

# Directors' & Officers' Liability

RECENT DEVELOPMENTS OF IMPORTANCE

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## Not For the Feint of Heart

There have been a number of significant developments in Canadian corporate law recently which impact the duties owed by directors and officers to a corporation and which, as a result, have implications for the exposure of these individuals to liability. This article addresses: (i) the expanding scope of directors' and officers' liability for misleading public disclosure; (ii) the low threshold that has been established for secondary market purchasers of securities to commence class actions against issuers and their directors and officers; and (iii) upcoming changes to Québec's corporations legislation.

## I. Non-Misleading Disclosure Obligations

In Canada, securities legislation imposes certain obligations on issuers (and their officers and directors) to avoid making misleading or untrue statements. In Ontario, pursuant to section 122 of the *Securities Act* (Ontario) (the "*OSA*"), it is an offence to make a misleading or untrue statement in any material evidence or information submitted to securities regulators or to make a misleading or untrue statement in any application, release, report, preliminary prospectus, prospectus, return, financial statement, information circular, take-over bid circular, issuer bid circular or other document that is required to be filed or furnished under Ontario securities laws. Other Canadian provinces have similar provisions in their securities laws.

These provisions of the *OSA* recently came under the scrutiny of the Ontario Securities Commission (the "OSC") in *Re Biovail Corporation* with somewhat surprising results. Despite a finding in that case that neither the issuer nor (one of) its directors had breached section 122 of the

*OSA*, the OSC nevertheless concluded that it ought to impose sanctions on the individual director pursuant to its public interest jurisdiction, for his role in misstatements made by the company.

### *Re Biovail Corporation*

The *Biovail* decision arises from events in October 2003 when a truck carrying Wellbutrin XL, an antidepressant drug manufactured by Biovail Corporation ("Biovail"), was involved in accident. Following that accident, Biovail made statements regarding the financial impact of that event to its financial results for its 2003 third-quarter earnings. Specifically, Biovail made statements to the effect that the accident was one of the reasons for its failure to meet previously issued revenue and earnings guidance for its third quarter and stated that the revenue associated with the product involved in the accident was in the range of C\$10 to C\$20 million or C\$10 to C\$15 million (Biovail in fact, later recorded the loss as C\$5 million). These statements were made in a series of news releases in October 2003, and further released in March 2004 (the "Releases"), an analysts conference call and various "roadshow" presentations.

Prior to the proceeding, the OSC approved settlement agreements with Biovail and three senior officers of Biovail in respect of the allegations made against them regarding the statements. As a result the proceeding was brought only as against the non-settling respondent, Eugene N. Melnyk ("Melnyk"), the Chairman and Chief Executive Officer of Biovail at the time the statements were made. At issue in the proceeding was whether Biovail knew, or ought to have known, that the statements made were materially misleading or untrue, thereby violating Ontario securities laws, and whether Melnyk authorized, permitted or acquiesced in all of the alleged misstatements and was therefore also guilty of an offense. It was also alleged that the conduct leading to the alleged

misstatements was contrary to the public interest.

After reviewing the statements in issue the OSC concluded that, while the statements were misleading to investors, some of those statements were not misleading in a *material* respect, as required in order to constitute an offence under section 122 of the *OSA*. In addition, even those statements which were misleading in a material respect were not statements, evidence or documents that were provided under Ontario securities laws. Accordingly, there was no breach of section 122 of the *OSA* by either Biovail or Melnyk.

However, the OSC is granted broad public interest jurisdiction authority under section 127 of the *OSA* to impose sanctions to protect investors and the capital markets. The OSC rejected the assertion that, in order for Melnyk's conduct to engage that jurisdiction, that conduct was required to be abusive or egregious in nature. The OSC determined that there is an essential public interest in ensuring that all public statements made by reporting issuers and others are accurate and not misleading and can be relied on by investors, even if those statements do not meet the materiality threshold of section 122 or are not set out in the documents to which that provision applies. Rather, the OSC held that any public misstatement by an issuer or a responsible person potentially falls within the ambit of the OSC's public interest jurisdiction, although the OSC noted that its exercise of this authority would not be appropriate in all cases and was context-specific.

The OSC found that Melnyk was the founder and driving force of Biovail at the relevant time and he could not separate himself from the actions of the company. The OSC rejected Melnyk's arguments that he did not know key information that other officers and employees knew at particular times and found that Melnyk had access at any time to whatever information was known to Biovail, was directly involved in decisions related to

some of the disclosure and had final approval of the Releases and other public statements. The OSC concluded that Melnyk was an active CEO and could not disclaim responsibility on the basis that he relied in good faith on other officers of the company. Melnyk bore the onus of establishing that he acted with due care and diligence in the circumstances and, in the OSC's view, he failed to satisfy that burden. In the result, the OSC held that Melnyk acted contrary to the public interest and should be sanctioned accordingly.

