CITATION: Serafino (Re), 2021 ONSC 4734
COURT FILE NO.: CV-21-00659187-00CL
DATE: 20210712

SUPERIOR COURT OF JUSTICE – ONTARIO
(COMMERCIAL LIST)

RE: IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-36, AS AMENDED

AND DOMENICO SERAFINO AS A PERSON INTERESTED IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF HYDRX FARMS LTD., CANNSCIENCE INNOVATIONS INC. AND SCIENTUS PHARMA INC.

BEFORE: Wilton-Siegel, J.

COUNSEL: *D. Preger, L. Corne* and *J. Cheung*, for the Moving Party, Cobra Ventures Inc.

R. Slattery, S. Nassabi and *T. Dunn*, for the Respondent, Domenico Serafino

J. Larry, for the Monitor, Schwartz Levitsky Feldman Inc.

HEARD: June 30, 2021

ENDORSEMENT

[1] By motion record dated April 23, 2021, Cobra Ventures Inc. ("Cobra") sought certain determinations regarding the indebtedness owing by the debtor, HydRx Farms Ltd. ("HydRx"), to Cobra (the "Cobra Secured Indebtedness"), the validity and enforceability of a senior secured convertible debenture issued by HydRx currently held by Cobra, and Cobra's entitlement to credit bid up to the full amount of the Cobra Secured Indebtedness, including in any sale and investment solicitation process approved in this proceeding under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the "*CCAA*"). The relief sought was opposed by Domenic Serafino ("Serafino"), a director of HydRx, who has, in turn, sought certain declarations that would limit the amount of the Cobra Secured Indebtedness and Cobra's entitlement to credit bid the Cobra Secured Indebtedness in any sale and investment solicitation process. By an endorsement dated June 30, 2021, the Court denied the relief sought by Serafino for written reasons to follow. This endorsement sets out the Court's reasons for that determination.

Factual Background

[2] The following are the relevant facts in this matter.

[3] HydRx is a corporation incorporated under the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (the "*CBCA*"). In 2017, HydRx, the debtor in these proceedings under the *CCAA*, issued a senior secured convertible debenture in the principal amount of $11.5 million (the

"Debenture") to Aphria Inc. ("Aphria"). The Debenture was secured against all of the property and undertaking of HydRx and was registered against HydRx's real property in Whitby, Ontario.

[4] The maturity date of the Debenture was originally August 14, 2019. It was subsequently extended to November 12, 2019, and further extended until the earlier of January 30, 2020 and the date of the occurrence of a termination event under a support agreement between Aphria and HydRx. On January 20, 2020, Aphria demanded repayment and issued a notice of intention to enforce security.

[5] In July 2020, after a sales process, Aphria agreed to sell the Debenture for $5 million to Cobra. The sale closed on September 28, 2020. The assignment of the Debenture from Aphria to Cobra was registered against title to HydRx's real property. At all relevant times, the only asset of Cobra was the Debenture.

[6] Cobra is a corporation that was incorporated by World Class Extractions Inc. ("WCE"). At the time of acquisition of the Debenture, Cobra was owned, as to 50%, by WCE and, as to 50%, by 2775361 Ontario Inc. ("277"). The owner of WCE is Leo Chamberland ("Chamberland"). 277 is owned, as to 60%, by personal friends of Richard Goldstein ("Goldstein") and, as to 40%, by First Republic Holdings Corporation ("FRHC"). FRHC is Goldstein's family holding corporation. He is the president and sole director of that corporation. At all relevant times, it appears that Goldstein was the controlling mind of FRHC.

[7] At the time of entering into the transaction to acquire the Debenture in Cobra, Goldstein and Chamberland contemplated using the Debenture in a possible recapitalization plan of HydRx which would have involved the conversion of the Debenture and a further equity financing of HydRx (the "July Plan"). Chamberland and Goldstein discussed the July Plan with Serafino, a director of HydRx, in July 2020. However, no commitments were entered into at that time and the July Plan never progressed beyond a preliminary stage. No agreement on any version of the July Plan was ever reached.

