

Commercial Crime

LEXPART Article

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OVERVIEW

Commercial crime, in all of its major forms – fraud, theft, conspiracy, money laundering, and insider trading – has become the media’s darling. The turn of the millennium did not bring the anticipated technology meltdown but rather a flurry of corporate fiascos. Now, as they finally begin to subside, we are left to deal with the ramifications of white-collar crime having made the leap from the business section to the front page. These include, a newly educated investing public (that is suddenly well-versed in the nuances of corporate accountability, disclosure obligations, audit engagements, director and officer liability, and shareholder remedies), a raft of new statutory and regulatory rules, and governments and regulators that are anxious to restore investor confidence.

What has resulted is a complex matrix of rules and proposed rules, organizations and proposed organizations, penalties and proposed penalties all aimed at enhancing corporate governance and director accountability. Naturally, it is the securities-related offences and the regulators of the capital markets that have garnered the most attention and hence deserve the focus for this year’s review of the most significant developments in commercial crime. Interestingly, however, many of the changes in the commercial crime arena come from a renewed enthusiasm for creating more regulation, widening the scope of civil liability, and increasing the penalties across the board, not, as one might expect, on creating new criminal offences.

Given the emphasis on more regulation we begin our review of the recent developments with a quick look at the current regulation and supervision of Canada’s capital markets and a few of the impending additions to the current framework. We will then provide an overview of the statutory and judicial expansion of liability for corporate executives and auditors and a sampling of some of the new and proposed penalties for commercial crimes, all with a view to highlighting some of the considerations that these enhanced penalties bring into play for market participants and their counsel alike. We conclude with a brief look at the movement towards more criminal trials that is sure to change the face of commercial crime in Canada forever.

REGULATION AND SUPERVISION OF CANADA’S CAPITAL MARKETS

The regulation of Canada’s capital markets has recently been the topic of much debate. This is due, at least in part, to a perception that Canada’s capital markets cannot compete with the US markets unless, and until, a national regulator is in place. While a comprehensive review of the pros and cons of a single national regulator are clearly beyond the scope of this article, we should be mindful of the complexity of Canada’s regulatory regime highlighted by this debate, and what it means for market participants.

As BC lawyer John Briner noted in his article, *The Power of One*, “currently, there are thirteen regulators in thirteen different jurisdictions giving their own interpretations to thirteen different sets of laws, rules and regulations. All told, there are over 40 financial regulators, including self-regulatory organizations, in Canada.”¹

The Commissions

The various provincial Securities Acts provide the primary statutory source of government regulation of Canada’s capital markets. Although the Acts are not identical, a recent review undertaken by the Canadian Securities Administrators for their Blueprint Proposal for Uniform Securities Laws reveals a substantial amount of harmonization. That is not to say, however, that the provincial regulators necessarily see eye-to-eye on how best to regulate the capital markets. Indeed, there are many recent instances of provincial regulators making or proposing substantial amendments to their respective regulatory regimes, without much apparent consideration for the impact of these changes on the regulation of the country’s capital markets as a whole. Ontario’s Bill 198, *Keeping the Promise for a Strong Economy Act (Budget Measures)* which, among other things, increased Commission penalties and to which we will refer later in our discussion of penalties for commercial crime, Quebec’s Bill 107, *An Act respecting the Agence nationale d’encadrement du secteur financier* which consolidated the many inter-provincial regulators of Quebec’s financial industry into a single regulatory body, British Columbia’s proposed Deregulation Model, and Alberta’s proposed Passport System, provide just a few examples.

As the primary market regulators, the Canadian Provincial Commissions are involved in regulating, supervising and bringing enforcement actions against market participants. The Commissions, and the Acts they administer, impose a mandatory system of registration and disclosure on certain (though not always easily ascertained) market participants. To this end the Commissions are given extensive powers of investigation and have a variety of enforcement mechanisms at their disposal. In addition, the Commissions have a public interest discretion which allows them to make a variety of orders in the public interest as part of their adjudicative function.

The Securities Acts also empower the Commissions to recognize other organizations that regulate the operations and standards of practice and business conduct of market participants as self-regulatory organizations (SRO’s). When they choose to recognize an organization as an SRO, the Commissions also have the authority to make decisions with respect to the by-laws, rules, regulations, policies and procedures of those SRO’s. While we are unable to make a comprehensive review of the many SRO’s involved in supervising Canada’s capital markets, there are two organizations that warrant special consideration.

