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Recent Developments in the Securities Class Action Field in Canada

By Ian Rose

Ian Rose is a Partner in the Montreal office of Lavery, de Billy. He specializes in litigation and insurance, with particular emphasis on directors' and officers' liability. He is a member of the Steering Committee of the Canadian Chapter of PLUS. He can be reached at IRose@lavery.qc.ca or 514-877-2947.

December 2005 saw two important developments affecting securities class actions in Canada. The first was the release of the decision of the Ontario Court of Appeal in *Kerr v. Danier Leather*.[1] The second was the coming into effect of Ontario's new regime providing a statutory civil recourse to investors in the secondary market for misrepresentations in a company's public documents or the public statements made by its executives, or for its failure to make timely disclosure of material changes in its circumstances.

In *Danier* the Ontario Court of Appeal reinforced the application of the business judgment rule in Canada, even regarding decisions concerning disclosure of material facts relating to an earnings forecast arising between the issuance of a final IPO prospectus and the closing date of the offering. This decision provided some solace to the business community in Canada that had viewed the 2004 trial decision in *Danier*[2] with alarm.

However, any comfort that may have been gained by the *Danier* decision has certainly been attenuated by the prospect of increased securities class action activity that is widely predicted as the probable result of Ontario's new legislation, commonly known as Bill 198.

KERR vs. DANIER LEATHER

On December 15, 2005 the Ontario Court of Appeal reversed the May 2004 trial decision in *Kerr vs. Danier Leather*, reaffirming the business judgment rule in the context of financial forecasts made in an IPO prospectus.

In doing so, it provided some relief to Canadian executives who had viewed with alarm the trial decision that had awarded damages estimated at some CAN$14 million for an alleged misrepresentation related to financial forecasts contained in the prospectus for an initial public offering of Danier Leather shares.

The Background

This action was a securities class action arising from an alleged misrepresentation in the prospectus material, based on Section 130 of the *Ontario Securities Act*. It was the first securities class action in Ontario that had proceeded to trial, and the trial decision had been viewed with some concern, particularly in light of the new recourses now available to purchasers of shares in the secondary market.[3]

Section 130 of the *Ontario Securities Act* provides that purchasers of shares in a public offering pursuant to a prospectus containing a misrepresentation have a right of action for damages, and that the purchaser is "deemed to have relied on such misrepresentation." This deemed reliance is an important component of Section 130, as it thus relieves the purchasers from having to prove they each relied on the prospectus.

The issue of reliance has proved to be a significant stumbling block to securities class actions in Canada. Without such deemed reliance, securities class actions have in fact generally failed at the certification stage as plaintiffs have been unable to overcome the hurdle of having to prove they each relied on the misrepresentation in order to gain necessary class action status.

However, as this was a case of a misrepresentation in a prospectus, the reliance is deemed in the statute, and thus the hurdle was overcome. For transactions in the secondary market, which account for the vast majority of the securities purchased in Canada, this hurdle still existed up until December 31, 2005. As we explain below, all this has changed with the new legislation which has just come into effect in Ontario containing a similar deemed reliance provision for secondary market purchasers.

The Facts in Danier

Danier offered shares to the public in an IPO in May of 1998. In doing so, it had issued a prospectus containing a forecast and anticipated earnings for the fourth quarter of its fiscal year. After the final prospectus had been filed, but before the offering closed, information made available to senior management indicated that sales levels were not achieving the anticipated levels upon which the forecast had been based. However, senior management continued to believe the original forecast was achievable and, as a result, didn't amend the prospectus. Once the IPO had closed, Danier did issue a revised forecast, and the share price subsequently dropped significantly (from CAN$11.65 to CAN$8.25). As it turned out, the original forecast was in fact substantially achieved, but in the interim, a class action was commenced alleging the original forecast constituted a misrepresentation.

The class action plaintiffs were successful at trial, the trial judge deciding that the internal analysis available to management was material, and thus Danier was required by Section 130 of the *Securities Act* to update the prospectus.

The trial judge found that although the directors believed the forecast remained accurate, that did not relieve them of their obligation to disclose that they had received new material facts after the prospectus date that made the factual assertions implied in the forecast untrue. There was a finding that the prospectus contained an implied representation that the forecast was "objectively reasonable," but that the forecast was not, in fact, objectively reasonable at the time of the closing. The trial judge did not apply the business judgment rule to management's decision not to issue an update of the information prior to the closing of the IPO.

