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INVESTMENT AND FINANCIAL SECURITY ADVISORS: RESPECT YOUR CLIENTS' GOALS AND DOCUMENT YOUR FILES!

DINA RAPHAËL

TWO RECENT DECISIONS OF THE COURT OF APPEAL[1] REMIND US OF THE DUTY ON INVESTMENT ADVISORS AND FINANCIAL SECURITY ADVISORS TO KNOW THEIR CLIENT AND THE CORRELATIVE DUTY OF INFORMATION. IN BOTH CASES, THE COURT OF APPEAL HELD THAT THE ADVISOR HAD BREACHED HIS DUTY TO KNOW HIS CLIENT, ASSESS THE CLIENT'S NEEDS, AND INFORM AND ADVISE THE CLIENT. BOTH CASES ALSO DEALT WITH THE CLIENT'S POSSIBLE CONTRIBUTORY NEGLIGENCE.

GUILLEMETTE CASE

The owners of Alimentation Denis & Mario Guillemette inc., acting both through their business and in their personal capacity, wished to provide for their retirement by investing in safe and low-risk investments. They retained the services of an investment advisor who was duly informed of these goals. At the start of their relationship, which extended from 1990 to 2008, the advisor made investments that yielded a good return. However, over time, he concentrated his clients' portfolio in high-risk products, and they ended up losing all of their savings.

After referring to the fundamental principles that an advisor must know his client and must properly inform his client, the Court held that the advisor failed to respect his clients' wishes by not adequately diversifying their portfolio and by investing in high-risk securities. In addition, the advisor invested a part of the amounts entrusted to him in financial products that he was not authorized to trade in under the various certificates he held during the periods in question.

In his defence, the investment advisor pleaded the contributory negligence of his clients, arguing that they ought to have informed themselves more fully of the investments he suggested to them. The Court wrote that while one may find that the clients were naïve, they could not be considered to be negligent for failing to "pierce the wall of appearances that the investment advisor had erected", since he got caught in it himself by choosing investments based on the recommendations and studies of recognized financial institutions. The Court indicated that the respondents were relatively modest, educated people who had no knowledge of investments in the stock market or financial products. It applied the rule laid down by the Supreme Court in the *Laflamme* case,[2] citing the following excerpt:

> I would add that the sense of trust that is characteristic of a contract of mandate also has a significant impact on the state of mind of a client who is the victim of a fault committed by a manager. In this case, that trust lay in the belief acquired in the professional merit of the manager, as a result of which a client, especially one who is not knowledgeable, may be unable or at least reluctant to

[1] *Souscripteurs du Lloyd's v. Alimentation Denis et Mario Guillemette inc.*, 2012 QCCA 1376; *Audet v. Transamerica Life*, 2012 QCCA 1746.

[2] *Laflamme v. Prudentielle Bash Commodities Canada Ltd.*, [2000] 1 S.C.R. 638.

> believe that the manager is incompetent. Both that trust and the confusion resulting from a loss of trust will make it particularly difficult for the victim to take charge of the situation. Awareness of the extent of the injury dawns more slowly. This situation, which the manager himself has created by representing himself as a professional worthy of trust, must be taken into account before blaming the victim for any want of diligence in mitigating damages, especially since the measures to be taken were not obvious and responsibility for taking or advising those measures rested primarily on the respondents, as knowledgeable dealers and managers.[3]

The Court added that considering the complexity of investments and the associated risks, where a person entrusts his affairs to an investment advisor precisely because he doesn't know much about investing, he cannot be required to be constantly checking and double-checking the investments when the very reason for relying on the professional was to avoid such worries in the first place.[4]

THE AUDET CASE

Following the death of their mother, Pierre and Marie Audet entrusted their assets to a financial security advisor who had previously advised their mother. The advisor had convinced their mother to take out several life insurance policies with Transamerica, which provided a considerable inheritance. The Audets continued doing business with the same advisor.

The trial judge found that the advisor failed to prepare the investment profile of his new clients and to conduct an analysis of their financial needs.

The advisor convinced the Audets to take out a myriad of life insurance policies without ensuring that they had the necessary cash available to pay the annual premiums. As a result, they were forced to finance them with bank loans. The advisor received commissions of $228,508.00 for the issuance of two of the policies purchased by the Audets. The Court noted that "he made a huge return on the transaction."

In addition, on the advisor's suggestion, the Audets invested in index funds. This was the first time that the advisor had sold such products. He explained to his clients that the return on the funds would primarily be in capital gains and that 10% of the invested amounts could be withdrawn annually without penalty. He did not however inform his clients of the guarantee on the principal, which was reduced by any withdrawal made before maturity. He also did not clearly explain the freeze option and the fact that the crystallized amounts had to remain invested for ten (10) years. The advisor received commissions of $156,188.00 on the investments in these index funds.