The Investment Dealers Association

¹ This article can be found on the Corporate Knights website at www.corporateknights.ca.

The IDA is Canada's national regulator of investment dealers and while the organization is not new to the Canadian regulatory regime its supervisory and enforcement role is currently subject to a number of proposals. The mandate of the IDA is akin to that of the Commissions: to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets. Membership in the IDA is voluntary for investment dealers, and firms must meet certain capital and business conduct requirements in order to be registered. Once registered, however, member firm employees must act in accordance with the IDA rules failing which they will be subject to disciplinary action by the IDA.

For the most part the activities caught by the IDA are those directly related to client trading and account practices. The Disciplinary Sanction Guidelines set out and define such offences as unsuitable recommendations, discretionary and unauthorized trading, churning and failing to know your client. The IDA is often the front line for commercial crime; both in its detection and in its regulatory consequences for any broker or house that may be involved.

The IDA by-laws provide for disciplinary hearings before a Hearing Panel of the District Council (the "Council"), which is empowered to impose a variety of sanctions ranging from a reprimand to a suspension to a fine of up to \$1 million per offence or triple the amount of the profit made or the loss avoided, whichever is greater. It is important to note, however, that the IDA has tabled a proposed amendment to its by-laws that will beef up its hearing process and increase its sanctioning powers. In respect of the former, as proposed the amendments to by-law 20 will increase both the quantity and the qualifications of panel members with a particular emphasis on the inclusion of former judges on the panels. In addition, the amendment proposes a new process to address potential conflicts of interest of panel members. In respect of the latter, a new catch-all penalty provision has been proposed to enable the Council more flexibility in sanctioning its members. The proposal also includes an increased penalty of \$5 million for member firms.

Another noteworthy proposal dealing with the role of the IDA is the recent report released by the Regulatory Burden Task Force (the "Task Force").² Established by the OSC in the fall of 2001, the Task Force's mandate was to pinpoint regulatory activities that increase the regulatory burden for market participants. In the result, some would argue that the Task Force, with its 81-page report including recommendations to establish a national securities regulator and to merge the IDA with Market Regulation Services and the Mutual Fund Dealers Association of Canada (MFDA), has actually gone beyond this initial mandate. Nevertheless, many of the issues raised by the Task Force, and much of the criticism that gave rise to those issues, involve the regulatory activities of the IDA. Interestingly, however, much of the criticism of the IDA is based on the widely held perception in the marketplace that the IDA shows excessive leniency and insufficient response to investors. How the Commissions choose to handle these and other concerns will be of great interest for market participants and the Canadian regulatory structure as a whole.

² The task force members are Morley P. Carscallen, F.C.A., W. Keith Gray, and J. Garnet Pink, Q.C.

Market Regulation Services Inc. (RS)

Just as the IDA's role in regulating the market is focused on the supervision of investment dealers and their employees, RS' role is limited in scope to reviewing trading activity. Each and every trade on the Toronto Stock Exchange (TSX), TSX Venture, Bloomberg and the Canadian Trading and Quotation System Inc. (CNQ) is reviewed in real time to ensure compliance with the Universal Market Integrity Rules (UMIR). These rules establish the methods that must be used in receiving and executing orders and prohibits or prescribes the manner in which certain trades can take place.

Having opened its doors for business on March 1, 2002, RS is relatively new to the regulatory landscape. Not surprisingly its hearing process and disciplinary roles are not unlike those of the IDA; however, it differs from the IDA in that its powers of supervision and enforcement are not conditional on membership. RS has jurisdiction over all 'Regulated Persons', defined in UMIR as a 'Participant' or 'Access Person', in turn defined as (1) any dealer that is registered in accordance with the securities legislation of any jurisdiction and who is a member of an exchange, and (2) any subscriber or user, respectively.

It should be noted that RS also provides investigative assistance to the provincial securities Commissions, other market regulators, and most importantly to the police.