The Ontario Court of Appeal, in an unanimous ruling, reversed the trial court's decision, making a distinction between a "material change" that occurs before closing, which must be disclosed by amendment, and the occurrence of new "material facts" during that period, which do not.

The Business Judgment Rule

More importantly, the Ontario Court of Appeal concluded that the trial judge had failed to give any deference to the business judgment of senior management regarding the attainability of the forecast, which it states in the end turned out to be correct. In doing so, the Court of Appeal concluded that the trial judge had failed to give effect to recent jurisprudence in the Supreme Court of Canada and in the Ontario Court of Appeal on how management's judgments on matters of business are to be evaluated by the courts. In this regard, it referred specifically to the Supreme Court of Canada decision of October 2004 in *Peoples Department Stores Inc*. v. *Wise*[4] and the jurisprudence cited in that decision. It disagreed with the argument that the business judgment rule had no application in this case. It stated rather that "the exercise of determining whether there was a misrepresentation has the concept of business judgment about reasonableness built into it." The Court of Appeal called a forecast a "quintessential example of the exercise of business judgment". In looking at the case from that light, it went on to state that the "reasonableness" that is the centerpiece of the business judgment rule involves a "range of reasonableness". In doing so, it quotes the statement in the 1998 Ontario Court of Appeal decision of *Maple Leaf Foods* v. *Schneider*,[5] echoed by the Supreme Court of Canada in *Peoples* to the effect that:

> The Court looks to see that the directors made a *reasonable* decision *not a perfect decision*. <u>Provided the decision taken is within a range of reasonableness</u>, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. As long as the directors have <u>selected one of several reasonable alternatives</u>, deference is accorded to the board's decision [citation omitted]. This formulation of deference to the decision of the Board is known as the "business judgment rule" [italics in original, underlining added].[6]

The *Danier* decision in the Ontario Court of Appeal reaffirms that Canadian courts should defer to management, including its opinions regarding the attainability of forecasts, and should help prevent Canadian judges from substituting in hindsight their views about business decisions for those of senior management and directors, as long as these decisions are reasonable. As the plaintiffs have indicated their intention to seek leave for appeal to the Supreme Court of Canada, it is too early to tell whether another chapter remains to be written in this matter.

<u>ONTARIO'S NEW SECONDARY MARKET RECOURSE</u>

On December 31, 2005, amendments to Ontario's *Securities Act* came into effect providing investors with a new recourse against companies and their directors, officers, employees and consultants for any misrepresentation in their public documents or public oral statements, or for failure to make timely disclosure of material changes in the company's circumstances. This legislation, commonly known as "Bill 198," has created a powerful new right of action which arises whether or not there is actual reliance by the investor on the issuer having complied with its disclosure requirements. There is some serious concern that it may give rise to a significant increase in securities class action lawsuits in Canada.

The Origins of the Legislation

The origins of this legislation date back several years to a proposal made by the Canadian Securities Administrators, a group comprised of members of the various securities commissions from across Canada. The proposed draft legislation was released in November 2000, following recommendations made by a committee of the Toronto Stock Exchange - the Allen Committee - in a report issued in March of 1997 in the context of the worldwide trend toward greater transparency in corporate governance.

That committee report clearly stated that its recommendations were intended to emphasize deterrence rather than compensation as the primary goal of the legislation, recommending "the creation of a limited statutory regime whereby issuers and others who are responsible for continuous disclosure violations may be liable in civil actions brought by injured investors to recover their damages".[7]

These recommendations were made as a result of the conclusions of the Allen Committee that there was a significant degree of non-compliance with the existing continuous disclosure rules in Canada, that the current sanctions available to regulators were inadequate as a deterrent, and that private remedies available to investors in the secondary trading markets injured by misleading disclosure were so difficult to pursue and establish that they were largely academic.

In their comments regarding the proposed legislation,[8] the Canadian Securities Administrators had compared their proposals with the U.S. experience, stating "the CSA recognize that a due diligence standard is a more rigorous liability standard than the fraud based standard under Rule 10b-5. The key element of intent or recklessness which a plaintiff must establish to succeed in a Rule 10b-5 action need not be proved to establish liability on the basis of an absence of due diligence."

Although the recently adopted legislation contains a certain number of modifications, it is in most respects the same as the initial draft legislation proposed by the Canadian Securities Administrators in 2000.

The Ontario legislation is the first to be brought into effect. Other jurisdictions in Canada have indicated their intention to adopt similar legislation, and British Columbia has in fact adopted similar legislation, but it has yet to be proclaimed into effect.