At the time of writing this article, it is not known whether Melnyk will seek to challenge any of the rulings of the OSC through the judicial review process nor is it known what sanctions will be imposed by the OSC in respect of these findings. A sanction hearing is to be scheduled shortly.

### [The Implications of the \*Biovail\* Decision](#)

The decision in *Biovail* signals a real expansion of both the OSC's public interest jurisdiction under the *OSA*, and the potential for directors and officers of public companies to incur liability with respect to a company's public disclosure statements (even where such statements may themselves not attract sanctions). While careful to note that sanctions under the OSC's public interest authority will not be appropriate in the case of *any* misstatement, this decision nevertheless underscores the importance for directors and officers to exercise the utmost care and diligence in ensuring the accuracy of all of a company's public disclosure, regardless of the particular content of that disclosure.

## II. Securities Class Actions

Unlike in the United States, securities class actions are a relatively new phenomenon in Canada. The late development of securities classes in Canada can likely be attributed to the fact that most Canadian provinces have only had class proceedings legislation in place

for less than 20 years and, until very recently, it was almost impossible for secondary market purchasers to sustain a misrepresentation action, given that reliance (a key component of a claim of misrepresentation) is generally considered to require an individual assessment, and is therefore not suitable for determination as a "common issue" on a class-wide basis. Unlike in the United States, the Canadian courts specifically rejected the "fraud on the market" theory of liability (which assumes an efficient market responds to all information and therefore individual reliance issues are not necessary).

In 2006, the landscape for Canadian securities class actions changed dramatically with the enactment in Ontario, of the secondary market liability provisions into Part XXIII.1 of the *OSA*. Those provisions allow secondary market security purchasers to maintain actions against issuers, directors and officers (amongst others) for alleged disclosure violations without the need to prove individual reliance. Since that time, most other Canadian provinces have adopted similar legislative provisions.

Under the secondary market liability provisions, an action may only be commenced with leave of the court where the plaintiff can establish that: (i) the action is brought in good faith; and (ii) there is a reasonable possibility that the action will be resolved at trial in the plaintiff's favor.

### [Silver v. IMAX Corporation et. al.](#)

On December 14, 2009, Justice van Rensburg of the Ontario Superior Court of Justice released two related decisions granting the plaintiffs leave to proceed with the action and certifying the class in *Silver v. IMAX Corporation et. al.* The *IMAX* case is significant as it represented the first time a court applied the statutory test for leave to proceed with a secondary market class action against an issuer and certain of its directors (amongst others).

In *IMAX*, the plaintiffs are IMAX shareholders who allege that IMAX misrepresented in its 2005 Form 10-K, 2005 Annual Report and in various press releases issued in February and March 2006 that the financial results disclosed in those documents were prepared in accordance with GAAP. The plaintiffs assert that, as a result of these alleged misrepresentations, the company also misrepresented its estimated earnings per shares as set out in those documents. Included as defendants in the Action are a number of current and former officers and/or directors of IMAX.

### [The Threshold for Obtaining Leave to Proceed](#)

#### [Good Faith](#)

In considering the "good faith" aspect of the statutory test, the defendants urged Justice van Rensburg to accept a standard whereby the plaintiffs would be required to show the action was being brought for the benefit of the corporation, and not just the personal benefit of the plaintiffs, and that the plaintiffs held a reasonable belief as to the merits of their claim. This standard was, however, ultimately rejected by the Court, in favor of the lesser requirement that the plaintiffs merely demonstrate an honestly held belief that they have an arguable claim and the claim has been brought for reasons which are consistent with the purposes of the *OSA*, and not brought for an "oblique or collateral purpose."

In considering the evidence before her, Justice van Rensburg accepted that the plaintiffs had brought the action in order to facilitate shareholders' recovery of damages and to hold the defendants accountable for their alleged misrepresentations and thereby deter other market participants from similar conduct. Accordingly, Justice van Rensburg concluded that the good faith component of the leave test had been met.

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### Reasonable Possibility of Success

The second aspect of the leave test requires plaintiffs to demonstrate a “reasonability possibility” that they will be successful at trial. The defendants argued that this portion of the test required the Court to set a high threshold such that the plaintiffs should be required to demonstrate that, at trial, they could overcome the statutory defenses raised by the defendants. However, Justice van Rensburg did not agree.

Instead, Justice van Rensburg held that, while the plaintiffs were required to submit evidence regarding the alleged misrepresentation and the actions of the directors and officers in relation to that misrepresentation, the “reasonable possibility” standard required only a showing of “something more than a *de minimus* possibility or chance that the plaintiff will succeed at trial.” On the evidence, the Court found that this low threshold had been met.

