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October 12, 2012

By Facsimile No. 416.598.3730

Matthew P. Gottlieb/Shannon Beddoe
Lax O'Sullivan Scott Lisus
145 King Street West
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Dear Counsel:

Re: David Phillips et al. ats
First Leaside Wealth Management Inc., et al.
Commercial List No. CV-12-9821-00CL

Enclosed is the Statement of Defence of the Defendants, for service upon you pursuant to the *Rules of Civil Procedure*.

Yours truly,

Bruce O'Toole

*smf
Enc.

Court File No. CV-12-9821-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

BETWEEN:

FIRST LEASIDE WEALTH MANAGEMENT INC., FIRST LEASIDE FINANCE INC., FIRST LEASIDE SECURITIES INC. and FL SECURITIES INC.

Plaintiffs

and

DAVID PHILLIPS, MARGARET DAVIS and 970877 ONTARIO INC.

Defendants

STATEMENT OF DEFENCE

1. The defendants admit the allegations contained in paragraphs 2-4, 6-14, 17-20, 23-28, and 72 of the statement of claim.

2. The defendants deny the allegations contained in paragraphs 1, 5, 15, 22, 29-71 and 73-87 of the statement of claim.

3. The plaintiffs, First Leaside Wealth Management Inc. ("FLWM"), First Leaside Securities Inc. ("First Leaside Securities"), FL Securities Inc. ("FL Securities") and First Leaside Finance Inc. ("First Leaside Finance") are part of a larger group of affiliated companies and partnerships that were involved in, among other things, the operation and development of commercial properties and the provision of investment and wealth management services to investors (collectively the "First Leaside Group").

4. FLWM is the parent company of the other First Leaside companies.

5. The defendant David Phillips ("Phillips") was the chief executive officer and a director of FLWM until November 2011. He was the president and a director of First Leaside Securities until November 2011. Phillips was also the sole director and an officer of FL Securities from July 30, 1999 to March 1, 2004.

6. As a director of FLWM, and CEO and COO of the First Leaside Group, Phillips oversaw all aspects of the First Leaside Group's business and operations. He was responsible for raising capital, originating and negotiating deals and structuring various financing arrangements. Until 2010, Phillips was also the leading salesperson of securities selling up to $30 million annually.

7. Margaret Davis ("Davis") is the spouse of Phillips. From 2003 to the present time, Margaret Davis has been an officer and director of FLWM. During that time, her role within the First Leaside Group was an administrative and clerical one, which included day-to-day operations and cash management in coordination with the director of finance. Davis has never been an officer or director of any other plaintiff companies.

Overview

8. The plaintiffs' claim is a misconceived attempt to reopen lease agreements, business decisions to make capital improvements and compensation arrangements entered into between the parties between 2004 and 2011. All such agreements and decisions were made by personnel with the authority to enter into such arrangements. The arrangements were commercially reasonable and were entered into openly and transparently. They were reported, where appropriate, in the financial statements, regulatory filings and in the underlying general ledgers of the relevant entities within the First Leaside Group. The First Leaside Group entities and Phillips and Davis

filed tax returns with Canada Revenue Agency in each taxation year based on the legal efficacy of the arrangements entered into.

9. The basis of the Chief Restructuring Officer's (the "CRO") decision to attempt, on behalf of the plaintiffs, to retroactively challenge seven years of legal arrangements entered into by the plaintiff entities is unclear. Whether he would have made the same decisions had he been a directing mind of the First Leaside entities at the time is not relevant. Nor is it clear how the invitation in the statement of claim to second guess the leasing and compensation arrangements entered into in prior years accords with the mandate to restructure the plaintiff entities for the benefit of its stakeholders.

10. The theme of the statement of claim that the legal arrangements referenced above constituted the "diversion" or "conversion" of funds is absurd. The statement of claim fails to recognize that Phillips, as the principal of FLWM, and Phillips and Davis, as the sole common shareholders of FLWM, were entitled to receive dividends and other compensation from FLWM. It was also permissible for them to have loan accounts.

11. The statement of claim mischievously fails to acknowledge that First Leaside Securities and FL Securities paid commercial rates of rent for the use of the Property (defined below) and had a commercial interest, common to any tenant of commercial premises, in paying for leasehold improvements to the leased premises. The equation of the payments of rent and leasehold improvements with the "improper diversion" of funds is simply rhetorical excess.