The advisor also insisted that the Audets should each take out a leverage loan to give them access to cash to purchase new products.

Finally, he did not provide them with the correct information on the tax treatment of the returns earned on the invested funds or the consequences of the withdrawals on the guarantee of the principal invested in the insurance policies.

The Audets lost nearly $2M in this adventure.

The Court of Appeal affirmed the trial judgment which had held that the tax treatment was not a determining factor in the Audets' decision to invest in the Transamerica fund, but found that there were other clear transgressions by the advisor.

It noted that knowledge of the investor's profile, objective analysis of his needs, and an extensive understanding of the products offered are necessary to properly advise the client.[5] The Court believed the testimony of the client, Pierre Audet, who stated that the advisor asked them no questions regarding their needs, expectations or sources of income. The Court of Appeal wrote:

> [Translation] Given the absence of a writing, it was up to Thibault (the advisor) to convince the trial judge that he nevertheless tried to determine the financial and personal situations of each of the Audets, as well as their needs.

The Court found that the advisor knew that Pierre Audet had a house charged with a mortgage and an approximate salary of $50,000. Marie Audet had two children, a house with a small mortgage and earned about $37,000. The Audets did not need the money from their inheritance to live and their sole objective was to protect the inherited amount and grow the capital.[6] The advisor maintained that he did not need any more information to properly advise his clients.

[3] Idem p. 662.

[4] *Lloyd's*, paragraph [36].

[5] Paragraph [79].

[6] Paragraph [80].

The Court also noted that even if the lack of diversification could be considered a risky strategy in the circumstances, and maybe even a breach of ethics, it did not cause any prejudice because the principal was guaranteed and the results showed that there had been an impressive return. The problem was precisely that this exceptional return resulted in a significant tax burden, forcing the Audets to choose between i) borrowing the necessary amounts to pay off the taxes, or ii) selling off a portion of their investments in the funds in order to generate the cash.

The liquidity problem was also aggravated by the fact that the advisor had convinced the Audets to take out multiple life insurance policies requiring the annual payment of substantial premiums which, in 2000, stood at $279,000 for one of them and $309,000 for the other. The evidence showed that the Audets did not have the means to maintain these multiple insurance policies and that they had purchased them on the advisor's insistence.

In summary, the investment strategy suggested by the advisor to each of the Audets was not suited to their circumstances due to his poor knowledge both of their actual financial situation and of the products he recommended to them, in particular, their tax consequences, and finally, his obvious desire to pocket a maximum in commissions on the products sold.

Here again, the issue was raised of the causal link between the wrongdoing committed by the advisor and the damages suffered. The advisor pleaded that the Audets caused a portion of their own losses by suddenly liquidating their investments, and that they failed to reduce their damages.

The Court rejected this argument and upheld the trial judgment on this point, finding, in particular, that the decision by the Audets to liquidate their investments actually insulted the financial security advisor who then abandoned them when he realized they no longer wished to follow his advice unconditionally. The Court noted that the most striking example of this abandonment was the financial security advisor's refusal to accompany and support Ms. Audet when she wished to meet a Transamerica representative to discuss the tax problems on the return on the investments.[7]

The advisor also pleaded that the trial judge ought not to have used a return of 5% which would have been obtained on an investment certificate as the basis for assessing the damages because the Audets were familiar with this product and had chosen not to purchase it. The Court wrote:

> [Translation] the argument is unconvincing. If the Audets did not choose this product, it was because Thibault enticed them with greater returns from other products.

COMMENTS

Investment and financial security advisors must not only know their clients and identify their needs, they must also know their own products so that they can make appropriate recommendations. Advisors must never overestimate their clients' knowledge and must take the necessary time to explain the recommended products and ensure their clients understand them.

Finally, advisors should ensure they do not engage in actions which the court could perceive as a means for the payment of multiple commissions and therefore a source of exorbitant income: the multiplication of transactions and purchase of excessive insurance combined with the payment of large commissions to an advisor expose him to both civil and regulatory proceedings.

In a context in which the regulatory authorities are taking every possible measure to strengthen client protection and more strictly regulate the advisor-client relationship (IIROC notice #12-0107, "Client Relationship Model – Implementation", dated March 26, 2012), advisors must be transparent and ensure that they know their clients and their products. They are well advised to document their files both during the first meeting with the client and throughout their business relationship: without paper trail, the advisor will be helpless!

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[7] Audet judgment, paragraph [100].

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