher than any of the comparable market figures cited by the appraiser.□

Allegations against Genstar In a $51 Million US "Investment"

Antitrust and securities law allegations against Genstar Ltd of Montreal are the subject of pre-hearing discovery in Northern California District Court in San Francisco, in a case in which The Flintkote Co., a big US building-supplies manufacturer, says Genstar is illegally attempting to take over Flintkote.

The securities law issues relate to Genstar's purchase of about 21% of Flintkote stock for $51 million last summer, using what Flintkote says were deceptive tactics. As well, Flintkote says the purchases should be annulled and further purchases forbidden because the two companies compete in the same markets, particularly as manufacturers and sellers of concrete and drywall, and the alleged takeover attempt would lessen competition.

Genstar, one of the largest Canadian companies in land development, construction and building supplies, is the successor company to Sogemines Ltd, formed in 1951 by Societe Generale de Belgique SA.

Flintkote says Genstar failed to disclose it is controlled by Societe Generale; chose to expand into the US because of an oversupplied market in Canada; and could have expanded its own operations into the US but chose an acquisition route that will have anticompetitive results.

Genstar has denied all the allegations, and says it purchased the Flintkote stock simply as an investment. A hearing is now scheduled for sometime in July on Flintkote's application for a preliminary injunction.

Genstar subsidiaries have twice been convicted of price-fixing under the Canadian Combines Investigation Act in recent years, once in 1974 in the cement industry, and once in 1978 in gypsum wallboard. (Flintkote says Genstar neglected to disclose these convictions as required in its US public filings.)

The Canadian federal government has since 1976 accepted Genstar's dubious claim that it is not controlled by Societe Generale, thus freeing Genstar from compliance with Foreign Investment Review Agency requirements in its many takeovers. Flintkote says "Genstar has achieved its present size primarily through acquisition of numerous other companies rather than by internal development."

The Flintkote claim also says, by way of background, that "Almost 25% of Genstar's voting securities are represented by anonymously held, voting 'bearer share warrants.' Although denominated warrants, these shares have all the attributes of Genstar's common stock except they are not registered as to ownership. Genstar has deliberately avoided taking steps to ascertain the identities of these 'bearer share warrants.' However, they are believed to be controlled by Societe Generale and those who directly or indirectly control Societe Generale."

Flintkote says Societe Generale "dominates and controls" Genstar through these warrants, through direct and indirect ownership of about 20% of the common stock, and through shareholdings of others associated with Societe Generale. "Societe Generale exercises its influence and control over Genstar through, among other means, four members of Genstar's Board of Directors... Societe Generale is believed to have orchestrated the illegal acts and transactions complained of." Flintkote says the role of Societe Generale is one of the things Genstar didn't disclose in its US filings.

Of the Belgian "parent" itself, the Flintkote complaint says this: "Defendant SoGen (Societe Generale), a Belgian corporation headquartered in Brussels, Belgium, heads one of the largest and most powerful industrial organizations in the world. SoGen's vast corporate empire includes substantial interests in over 80 corporations which, in turn, control countless other companies throughout the world. SoGen is controlled by a group of powerful European corporations and individuals who, together with SoGen, control many of the companies in which SoGen invests."

Flintkote says the Genstar purchases of its stock were really part of a tender offer for control, which wasn't announced as a tender offer. It started, according to the complaint, with Genstar "making a series of aggressive and conspicuous open market purchases of Flintkote stock, and then causing and permitting false rumors to circulate within the investment community of an impending takeover of Flintkote. Through these rumours, defendants manipulated independent arbitrageurs to bid up the price of Flintkote stock and to otherwise solicit and pressure long-term Flintkote shareholders to make hasty investment decisions to sell their Flintkote shares at a premium over the market price which existed" prior to the Genstar purchases. Genstar thus acquired about 12% of Flintkote stock.

The next step, Flintkote says, was for Genstar to file with the Securities and Exchange Commission (SEC) a statement that Genstar only intended to purchase an additional 8% of Flintkote stock, not all or a majority of it, and Flintkote says this was done "in order to pressure arbitrageurs and other investors, who had been deceived by defendants into acquiring Flintkote shares in the belief that an offer to purchase all of Flintkote shares was imminent, to make uninformed and hasty decisions to sell their shares to Genstar at a reduced price." The day after this announcement was made, Genstar purchased 500,000 Flintkote shares, about 7% of its stock and the largest daily volume in its history, and "Despite the heavy buying pressure exerted by Genstar's purchases, the price of Flintkote's shares fell by $2 per share" on that day. Most of the shares bought that day, says Flintkote, "were previously accumulated by arbitrageurs who purchased Flintkote shares based on false rumors caused by the defendants that a formal tender offer for all of Flintkote's outstanding stock would be made, and who 'dumped' their stock in response to defendants' false and misleading SEC statements that they had no present intention to acquire a majority of Flintkote shares."