12. The statement of claim inexplicably fails to recognize that Phillips was entitled to receive compensation from First Leaside Securities and FL Securities for both his management services and in consideration for the significant amounts of capital he personally raised. In fact, no attempt

has been made by the CRO to review and question only those payments or transactions that on their face do not reveal a commercial basis. Rather, any and all payments that have benefitted Phillips and Davis have been crudely labelled as "improper" without explanation or analysis.

13. The fact is that the transactions now being challenged by the CRO as the new representative of the plaintiff entities were authorized by and known to the plaintiff entities at the time. Even if there was any legal basis to challenge the transactions referenced in the statement of claim, which is denied, these transactions have not been newly discovered by the plaintiff entities and the majority of the transactions are precluded from review by the *Limitations Act, 2002*, S.O. 2002, c. 24 S.B.

The Property

14. The property located at 430 Regional Road 8, Uxbridge, Ontario (the "Property") was originally purchased by FL Securities in 1994. It was purchased with the intention of relocating the plaintiffs' offices from their previous location on Bay Street.

15. On or about September 30, 1999, FL Securities, which at that time was wholly owned by Phillips and had no debt, transferred the Property to Davis for the amount of $400,000, which was approximately the same amount paid by FL Securities when it purchased the Property.

16. From 2004 to 2011, Davis entered into four separate leases in respect of the Property (the "Leases") with either FL Securities or First Leaside Securities named as the lessee. During this period, each of the plaintiff companies used the Property as its offices and conducted all of its business from the Property.

17. The first lease, with an effective date of January 1, 2004, and for a term of seven years, required the lessee, FL Securities, to pay 75% of all electricity costs and 44% of all other expenses, including but not limited to maintenance, utilities, insurance, property tax, security and capital improvements (the "First Lease").

18. Subsequently, First Leaside Securities, as lessee, entered into three additional Leases, which were as follows:

(a) A lease effective from March 1, 2006 to February 28, 2008 (the "Second Lease");

(b) A lease effective from February 29, 2008 to February 28, 2010 (the "Third Lease"); and

(c) A lease effective from March 1, 2010 to December 31, 2012 (the "Fourth Lease");

19. Each of the Second, Third and Fourth Leases, provided for monthly rent of $7,000 in exchange for leasing approximately 2,800 square feet of the Property.

20. Most of the plaintiffs' clientele consisted of sophisticated individuals with significant net worth. Capital improvements were required to give the plaintiffs' offices an appropriate professional appearance. All of the capital improvements to the Property paid for by the plaintiffs were carried out for proper and legitimate business purposes, including but not limited to the following:

(a) To provide office space to the plaintiffs' employees;

(b) To provide space for daily meetings between staff and clients;

(c) To provide a venue for client-related events, including annual general meetings;

(d) To provide a venue for intra-office events, such as board meetings; and

(e) To provide amenities for the staff, such as a gym and childcare space.

21. At all material times, the plaintiffs were fully aware of the capital improvements and rent payments. For instance:

(a) FL Securities' financial statements specifically referred to the occupancy costs and capital improvements;

(b) FL Securities took the benefit of tax deductions in respect of the rent and occupancy expenses and claimed depreciation in respect of the capital improvements to the Property;

(c) First Leaside Securities disclosed, in its regulatory filings, that it paid $7,000 per month in rent to a party related to one of its directors;

(d) First Leaside Securities disclosed, in its regulatory filings, that it was in an expense-sharing agreement with FLWM and First Leaside Securities; and

(e) First Leaside Securities made express reference, in its regulatory filings, to the capital improvements.

22. At no time prior to the commencement of this action did any officer or director of any of the plaintiff companies ever object to the Leases, or question the accuracy of the occupancy costs or the capital improvements made to the Property.

23. The costs of the capital improvements to the Property were generally paid by FL Securities. The expenses were then allocated in accordance with the First Lease. 44% of the capital

improvement costs were to FL Securities and its affiliates and the remaining 56% was allocated to Davis. Davis' allocation was charged to her husband's loan receivable account owing to First Leaside.

24. Prior to the end of each year, the amounts owing on Phillips' loan receivable account to the First Leaside companies were reduced by the amounts owing to him by the First Leaside companies in respect of authozied salary, bonuses and dividends. The salary, bonuses and dividends received by Phillips each year were included in his taxable income which the relevant First Leaside company in turn deducted from its income.