[8] On September 6, 2020, the HydRx board of directors, apart from Serafino, resigned when its D&O insurance carrier refused to renew coverage. On October 23, 2020, Goldstein and Rosie Mondin ("Mondin"), a senior executive of WCE, became directors of HydRx.

[9] On October 7, 2020, Cobra entered into a loan agreement with Rydan Financial Inc. ("Rydan"), pursuant to which Cobra borrowed $1 million (the "Rydan Loan Transaction"). While it appears that the net proceeds of this loan were advanced by Cobra to HydRx to fund its on-going operations, this fact does not form any part of the Court's determination. As security for the loan, Cobra granted an assignment of the Debenture to Rydan. On October 23, 2020, Cobra registered a transfer of charge respecting the assignment on the title to HydRx's real property.

[10] In November and December 2020, Chamberland and Goldstein had a falling out. The parties dispute the reasons for this development. At a minimum, however, it is clear that Goldstein and Chamberland could not reach an agreement on implementing any version of the July Plan. The exact reasons for their differences are not relevant to the issues in this proceeding.

Chamberland and Goldstein agreed that the first of them who was able to buy out the other would be entitled to do so.

[11] On December 22, 2020, Goldstein caused Cobra to demand payment of the Debenture from HydRx and to issue notices of intention to enforce its security.

[12] On December 29, 2020, Cobra, 277 and Windsor Private Capital Limited Partnership ("Windsor") entered into a term sheet for the provision of a loan to Cobra (the "Term Sheet"). The terms of the loan were finalized in a commitment letter dated January 15, 2021 (the "Commitment Letter"). Pursuant to the Commitment Letter, Windsor loaned Cobra $4 million, repayable in one year. The loan was secured by an assignment of the Debenture and a guarantee of 277 (the "Windsor Loan Transaction"). The Term Sheet also provided that Windsor would receive a 10% interest in Cobra.

[13] Cobra used the proceeds of the Windsor Loan Transaction to repay the loan under the Rydan Loan Transaction and to purchase WCE's 50% interest in Cobra (the "Cobra Buy-Out Transaction"). A portion of the remaining proceeds of the loan, which were approximately $358,000, were used to meet HydRx's immediate liquidity needs. As a result of these transactions, Cobra is now owned 90% by 277 and 10% by Windsor. Mondin resigned as a director of Cobra upon the closing of the Cobra Buy-Out Transaction.

[14] On March 22, 2021, Serafino, as an "interested person", sought and obtained an initial order under s. 11 of the *CCAA* with respect to HydRx. He took this step on an *ex parte* basis, as the board of directors, being comprised of only Serafino and Goldstein, was deadlocked. Schwartz Levitsky Feldman Inc. was appointed as the monitor (the "Monitor").

[15] By order dated April 30, 2021, the Court approved a sale and investment solicitation process (the "SISP") for HydRx. As part of the SISP, the Monitor sought a process to determine the amount, if any, owing by HydRx to Cobra together with any issues affecting the ability of Cobra to credit bid Cobra's claim in the SISP. That has resulted in the motions before the Court.

<u>These Proceedings</u>

[16] As mentioned, on April 23, 2021, Cobra commenced this motion seeking declarations that

(1) the indebtedness owing to Cobra by HydRx is in the amount of approximately $14.8 million as at March 31, 2021;

(2) the indebtedness owing to Cobra is secured by valid and enforceable security over all of HydRx's property; and

(3) Cobra is entitled to credit bid up to the full amount of such indebtedness including in any sale and investment solicitation process.

[17] Serafino opposed the Cobra motion. He alleges that Goldstein breached his statutory obligations under s. 120 of the *CBCA* in respect of the Cobra Buy-Out Transaction, the Rydan Loan Transaction and the Windsor Loan Transaction. He submits that Goldstein was required (a)

to make proper disclosure of each transaction to the board of directors of HydRx, as it existed at the time of such transactions, and (b) to obtain the approval of the board of directors to his participation in such transactions and his right to profit in such transactions.