The following is a brief overview of some of the key features of this legislation.

Who Does the Legislation Apply To?

This legislation will apply to any company that is a reporting issuer under the terms of the *Ontario Securities Act* as well as to any company having a real and substantial connection to Ontario whose shares are publicly traded. This would probably include any company whose shares are publicly traded in Ontario.

What Does the Legislation Apply To?

With the exception of securities that have been offered by a prospectus or by an exempt distribution, most transactions involving securities publicly traded in Ontario (estimated to be 94% of the transactions on the Toronto Stock Exchange) are covered by this legislation.

What Does It Require?

The legislation requires that those companies to whom the legislation applies not make misrepresentations in the documents they release or in the public oral statements their representatives make. It also requires these companies to make timely disclosure of any material changes in the companies' circumstances. Any document or public oral statement containing a misrepresentation or any failure to make timely disclosure may give rise to a right of action for damages against the company. Its directors and officers, the various influential persons as defined in the legislation (including their directors and officers), as well as the experts who have provided reports, statements or opinions containing misrepresentations, may also be held liable under these provisions.

Who Has a Right of Action?

Any person or company who has acquired or disposed of the issuer's securities during the period between the time the document was released, the public oral statement was made, or the material change was required to be disclosed, and the time when the misrepresentation was publicly corrected or the material change disclosed, has a recourse under the provisions of the legislation.

Deemed Reliance

One of the most important features of this legislation is that this right of action exists **whether or not** the person or company **relied** upon the misrepresentation or the fact that there was compliance with the disclosure requirements.

Damages

Damages are defined in the legislation as generally being equal to the difference between the average price paid for the securities and the price received upon disposition within the 10 days following the public correction of the misrepresentation or disclosure of the material change (or a variant thereof in the event the shares are not disposed of within that time frame).

Proportionate Liability

The legislation provides for proportionate liability, effectively limiting the damages assessed against each party found liable to only that portion of the damages corresponding to that party's share of the responsibility for the damages.

Limits on Damages

The legislation provides for limits on the amount of damages that can be claimed. These limits have been described as providing an additional safeguard against strike suits.[9]

These limits are:

- for a company, the greater of 5% of its market capitalization, or $1,000,000;
- for directors, officers, and influential persons (including their directors and officers), the greater of $25,000, or 50% of their aggregate compensation from the issuer and its affiliates; and
- for experts, the greater of $1,000,000, or the total revenue of the expert and its affiliates from the issuer and its affiliates for the 12 months preceding the misrepresentation.

These limits will be reduced by damage awards in other jurisdictions in Canada resulting from the same misrepresentation or failure to make timely disclosure.

It is important to note, however, that these limits **do not apply** to anyone, other than the responsible issuer, if it is proven that he, she, or it **knowingly** "authorized, permitted or acquiesced in the making of the misrepresentations or the failure to make timely disclosure while knowing it was a misrepresentation or failure to make timely disclosure, or influenced the making of the misrepresentation or the failure to make timely disclosure". Although proof of such knowledge may eventually prove difficult, allegations of such knowledge will be relatively simple to make and will thus permit claims to be made for amounts far in excess of the limits provided for in the legislation.

Defences

While there are a number of provisions in the legislation regarding defences and burden of proof that will provide those sued with significant means of exoneration, unfortunately, to have any effect, most of these will require the case to have reached a stage where evidence is to be heard and will thus not provide much solace at the early stages of litigation. By the time these defences can be given effect in a judgment, considerable damage may already have been done to both the reputation and the financial well-being of those sued.

The following are some of the key provisions regarding defences and burden of proof:

There is no liability unless the Plaintiff proves that the person or company accused of misrepresentation in a non-core document or a public oral statement knew or deliberately avoided acquiring knowledge that it contained the misrepresentation (or was guilty of gross misconduct in connection with its making or release). This provision does not apply with regard to an expert. (Sections 138.4(1) and (2)).

Similarly, there is no liability for failure to make timely disclosure unless the Plaintiff proves the person or company knew - or deliberately avoided knowing - of the change in circumstances and that the change was material at the time the failure to make timely disclosure first occurred (or was guilty of gross misconduct in connection with the failure to make the timely disclosure). This provision is not applicable to the company (the responsible issuer), its officers, an investment fund manager, or its officers. (Sections 138.4(3) and (4)).

There is no liability if the Plaintiff acquired or disposed of the securities knowing the document or statement contained a misrepresentation or had knowledge of the material change. The Defendant has the burden of proof. (Section 138.4(5)).