Integrated Market Enforcement Teams (IMET's)

This is the new kid on the block and is not to be confused with the older Integrated Marine Enforcement Units, also known as IMET. This RCMP initiative to combat commercial crime in the capital markets, envisions the creation of nine IMET's across the country, each team consisting of ten people, including RCMP investigators, lawyers and other investigative experts. The teams will work closely with securities regulators including the provincial Commissions, the IDA and RS, and federal and provincial policing authorities. The first two teams were launched in November 2003 in Toronto with the additional teams expected by April 2006.

LIABILITY

To understand the commercial crime issues that market participants must worry about, a useful starting point is their corporate liabilities generally.

Directors and Officers

Directors and Officers have never been immune to liability for their actions or the actions they take on behalf of the corporation. However, the principles of good faith and due diligence, and the judicial deference that has come to be known as the Business judgment

rule, have traditionally offered these corporate executives some measure of protection from personal liability.

Good faith is an important concept in both the corporate world generally, and for the application of the Business judgment rule in particular. In respect of the former, many of the corporate statutes preclude corporate indemnification of directors and officers who do not act honestly and in good faith with a view to the best interests of the corporation. In respect of the latter, the Business judgment rule is based, at least in part, on the good faith of the decision-maker. Hence the significance of Madam Justice Lax's recent decision in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi et al.* (2002), 214 D.L.R. (4th) 496 (Ont. S.C.J.) (the "*Repap*" decision).

Repap was brought as an oppression remedy by a disgruntled shareholder. The case deals with the specific issue of executive compensation packages, however, it has far-reaching consequences for Board approval of, or acquiescence in, agreements that are subsequently determined not to have been in the best interests of the corporation. In this case, Mr. Berg, the former chairman of Repap Enterprises Inc., negotiated for himself a lucrative compensation package including a retroactive signing bonus of 25 million shares, a stock option grant of 75 million shares, a market capitalization bonus, and an immediate pension of 8 years. When certain members of the board expressed their discontent they were removed and replaced with members more sympathetic to Mr. Berg's needs.

Madam Justice Lax was anything but sympathetic to the means by which the compensation package was obtained and the plight of the board members who approved it – even though the evidence showed that the Board had held both board and compensation committee meetings to consider the agreement and had a lawyer involved in the negotiation of the agreement. Madam Justice Lax was prepared to look beyond the façade of board consideration and approval to the “non-existent arms length negotiations, a lack of material information in the possession of the Board, and undue haste, including a cursorily-prepared ‘reasonableness’ opinion supporting the Agreement.”³

Mr. Berg tried, unsuccessfully, to argue that the decision of the Board to approve the compensation package should not be interfered with on the basis of the Business judgment rule. In *CW Shareholdings Inc. v. WIC Western International Communications Inc.* Justice Blair defined the business judgment rule as follows:

This rule is an extension of the fundamental principle that the business and affairs of a corporation are managed by or under the direction of its board of directors. It operates to shield from court interference business decisions which have been made honestly, prudently, in good faith and on reasonable grounds. In such cases the board's decision will not be subject to microscopic examination and the court will be reluctant to interfere and to usurp the board of director's function in managing the corporation.⁴

³ *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* (2002), 27 B.L.R. (3d) 53 (Ont. S.C.J.), ("*Repap*").

⁴ 39 O.R. (3d) 755.

To this traditional approach Madam Justice Lax added that “directors are only protected to the extent that their actions actually evidence their business judgment. The principle of deference presupposes that directors are scrupulous in their deliberations and demonstrate diligence in arriving at decisions.”⁵ This suggests a much greater level of judicial scrutiny of board decisions.

Madam Justice Lax’s finding that Mr. Berg failed to meet his duty to act in the best interests of the corporation also raises serious issues for individual directors when negotiating a personal compensation package. The inherent conflict in negotiating a personal deal with a board (to which you owe a higher duty) appears to be an almost impossible situation for the director. The recent US decision on a motion to strike the plaintiff’s claim in *Re The Walt Disney Derivative Litigation*⁶ suggests that, difficult as the situation may be, directors may be held personally liable for negotiating compensation packages that are harmful to the company or that create undue risk for the company. This is not to suggest, however, that the courts are prepared to second-guess board decisions as a matter of practice – it is significant that in both *Repap* and *Disney* the compensation packages were arguably so generous as to hurt the bottom line of the corporation and in both cases the good faith of the directors in agreeing to compensate their fellow director was in issue. Stay tuned as the *Disney* case is expected to go to trial in early 2004.