[18] Serafino sought an order (1) prohibiting Goldstein and Cobra from profiting from the Debenture and requiring each of Goldstein and Cobra to account to HydRx for any profit or gain realized as a result of Cobra's acquisition of the Debenture; and (2) further reducing any entitlement of Cobra under the Debenture in an amount equal to the costs incurred by HydRx in respect of the *CCAA* proceedings which would not have been necessary but for the need to protect HydRx from Goldstein as a director, whose actions he characterized as "defaulting and predatory". Alternatively, should Cobra be found to have no entitlement to payment under the Debenture, Serafino sought (3) an order for damages against each of Goldstein and Cobra in an amount equal to the costs incurred by HydRx in respect of the *CCAA* proceedings which would not have been necessary but for the need to protect HydRx from Goldstein; and (4) a declaration that Windsor is not an innocent arm's length third party creditor for value without notice of irregularities and, as such, is not entitled to (i) recover any amount over and above the amount that is found to be owing by HydRx to Cobra, if any; and (ii) a security interest over the real and personal property assets of HydRx to support the loan obligations of Cobra to Windsor.

The Issues

[19] The Court advised Cobra that, in its opinion, the record before it was not sufficient to determine the second declaration sought, which amounted to a corporate law opinion and was, in any event, typically the responsibility of legal counsel to a monitor in proceedings under the *CCAA*. Serafino advised the Court subsequent to the hearing that he does not oppose Cobra's request for an order that the indebtedness owing to Cobra by HydRx is in the amount of approximately $14.8 million as at March 31, 2021. Accordingly, an order to this effect shall issue.

[20] The hearing on Cobra's motion was limited to the issues of the amount of the Cobra Secured Indebtedness and Cobra's entitlement to credit bid such indebtedness in any SISP.

[21] In this respect, Serafino raised three issues in his Factum:

(1) whether Goldstein discharged his statutory duty of disclosure under s. 120 of the *CBCA*;

(2) if not, whether Goldstein and Cobra are entitled to profit from Cobra's acquisition of the Debenture; and

(3) if not, whether HydRx is entitled to damages or protection from the economic loss resulting from Goldstein's breach of his statutory obligations as a fiduciary of HydRx.

[22] In view of the disposition below of the first issue, however, it is not necessary to address the remaining two issues.

Did Goldstein Fail to Comply with Statutory Obligations of Disclosure Under Section 120 of the *CBCA*?

[23] As mentioned, Serafino argues that Goldstein breached s. 120 of the *CBCA* in failing to give notice to the board of HydRx of, and to receive the approval of the board for, the Rydan Loan Transaction, the Windsor Loan Transaction and the Cobra Buy-Out Transaction.

[24] The relevant provisions of s. 120 of the *CBCA* read as follows (italics added):

> 120 (1) A director or an officer of a corporation shall disclose to the corporation, in writing or by requesting to have it entered in the minutes of meetings of directors or of meetings of committees of directors, the nature and extent of any interest that he or she has in a material contract or material transaction, whether made or proposed, *with the corporation*, if the director or officer
>
> (a) is a party to the contract or transaction;
>
> (b) is a director or an officer, or an individual acting in a similar capacity, of a party to the contract or transaction; or
>
> (c) has a material interest in a party to the contract or transaction.
>
> (2) The disclosure required by subsection (1) shall be made, in the case of a director,
>
> (a) at the meeting at which a proposed contract or transaction is first considered;
>
> … or
>
> (d) if an individual who is interested in a contract or transaction later becomes a director, at the first meeting after he or she becomes a director….
>
> (8) If a director or an officer of a corporation fails to comply with this section, a court may, on application of the corporation or any of its shareholders, set aside the contract or transaction on any terms that it thinks fit, or require the director or officer to account to the corporation for any profit or gain realized on it, or do both those things.

[25] Serafino argues that the Debenture is a material contract of HydRx. Accordingly, Serafino suggests that any transactions involving the Debenture or the assignment of the Debenture, whether by way of security or otherwise, constitute transactions with HydRx for the purposes of s. 120 of the *CBCA*. On this theory, because each of the Rydan Loan Transaction, the Windsor Loan Transaction and the Cobra Buy-Out Transaction involved dealing, directly or indirectly, with the Debenture, and because Goldstein had an interest in Cobra, Serafino argues that he was required to give notice of each of these transactions to HydRx and obtain the approval of the board of directors of HydRx.