Flintkote says Genstar's SEC filings failed to disclose that in fact Genstar intended and still intends to acquire control of Flintkote.

The complaint says as well that Genstar intends to take advantage of the Flintkote-Genstar business relationship, especially in the concrete and drywall markets, and that Genstar's SEC filings failed to disclose that "defendants' purchases of Flintkote stock violate the antitrust laws of the US and thus will involve both Flintkote and defendants in time-consuming and expensive litigation, and cause tremendous negative consequences to Flintkote's business."

The Flintkote complaint analyses separately the drywall and concrete markets, in which both companies are among the top North American firms. Of drywall, it says, "The domestic (US) gypsum wallboard industry is a 'tight oligopoly.' Concentration ratios in the industry are extremely high. On a nationwide basis, the four largest companies account for approximately 80% of all gypsum wallboard shipments.... Barriers to entry into gypsum wallboard manufacturing are high." The complaint says there is oversupply, or at least overcapacity, in Canada, and undersupply in the US.

"Recently," the complaint says, "gypsum wallboard demand has increased greatly throughout the US, to the extent that most domestic manufacturers have placed their customers on allocation. This increase in demand together with a shortage of production capacity has resulted in substantially higher prices. Between 1971 and 1978, prices of gypsum wallboard have increased 48%. Domestic production of gypsum wallboard is expected to remain inadequate to satisfy demand for some time."

By contrast, "There is substantially less demand for gypsum wallboard in Canada than in most areas of the US. Although total Canadian capacity is 2.3 billion square feet annually, due to the depressed Canadian construction industry substantially less than that amount has been sold annually in Canada. Thus, approximately 50% of Genstar's gypsum wallboard production in British Columbia is exported to the US... Genstar has recognized the chronic nature of the depressed Canadian construction industry and has stated its intention to exploit US markets more vigorously."

The same state of affairs exists in the cement industry, Flintkote says.

Continued on page 7

Genstar

Genstar has the ability, according to the complaint, to establish either its own distribution facilities or manufacturing plants to expand in the US, which wouldn't have the anticompetitive effects of the alleged takeover attempt.

Flintkote concludes, "Genstar's unlawful and as yet undisclosed plan to seize control of Flintkote will serve both to provide Genstar with an outlet for its excess cement and gypsum capacity and, at the same time, eliminate Flintkote as an independent competitor."

Flintkote provides a breakdown of the regional markets where it says this effect will be produced. They are primarily the US northeast and northwest, covered by Genstar manufacturing plants in Montreal and British Columbia.

Genstar, for its part, says Flintkote management too has a "plan," which is to entrench itself in a position of control over Flintkote, and to oppose the Genstar acquisition "without any sound business reason."

The court has ordered the discovery material kept secret, and the lawyers refuse to comment at all on the progress of the case, except Genstar company counsel James Unsworth says it's a fishing expedition.□

Rents

Continued from page 3

the Metropolitan Toronto area." But paradoxically, it said, rent increases "appear to have been quite sluggish in the early 1970s. This may have been the result of a tendency of many landlords, especially of small buildings, to maintain rents at low levels for any one of several reasons: a desire to retain existing tenants, the existence of multi-year leases; a concern for low-income tenants; or a limited interest in purely economic motivations." In fact, this flight of the imagination wasn't necessary. Rents were rising as fast as other prices, faster than what was necessary to meet operating cost increases, and only slightly behind the value of these units in the resale market.

(The discussion paper supports the hypothesis of sluggish rent increases in the early 1970s with the results of a rental market survey — which is, in fact, the 1977 survey for the year 1977 — "which found that in the eight cities surveyed, from 21 to 48 percent of units with the same tenant experienced no rent increase over a twelve-month period." The analyst didn't point out that even if the survey had been for one of the years he was talking about, it indicated that in Metro Toronto, which had the 21% of nil increases, the average rent increase, including the nil increases, was 8.6%.)