In the Canadian context there is one other case that is of importance to director and officer liability, and in particular the liability of directors and officers to the Trustee in Bankruptcy of insolvent corporations. In *Peoples Department Stores Inc. (trustee of) v. Wise*⁷ the judge at first instance found the directors liable to the Trustee thereby extending the fiduciary duty owed by the directors to the corporation to the corporation’s creditors. The basis for this extension was due, at least in part, to the directors decision to institute and continue new inventory procedures that eventually contributed to the insolvency of the company. On appeal the Quebec Court of Appeal reversed the decision at first instance, relieving the directors of any liability to the Trustee and reaffirming the business judgment rule.⁸ In March 2003 the Trustee sought leave to appeal to the Supreme Court of Canada. Leave was granted in August 2003 with a decision anticipated sometime in the next year.⁹

Keeping the Promise for a Strong Economy Act (Budget Measures)

In Ontario the legislative response to *Sarbanes-Oxley* began with Bill 198. Given royal assent in December 2002, the *Keeping the Promise for a Strong Economy Act (Budget Measures)* has made many changes to directors and officers liability. The changes are threefold: Firstly, the Act gives the OSC new rulemaking powers to, among other things,

⁵ *Repap*, note 1.

⁶ C.A. No. 15452 (Del. Ch. May 28, 2003).

⁷ [1998] Q.J. No. 3571.

⁸ [2003] O.J. No. 390.

⁹ [2003] S.C.C.A. No. 133.

change its rules to hold corporate executives accountable for the internal control of their companies. Secondly, the Act amends Part XXII of the *Securities Act* (Ontario), to add section 129.2. This section provides that where a company is determined not to have complied with Ontario securities law, those directors and officers who “authorized, permitted or acquiesced in the non-compliance” of the company will be deemed to also have not complied with securities laws. Thirdly, the Act amends the definition of ‘material fact’ so that the fact in question no longer needs to be a “fact that significantly affects” the market or value of such securities. Now, all that is required is a “fact that would reasonably be expected to have a significant effect on the market price or value of the securities.”¹⁰

This subtle change in the definition of a material fact has the potential to wreak havoc in boardrooms across the province. This is all the more likely given the seminal decision of the Ontario Securities Commission in *YBM Magnex International Inc.*¹¹ Here the Commission held that facts cannot be considered in a vacuum – those facts that on their own may not appear to be material, but that may pose a material risk to an issuer when considered in light of other facts, must be publicly reported. In *YBM* this extended to a series of rumours that, according to the Commission, suggested company-specific risks that were not disclosed in the company’s prospectus.

Pursuant to its new rulemaking powers, the Commission has introduced Multilateral Instrument 52-109, *Certification of Disclosure in Companies’ Annual and Interim Filings*. Slated to come into force on January 1, 2004, the instrument requires certain corporate executives (namely the chief executive officer or the chief financial officer) to certify that their companies have reasonable internal controls in place. A cursory nod of approval for internal controls will not suffice – the rules require the executive to evaluate the effectiveness of those controls. In addition, the CEO or CFO must certify that their issuers’ annual and interim financial statements do not contain misrepresentations and that they fairly represent the issuer’s present financial situation.

It should also be noted that Bill 198 introduces civil liability for the secondary market, however, these provisions have not yet been proclaimed into force. When, and if they are, this will broaden the scope of director and officer liability immensely.

Auditors

In an era of multi-service accounting firms there is no question that by the time the recent corporate and financial fiascos began to unfold, auditors had clearly transcended their traditional role “to ascertain and state the true financial position of the company”¹². Nevertheless, responsibility for the truth of the contents of the financial statements still ultimately lies with management and an auditor is entitled to rely upon representations made to them by management. More importantly, given the variety of services provided by accounting firms and the potential for conflicts of interest inherent in providing those

¹⁰ Section 177(2) of Bill 198, amending section 1(1) of the *Securities Act* (Ontario).

¹¹ (2003), 26 O.S.C.B. #28/03.