[26] Two more specific arguments underly the general proposition expressed above. First, Serafino argues that Cobra, and therefore Goldstein, acquired an interest in a material contract with HydRx when Cobra purchased the Debenture from Aphria and acquired a further interest in the Cobra Buy-Out Transaction. In addition, Serafino characterizes each of the Rydan Loan Transaction and the Windsor Loan Transaction as involving, in substance, the pledge of HydRx's assets for the benefit of Goldstein as an interested party in Cobra. He argues that these transactions therefore constituted transactions with HydRx in which Goldstein was interested and therefore required compliance with s. 120.

[27] I do not accept these submissions for the following reasons.

[28] First, and most importantly, I do not think that it is correct that any transactions involving the Debenture, or the assignment of the Debenture, constitute transactions with HydRx for the purposes of s. 120. Section 120 pertains to contracts or transactions "with the corporation". None of the Rydan Loan Transaction, the Windsor Loan Transaction and the Cobra Buy-Out Transaction constituted such a contract or a transaction.

[29] The Rydan Loan Transaction and the Windsor Loan Transaction were each transactions solely between Cobra and Rydan or Windsor, respectively. While it is correct that Cobra assigned its rights as the holder of the Debenture to its lenders, HydRx had no involvement whatsoever in these loan transactions. In particular, as a contractual matter, Cobra did not require the approval of HydRx to enter into or complete these transactions. There was also no legal or economic effect whatsoever upon HydRx as a result of these transactions.

[30] Similarly, the Cobra Buy-Out Transaction constituted a transaction solely between WCE and 277 under which 277 acquired WCE's 50% shareholding in Cobra. There was no contractual obligation of an assignor of the Debenture to obtain the approval of HydRx. HydRx had no involvement in this transaction and no right to participate in any manner. Nor was there any effect whatsoever upon HydRx's legal or economic position as a result of this transaction.

[31] Second, Serafino says that s. 120 should be interpreted liberally to catch all instances in which a director or officer of a corporation benefits from a transaction involving the corporation. For this reason, he suggests that the phrase "material transaction … with the corporation" should extend to the present circumstances. In particular, he suggests that the *CBCA* amendment in 2001 which introduced the term "material transaction" into s. 120 was intended to enlarge the scope of s. 120 to include transactions of the nature involved in this proceeding.

[32] However, there is no support for this interpretation of the scope of a "material transaction" in s. 120. In particular, there is nothing in the wording of the *Analysis of the Changes to the Canada Business Corporations Act* issued by the Government of Canada in connection with the amendments to the *CBCA* in 2001, upon which Serafino relies, that supports his view of the intention of the insertion of the word "transaction". Instead, consistent with the purpose of s. 120, as discussed below, I think it is clear that the use of the word "transactions" was intended to do no more than capture transactions that do not involve a formal contract between a corporation and a director or officer of the corporation, an entity in which a director or officer of the corporation has

a material interest, or an entity of which a director or officer of the corporation is also a director or officer.

[33] Third, Serafino acknowledges that he has been unable to identify any case law in which a court has applied s. 120 to a contract or transaction in which the corporation at issue was not a party. In fact, in the only case directly on point, *Roppovalente v. Daris*, 2020 ONSC 5290, 12 B.L.R. (6th) 145, while admittedly dealing with very different circumstances, Ryan Bell J. reached the opposite conclusion at para. 26:

> Section 120(1) captures material contracts or transactions, or proposed material contracts or transactions, with the corporation – in this case, BCO Group. The s. 120 conflict of interest regime applies where a director or officer has an interest in a material contract with the corporation. … Read in the context of the section as a whole, it is plain that the "contract or transaction" referred to in s. 120(8) that may be set aside must be (a) material, (b) with the corporation, and (c) one in which the director or officer is, directly or indirectly, a party, or has a material interest….