There is no liability if the person or company proves he, she, or it made a reasonable investigation before the release of the document or public oral statement, and that at that time, he, she, or it had no reasonable grounds to believe the document or statement contained the misrepresentation. Similarly, regarding a failure to make timely disclosure, no liability lies if a reasonable investigation had been conducted and the person or company proves he, she, or it had no reasonable grounds to believe that the failure to make timely disclosure would occur. Once again, the burden of proof of this reasonable diligence defence lies with the Defendant. (Section 138.4(6)).

There is no liability for misrepresentations in forward-looking information if the Defendant person or company proves the document or public oral statement contained reasonable cautionary language and a statement of the material factors or assumptions that were applied in making the forecast or projection, and also that it had a reasonable basis for drawing the conclusions it did. Once again, the Defendant has the burden of proof of this safe harbor Defence. (Section 138.4(9)).

There is no liability when a Defendant proves that it had no knowledge and no reasonable grounds to believe at the time a document was released that it would in fact be released (except with respect to a document that is required to be filed with the Securities Commission). (Section 138.4(13)).

A person or company is not liable when the misrepresentation or failure to make timely disclosure occurred without his, her, or its knowledge or consent as long as he, she, or it promptly notifies the Board of Directors, and if no correction is made within two days after such notice, he, she, or it advises promptly, and in writing, the Securities Commission. (Section 138.4(15)).

The Potential Application of the Legislation Outside Ontario

What has not been addressed by most commentators is the potential application of this legislation to shareholders who avail themselves of the legislation to launch class actions elsewhere outside Ontario.

For example, it appears likely that Quebec courts will apply this new legislation to any recourse based on a sale of shares that has taken place on an Ontario stock exchange, including those of Quebec-based companies whose shares are publicly traded on the Toronto Stock Exchange.[10]

Accordingly, if a class action lawsuit is filed in Quebec invoking these provisions of the *Ontario Securities Act*, it appears likely that a Quebec court would apply at least the substantive aspects of it, including the key feature regarding deemed reliance. However, some of the purported safeguards against strike suits, being procedural in nature, may not be applicable in Quebec.[11]

CONCLUSION

Canada has until now largely escaped the high – some would say excessive – level of securities class action litigation seen in the United States. This may be changing with the recent amendments to Ontario's *Securities Act.* There is likely to be some increased activity in this area in Canada as a result of these changes, but it is too early to tell whether the built-in safeguards will work as planned to bring a certain level of reasonableness, or whether an imaginative plaintiff's bar will find a way around them.

However, the *Danier* decision would indicate that Canadian courts - at least at the appellate level – will continue to show deference to decisions of senior management in applying the business judgment rule, even to decisions about disclosure of material facts relating to forecasts.

FOOTNOTES

1 2005 Carswell Ont 7296 (Ont. C A) (eC).
2 [2004] O.J. No. 1916 (O.S.C.J.)
3 See our remarks regarding the new legislation below.
4 [2004] 3 S.C.R. 461. The author acted in that matter on behalf of Chubb Insurance Company of Canada, the liability insurer of the directors of *Peoples*, before both the Quebec Court of Appeal and the Supreme Court of Canada.
5 *Maple Leaf Foods Inc*. v. *Schneider Corp*. (1998) 42 O.R. (3d) 177 (C.A).
6 *Kerr v. Danier Leather*, par. 157.
7 Toronto Stock Exchange Allen Committee Report, March 18, 1997.
8 CSA Notice 53-302, November 3, 2000.
9 This term is commonly used to refer to very large claims filed within days or even hours of a drop in share price even when little, if any, evidence of corporate wrongdoing exists, in an attempt to force a lucrative early settlement.
10 See Art 3115 of the Civil Code of Quebec.
11 Generally speaking, in Quebec law, procedure is governed by the law of the Court before which the action is taken (Article 3132 C.C.Q.). Accordingly, some of the key safeguards that the supporters of this legislation claim to be deterrents strike suits, such as the requirement to receive the Court's leave to proceed, the requirement for approval of the Court before any suit is discontinued, abandoned or settled and the stipulation that the prevailing party is entitled to costs, may not be applicable in Quebec.

The views expressed in this article are those of the author alone.
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Contact PLUS for more information at:
5353 Wayzata Blvd., Suite 600
Minneapolis, MN 55416
Phone: 800-845-0778 or 952-746-2580
Fax 952-746-2599
www.plusweb.org