In any event, the 1975 survey, largely ignored, showed rents had been rising at an adequate rate. The 1976 survey, done during the first year of rent review, was a complete bust. The Housing Ministry was unhappy with the way the actual telephone survey was carried out by the consultants, and their published analysis and extracts aren't very informative, and possibly not very reliable either. It did indicate that the rate of rent increases had eased.

The deficiencies in the 1976 survey make comparisons difficult. The 1977 average rent-level compared with that of 1975 indicates average year-to-year increases for the 1975-77 period of 6.5%. But the reported increases seem to have been about 8% per year for that period. In any event, the rate of increases had eased to some extent.

The 1978 results showed the average rent level up by 10.1%, and reported increases (non-movers) of 6.8%. The results apparently indicate two things: (1) The lowering of the guideline rate to 6% didn't influence the historic increase rate which is above that, with landlords failing to comply with the legislation on a massive scale; and (2) "vacancy decontrol," also illegal, was a favored method of raising rents.

The average private-sector rent in Toronto in October 1978, the survey says, was $273. That represents an average annual rate of increase since 1971 of 8.1%. Reflecting on last year's increase of over the historic 1970s rate, one official said to me with a twinkle in his eye, "It's the market adjusting to rent review."

A rent review spokesman was less forthright. "We have never done any analysis, we have never seen anything done on the basis of compliance. We're totally at sea on this whole area of activity."□

Situations

The Toronto Island Marina, operated under a long-term lease from the Municipality of Metropolitan Toronto, was sold in April by the court-appointed liquidator of the lessee Toronto Island Park Marina Ltd to Toronto construction executive Joseph MacKenzie. Among the unsuccessful bidders was a partnership of criminal lawyers Clay Powell and Robert J. Carter together with members of the forensic accountancy firm of Lindquist, Holmes.

The former lessee had been controlled by real estate developer James H. Black, currently facing business-related criminal charges. The firm of Laventhol and Horwath Ltd was appointed receiver of the marina company in January 1978, after the company defaulted on financial obligations. The Laventhol firm is holding the cash purchase price of $540,500 pending court determination of the priorities of various creditors. Public company Claiborne Industries Ltd believes it has a first claim for $300,000 of the proceeds, based on a mortgage it holds on the leasehold property. The mortgage is part of the security Claiborne holds against advances of about $1 million the company made in the past to Black and two other shareholders. In a separate action, Claiborne is suing Black and others including Unity Bank, now Provincial Bank of Canada, to recover the entire amount of the advances.□

Syntex Agribusiness Inc., a US company, has obtained a default judgment against three individuals including Toronto lawyer Ian W. Outerbridge for a total of $380,000 in US District Court in Colorado. The judgment against Outerbridge is for $126,000, and Syntex has taken action in Supreme Court of Ontario to have its judgment against Outerbridge validated for execution in Ontario.

The judgments arose out of a 1976 real estate deal in Colorado in which Syntex sold property to a company called Bovimport Inc., described as a Canadian corporation, and in which Bovimport gave Syntex a note for $1.1 million. Guarantor of the note as to 50% was Caledon Cattle Company Ltd, and in turn, guarantors of the obligations of Caledon Cattle were Outerbridge as to one-third, former Abbey Glen Property Corp. president Roderick H. McIsaac as to one-third, and Christina Bauman and Lorimer Massie as to one-third.

Bovimport defaulted on the note, Syntex foreclosed and sold the property, and claimed there was still owing on the note the amount of $760,000. Syntex alleged in the Colorado court, "upon information and belief, Caledon is only a shell corporation controlled by defendants Massie, Baumann, Outerbridge and McIsaac, and does not have sufficient assets to pay plaintiff 50% of the amount determined to be due. Hence, Massie, Baumann, Outerbridge and McIsaac must pay plaintiff to the extent (of one-third each of the amount due by Caledon)."

Last December the Colorado court ordered judgment against Baumann, Massie and Outerbridge, since they had failed to answer the complaint. In February, Syntex retained the Toronto firm of McCarthy and McCarthy to bring action in Ontario against Outerbridge on the basis of the US judgment.

Outerbridge is the immediate past president of the Ontario Branch of the Canadian Bar Association.

McIsaac retired from Abbey Glen Property Corp. in 1975. His real estate career began in the late 1960s, when he was brought in to run Great Northern Capital Corporation, following its Atlantic Acceptance losses.

Outerbridge wouldn't comment. 'I can't, because there are too many people involved in the thing, and I've got a solicitor-client privilege that's got to be protected; . . . be careful."□

John Whitelaw's

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