¹² *Re London & General Bank (No.2)*, [1895] 2 Ch. 673 (C.A.).

services, the liability of the auditor has traditionally been narrowly defined by the courts as the decision of the Supreme Court of Canada in *Hercules Management Ltd. v. Ernst & Young*¹³ shows. If the Canadian reaction to the US *Sarbanes-Oxley* reforms is any indication, the post-Enron policy considerations may, however, be markedly different.

Although a thorough review of all of the proposed changes to the Canadian auditing regime is clearly beyond the scope of this article there are three proposals that deserve special mention. The first of these is the creation of the Canadian Public Accountability Board (CPAB), the Canadian equivalent of the US' Public Company Accounting Oversight Board (PCAOB). Created to develop an oversight program for auditors of Canada's public companies, the CPAB is designed to operate in tandem with Canada's other market regulators and Multilateral Instrument 52-108 *Auditor Oversight* has been introduced to facilitate this process.

The second proposed change of interest here is the Canadian Institute of Chartered Accountant's (CICA) *Independence Standards* which are currently under review after a lengthy comment period. The CICA proposal is the Canadian response to the US Securities and Exchange Commission's *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*.¹⁴ Like its American counterpart the *Independence Standards* address the prohibition of non-audit services and partner rotation. The *Independence Standards* do not address audit committee requirements because pursuant to s. 187(1) of Bill 198, the authority here lies with the Ontario Securities Commission.

The final proposed change is Bill 198's civil liability for purchases in the secondary market. Given royal assent in December 2002, one year later these portions of the legislation have not been proclaimed into force. If and when these provisions are proclaimed, section 185¹⁵ will give those purchasers who acquire securities of an issuer during the period between the time the misrepresentation is made and the time it is publicly corrected, a civil right of action and the deemed reliance long sought after by Canadian plaintiffs. This will be a first for Canadian securities law.

A quick review of the changes and proposed changes reveals an underlying approach that may not be addressing the real issues – many of the proposals are geared to enhancing the independence of the auditor from the company, and yet, the evidence would seem to suggest that the corporate fiascos that were the impetus for these changes would not have been avoided by increased auditor independence – they were caused by fraud, and that did not necessarily involve the auditors.

PENALTIES

Bill 198, Keeping the Promise for a Strong Economy Act (Budget Measures)

¹³ [1997] 2 S.C.R. 165.

¹⁴ Effective May 6, 2003 with various transition dates.

¹⁵ Section 185 of Bill 198 creates section 138.3 'Liability for secondary market disclosure', Part XXIII of the *Securities Act* (Ontario).

Perhaps the most controversial part of Bill 198 has been its introduction of the 'administrative penalty' into the *OSA*. Pursuant to the new provisions (proclaimed into force in April 2003) the Commission now has the power to order a person or company to pay an administrative penalty of \$1 million *for each failure to comply with the Act*. In addition, the Commission has been given the power to order a person or company to disgorge *any amounts* obtained as a result of non-compliance with the Act.¹⁶ This is not a first for Canada; in fact, each of Alberta, British Columbia, Manitoba, Nova Scotia, and Quebec has varying powers to impose administrative penalties. In addition, both the IDA and RS have the power to impose fines of up to \$1 million per offence.

The other potentially significant penalties created by Bill 198 are found in the secondary market liability provisions. These provisions create a comprehensive penalty regime for the directors, officers, influential persons and experts that we looked at earlier in the context of auditor liability. However, as these provisions have not yet been proclaimed it is unnecessary to make a thorough review of the penalties at this time.

Insider Trading

As commercial crimes go, there is little doubt that illegal insider trading holds a special place in the hearts of regulators. For a variety of reasons (not the least of which is the inherent unfairness in someone knowing something we don't know, and using that knowledge to make money, possibly at our peril) trading in securities while in the possession of material undisclosed information is regarded by the Courts and the Commissions as a heinous offence. Currently, this 'crime' is not, in fact, part of Canada's criminal code. The statutory prohibition is actually found in the various Securities Acts and hence the enforcement options are limited in scope to those options that are available to the Commissions. However, given the ability of the Commissions to levy fines (and quite substantial ones at that) and to proceed quasi-criminally, we would argue that the criminalization of the offence is not necessary.