25. Phillips and Davis (through their respective holding companies, 1331607 Ontario Inc. and 970877 Ontario Inc.) are the only common shareholders of FLWM. They took a portion of their compensation in the form of dividends, rather than salary to better their tax position. Each year, the director of finance at First Leaside would advise Phillips and Davis of the most tax effective division as between salary and dividends for their compensation.

26. Phillips annual compensation was reasonable given his responsibilities and sales performance. His level of compensation was transparent and openly discussed by the board of directors, and otherwise throughout the plaintiff companies to foster a spirit of sales competition.

27. Payment of Phillips' compensation was frequently deferred into subsequent years as a tax deferral mechanism. At the end of 2009, the First Leaside companies agreed that Phillips would receive an extra bonus because of the significant benefit to them of his having deferred payment of compensation earned for the years 2007, 2008 and 2009, as a result of which he allowed significant funds to remain in the First Leaside companies.

28. With respect to the windmill purchased by F.L. Research Management Inc. ("FL Research") the plaintiffs were aware of this transaction. All payments were reasonable and for authorized corporate purposes. The purchase was funded by a loan from FL Securities, which was authorized by the chief financial officer, for the benefit of the First Leaside Group in an effort to reduce electricity costs.

29. In any event, the CRO has control over FL Research, and as such, control of the windmill. The CRO has the ability to sell the windmill and repay the loan. There are no damages.

Causes of Action

Misrepresentation and Fraud

30. Contrary to paragraphs 65 and 66 of the statement of claim, there have been no inaccurate or misleading statements with respect to the use of the plaintiffs' funds. The plaintiffs were fully aware of the capital improvements and rent payments.

31. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Breach of Contract, Fiduciary Duty and Duty of Loyalty

32. Contrary to paragraphs 68 and 69 of the statement of claim, there has been no breach of contract, fiduciary duty or duty of loyalty.

33. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Oppression

34. Contrary to paragraphs 73 to 76 of the statement of claim, there has been no oppressive conduct.

35. At all material times, the plaintiffs were aware of all payments. All payments were within the reasonable expectations of the parties and were for authorized corporate purposes.

Conversion

36. Contrary to paragraphs 77 to 79 of the statement of claim, there has been no conversion of any amounts.

37. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Conspiracy

38. Contrary to paragraphs 82 and 83, there was no conspiracy to harm the plaintiffs.

39. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Unjust Enrichment

40. Contrary to paragraph 84 of the statement of claim, there has been no unjust enrichment.

41. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Knowing Assistance and Knowing Receipt

42. Contrary to paragraphs 85 to 87, the defendants, Phillips and Davis, have not breached any duties owed to the plaintiffs. Nor have they misappropriated, diverted or converted any of the plaintiffs' funds.

43. At all material times, the plaintiffs were aware of all payments. All payments were reasonable and for authorized corporate purposes.

Set-Off

44. The plaintiffs, Phillips and Davis, as directors of FLWM, are entitled to indemnification for all costs, charges and expenses incurred in respect of any civil, criminal or administrative action or proceeding to which they are made a party by reason of being or having been a director pursuant to FLWM's by-law indemnity and section 136 of the *Ontario Business Corporations Act*, R.S.O. 1990, c.B-16, as amended.

45. In addition, on November 3, 2011, Phillips and Davis, separately entered into indemnification agreements with FLWM which provided payment to them of all costs, charges and expenses incurred in respect of any civil, criminal or administrative action or proceeding to which they are made a party by reason of being or having been a director.

46. Phillips has been made a respondent in regulatory proceedings in which he has incurred expenses in excess of $100,000. To date, FLWM has refused to indemnify Phillips.

47. If it is determined that Phillips owes any amount to FLWM, which is denied, he pleads and relies on the doctrine of legal and equitable set-off with respect to the amounts owed to him for indemnification.

Limitation Period

48. The portion of this action dealing with amounts incurred prior to August 28, 2010, more than two years prior to the issuance of this claim, should be dismissed as barred by the limitation period. The defendants plead and rely upon the provisions of the *Limitations Act, 2002*, S.O. 2002, c. 24 S.B.

49. The defendants ask that this action be dismissed with costs.

October 12, 2012

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Plaintiffs

-and-

DAVID PHILLIPS et al.
Defendants

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STATEMENT OF DEFENCE

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