[34] The nature of the contract or transaction contemplated by s. 120 is, in fact, reflected in the case law cited by Serafino for the definition of materiality under s. 120. For example, in *McAteer v. Devoncroft Developments Ltd*., 2001 ABQB 917, 307 A.R. 1, at para. 309, the court cited with approval the following passage in Professor B.L. Welling in *Corporate Law in Canada: The Governing Principles*, 2nd ed. (Vancouver: Butterworths, 1991) at pp 452-453. The italicized language specifically contemplates transactions directly between the corporation and an entity in which a director is interested:

> What is meant by "material".... In the context of conflict of interest contracts, the meaning of "material contract" and "material interest" is conditioned by the purpose behind the section. *The purpose is to identify those negotiations in which a corporate manager's ability to bargain effectively on behalf of the corporation may be inhibited by some interest he has in the other side.* Any personal relationship or monetary interest he may have in the other side that might be thought to be an inhibiting factor is a material interest if disclosure of the relationship or interest might be relevant to the corporate decision *whether to involve the particular manager in the negotiations*. *Whether to participate in a proposed contract is a corporate decision and the corporation is entitled to full disclosure from its fiduciaries of all facts that might affect that decision*. [Emphasis added.]

[35] Similarly, at para. 62 of *Zysko v. Thorarinson*, 2003 ABQB 911, 345 A.R. 139, the court cited with approval the statement of Lax J. in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* (2002), 214 D.L.R. (4th) 496 (Ont. S.C.), at para. 194, that "[t]he purpose of section 120 of the *CBCA* is to mitigate the strictness of the common law principle relating to contracts between a director and a corporation."

[36] Fourth, there is no policy need for such an extensive operation of s. 120. Section 120 addresses circumstances in which the personal interest of a director or officer in a contract or a transaction may prejudice the corporation in the negotiation of the contract or transaction because

of a conflict of interest on the part of the director or officer. Other provisions of the *CBCA* and common law principles are available to police actions of directors or officers in bad faith or in breach of their fiduciary duties as directors. Section 120 is not necessary to provide a remedy in all circumstances in which a director or officer of a corporation acts in the director's or officer's own interests in respect of shares or debt of the corporation owned by the director.

[37] I also do not accept the specific conceptual characterizations of the Rydan Loan Transaction, the Windsor Loan Transaction and the Cobra Buy-Out Transaction upon which Serafino grounds his arguments for the following reasons.

[38] First, I do not think it is conceptually correct to characterize the Debenture as a material contract of HydRx in the sense contemplated by s. 120 of the *CBCA*. I accept that it is a material obligation of HydRx, but that is not the same as saying that it is a "material contract … with the corporation" for the purposes of s. 120.

[39] Serafino's argument that the Debenture is a material contact in which Goldstein is interested assumes that, upon an assignment of the Debenture to Cobra, a contract arose between HydRx and the assignee. Because Goldstein has a material interest in Cobra, Serafino says that the assignment of the Debenture to Cobra therefore gave rise to a material contract between HydRx and Cobra in which Goldstein has a material interest. For this reason, Serafino says that Goldstein was required pursuant to s. 120 to give HydRx notice of Cobra's acquisition of the Debenture upon becoming a director of HydRx. On the same theory, he argues that Goldstein was required to give notice of his proposed indirect acquisition of a further 40% interest in the Debenture pursuant to the Cobra Buy-Out Transaction and to receive the approval of the HydRx board to that transaction prior to completion.

[40] I do not think that this is an accurate characterization of the position of a debenture holder for the purposes of s. 120. The Debenture consists of an acknowledgement of a liability, a promise to repay the principal with interest, and a bundle of rights granted by HydRx to the holder of the Debenture from time to time which the holder may exercise in the event of non-payment. The issuance of the Debenture did not entail, or give rise to, any obligations of the holder of the Debenture that could be construed to establish a contract between the holder and HydRx. In the hands of the holder of the Debenture, it is an asset rather than the subject of a contract with HydRx.

[41] Similarly, I think that it is conceptually incorrect to suggest that an assignment by way of security or a pledge of a secured debenture constitutes a charge over the assets of the issuer of the debenture and, therefore, the use of assets of the issuer corporation for the benefit of parties who have an interest in the assignor or pledgor. Accordingly, I do not think that it is correct to suggest that Cobra pledged HydRx's assets for its benefit, or Goldstein's benefit, in connection with these transactions. For the same reason, I do not think it is correct to say that Goldstein caused Cobra to pledge or charge the assets of HydRx for his benefit pursuant to the Rydan Loan Transaction or the Windsor Loan Transaction. The assets of HydRx were charged by the Debenture at the time of, and upon the issue of, the Debenture. Cobra merely granted security over the package of rights constituted by the Debenture in its hands as the holder of the Debenture, which were limited to the rights of the holder of the Debenture to realize against the HydRx assets if HydRx failed to repay the debt evidenced by the Debenture.