Notwithstanding these concerns, and hot on the heels of the report of the Illegal Insider Trading Task Force, the federal government has announced new measures to strengthen its enforcement initiatives against capital markets fraud. Included in this initiative is the new criminal code offence of insider trading with a maximum penalty of 10 years imprisonment.¹⁷ This is a marked increase in penalty from those currently available

¹⁶ Subsection 127 (1) paras. 9 and 10.

¹⁷ The proposed section of the criminal code provides as follows:

392(1) A person is guilty of an indictable offence and liable to imprisonment for a term not exceeding ten years who, directly or indirectly, buys or sells a security, knowingly using insider information that they

- (a) possess by virtue of being a shareholder of the issuer of that security;
- (b) possess by virtue of, or obtained in the course of, their business or professional relationship with that issuer;

under the regulatory regime. Currently the subject of much heated debate, it appears likely, especially given the findings of the Task Force, that the provision will find its way into the criminal code. When it does, it won't be without controversy, nor will it be without its share of litigation. Having traditionally been a regulatory offence, or quasi-criminal at best, there will no doubt be a number of cases upon the introduction of the new provisions, querying the appropriateness of proceeding criminally vis-à-vis the seriousness of the behaviour. In addition, the differences in standard of proof, evidentiary issues and *Charter*¹⁸ protections that exists between regulatory and criminal proceedings are sure to give rise to a number of challenges before the Courts and the Commissions.

Criminal Proceedings

While insider trading may be the hot topic of the moment in white collar crime, it is only one of the many corporate crimes that transcend the threshold between regulatory and criminal offences. For example, in Canada the *Criminal Code* contains provisions for, among other things, fraud, manipulation of securities transactions and creating and/or circulating a false prospectus. Notwithstanding the option of proceeding with criminal charges, the lion's share of commercial crime has traditionally been dealt with at the regulatory level. Yet, if the recent calls for sharper penalties for white collar crimes, and the increased presence of criminal authorities (think IMET's) in monitoring the capital markets are any indication, a concerted movement towards criminalization is well under way. This is also evident in the means by which the authorities choose to proceed against alleged offenders.

There is one recent case that in making headlines has served to highlight what may well be a new readiness to proceed under the Criminal Code rather than the Securities Acts. In 1995 the Alberta Securities Commission commenced administrative proceedings against Lawrence Ryckman for a variety of securities offences including stock manipulation. The Commission ultimately banned Ryckman from trading stocks in the province for 18 years

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- (c) possess by virtue of, or obtained in the course of, a proposed takeover or reorganization of, or amalgamation, merger or similar business combination with, that issuer;
 - (d) possess by virtue of, or obtained in the course of, their employment, office, duties or occupation with that issuer or with a person referred to in paragraphs (a) to (c); or
 - (e) obtained from a person who possesses or obtained the information in a manner referred to in paragraphs (a) to (d).

392(2) Except when necessary in the course of business, a person who knowingly conveys insider information that they possess or obtained in a manner referred to in subsection (1) to another person, knowing that there is a risk that the person will use the information to buy or sell, directly or indirectly, a security to which the information related, or that they may convey the information to another person who may buy or sell such a security, is guilty of

- (a) an indictable offence and liable to imprisonment for a term not exceeding five years; or
- (b) an offence punishable on summary conviction.

¹⁸ *Canadian Charter of Rights and Freedoms*, Schedule "B" to the *Canada Act 1982* (U.K.) 1982, c.11.

and imposed a \$550,000 fine. More recently, in January 2003, the RCMP laid criminal charges against Ryckman for defrauding shareholders of his company Aabbax International Financial Corp. In light of the recent trends in commercial crime it will be interesting to see – if Mr. Ryckman is convicted of the charges – if the severity of the penalty or penalties imposed warrant proceeding in the courts instead of the Commission.

Conclusion

While the recent developments in commercial crime have been fast and furious (not to mention broad and, on occasion, indiscriminate) there is a sense amongst market participants and commentators alike, that the recent hectic pace of change is about to subside. In particular, as the dust settles from the Enron-like corporate fiascos there appears to be a renewed interest and optimism in moving on and getting back to business. As it turns out, this may not be as simple as it seems. It will likely depend on the outcome of many of the proposals that we have discussed herein. In any event, 2004 is bound to be a momentous year for commercial crime and market participants should be mindful of the import of the many new and proposed changes. Lawyers should cancel their vacations as we are likely to be very, very busy.