[42] Lastly, I note the following matters in respect of Serafino's position. In his Factum, Serafino argues that Goldstein used his fiduciary position as a director of HydRx to orchestrate events in such a manner as to effect either an acquisition of the HydRx business for the $5 million it cost Cobra to acquire the Aphria Debenture or a realization upon the assets of HydRx for his material personal benefit to the disadvantage of the stakeholders of HydRx that he was duty bound to protect. However, Serafino does not point to any action that Goldstein took as a director that had either effect.

[43] This is not an action for an alleged breach of a corporate opportunity of HydRx. There is also no allegation that Goldstein used any confidential corporate information of HydRx. Nor does Serafino allege any negotiations respecting any of the Rydan Loan Transaction, the Windsor Loan Transaction or the Cobra Buy-Out Transaction that gave rise to a conflict of interest between Goldstein's personal interest and the interest of HydRx. Because the transactions by which Goldstein indirectly acquired his 90% interest in the Debenture were between Cobra and Aphria in respect of the Aphria Transaction, and between Goldstein and Chamberland in respect of the Cobra Buy-Out Transaction, any "profit" that Cobra might make on the redemption of the Debenture was at the expense of Aphria and Chamberland, respectively, who will have sold their interests in the Debenture at less than market price. There is no sense in which any such "profit" will be realized at the expense of HydRx.

[44] Serafino's argument is ultimately that Goldstein was required to give notice of, and receive the approval for, transactions to which HydRx was not a party solely because he was a director of HydRx at the time. As discussed above, however, there is no policy basis for compliance with s. 120 in such circumstances. Moreover, fundamentally, Serafino's objection is not with any of these three transactions but rather with the fact that Cobra will be able to credit bid in the SISP in an amount that is greater than the amount paid by it for the Debenture. That situation arose because Aphria chose to sell the Debenture at a discount. The possibility of such a credit bid existed from the moment Cobra acquired the Debenture, before Goldstein became a director. HydRx could have repurchased the Debenture from Aphria to avoid this situation. The record does not disclose whether or not it participated in the Aphria sales process.

[45] In any event, while Serafino says that he does not seek to challenge the well accepted authority that indebtedness and security can be purchased at a deep discount, I think that that is exactly what he is doing in arguing that Goldstein's position alone as a director overrides the rights of a debenture holder in an insolvency. None of the Rydan Loan Transaction, the Windsor Loan Transaction and the Cobra Buy-Out Transaction had any effect whatsoever upon HydRx. It was in default before, and it remained in default after, each of these transactions. The fact that, after the Cobra Buy-Out Transaction and the Windsor Loan Transaction, Cobra was no longer owned as to 50% by Chamberland, whom HydRx would have the Court believe would never have demanded payment of the Debenture, and was thereafter controlled by Goldstein, who determined to have Cobra enforce its rights under the Debenture, is of no legal significance to HydRx. However, it demonstrates that Serafino's real objection is that Cobra intends to exercise its rights under the Debenture in these *CCAA* proceedings. Section 120 cannot serve as a substitute for an action specifically addressing the propriety of that action by Goldstein and Cobra to the extent grounds for such an action exist. In my view, as discussed above, the scope of s. 120 is limited to transactions between a corporation and a director or officer of the corporation, an entity in which

a director or officer of the corporation has a material interest, or an entity of which a director or officer of the corporation is also a director or officer.

[46] Based on the foregoing, Serafino's requested relief is denied in its entirety and an order shall issue that Cobra is entitled to credit bid up to the full amount of the indebtedness owing under the Debenture, including in any sale and investment solicitation process conducted in these *CCAA* proceedings.

Wilton-Siegel, J.

Released: July 12, 2021