Justice van Rensburg held that the defendants could lead evidence at the leave stage with respect to the statutory defenses available to them under the *OSA*, but in order to demonstrate that the action ought not to proceed, were required to

This leave ruling *IMAX* is of particular importance to directors and officers of public issuers as it provides the first judicial consideration of the statutory defenses available to defendants in a secondary market securities class action and provides some guidance as to what defendants will need to demonstrate in order to avail themselves of these defenses.

The first defense considered by the Court was the “reasonable investigation” defense set out in section 138.4(6) of the *OSA*. This provision establishes that it is a defense to an action in respect of a misrepresentation if the defendant proves that: (i) before the release of the document containing the misrepresentation, he conducted or caused to be conducted a reasonable investigation; and (ii) at the time of the release of the document he had

no reasonable grounds to believe that the document contained the misrepresentation.

In considering this defense, Justice van Rensburg was of the view that it contained two principal components, the first of which requires in the *IMAX* case a consideration of matters as the measures and systems in place at the company respecting the recognition of revenue for financial reporting, the roles and responsibilities of various person in the revenue recognition and reporting processes, policies and procedures and oversight and assurance measures, including the performance of audit functions. With respect to the individual officers and directors named as defendants, relevant considerations included their respective qualifications, knowledge and experience, as well as their roles and responsibilities within or in relation to the organization regarding financial reporting.

The second part of the reasonable investigation defense requires a consideration of the specific knowledge of each defendant and the knowledge that someone in his or her position ought to have with respect to the misstatement in issue. This part of the test focuses on the true state of affairs, meaning what was known to whom, and which of the defendants (if any) ought to have known that the misrepresentations, when made, were untrue.

The defendants urged Justice van Rensburg to apply the common law “business judgment rule” to the reasonable investigation defense which rule states that deference will be afforded to decisions of directors where the decision falls within a range of reasonableness. The Court, however, rejected that directors can rely on the reasonable exercise of their business judgment as a defense under the strict liability regime created by secondary market liability provisions contained in the *OSA*. The Court concluded that there was no compelling reason to apply the business judgment when considering the reasonable

investigation defense given that statutory disclosure obligations exist to protect investors and capital markets and there is a mandatory obligation to issue accurate financial statements. Reading in a standard of deference to a director’s decisions would be both unnecessary and inconsistent with scheme established by the *OSA*.

In applying the reasonable investigation defense to the director and officers of *IMAX*, the Court found that all but two of the directors and officers named in the proceeding had not tendered sufficient evidence to meet their burden of showing that the plaintiffs’ reasonable possibility of success at trial was foreclosed. Given that there was some evidence that most of the directors and officers had been involved in the financial accounting processes of the company (either directly or through their roles or participation in audit committee meetings) and there was evidence to suggest that there were some internal deficiencies in the accounting processes, the Court considered that sufficient to allow the action to proceed against most of the individual defendants. Leave to proceed was only denied as against two outside directors who had no role on the company’s audit committee, did not participate in meetings and who relied on the audit committee’s conclusion with respect to signing off on the company’s financial statements.

Accordingly, absent clarification of this defense by an appellate court, it seems that directors and officers will be held to a high standard to show that they had acted diligently with respect to their disclosure obligations and that the action ought not to proceed against them at the leave stage.

The Court also provided some insight into defendants’ ability to rely on the “expert reliance” defense set out in section 138.4(11) of the *OSA*. The Court concluded that this was not a general deference that is available whenever a misrepresentation is made by a person who has reasonably relied on expert advice and, instead, concluded that it had a much

narrower application. Specifically, the defense is only available where the misrepresentation in issue quotes or summarizes a report statement or opinion made by an expert. In this case, none of the misrepresentations in issue originated from an expert, even though expert's had been consulted by company as well as its directors and officers, and therefore was not applicable in the circumstances. Once again, if the Court's ruling in *IMAX* stands, the ability of directors and officers to rely on expert advice and opinions as a defense against a statutory misrepresentation claim appears to be extremely limited.

### The Certification Ruling

Concurrent with the leave ruling, Justice van Rensburg also issued a decision certifying the *IMAX* case as a class proceeding in respect of both statutory and common law causes of action alleged by the plaintiffs. While the Court applied the well-settled test for certification of class proceedings, the decision is notable in two principal respects.

### Certification of a Global Class

First, the plaintiffs sought certification of a global class comprised of all persons who purchased securities of IMAX during the relevant time period and who held some or all of their shares as of August 9, 2006, being the date when IMAX first disclosed it was being investigated by the Securities Exchange Commission. One of the arguments raised on behalf of the defendants against certifying a global class was that it would create a conflict of laws issues given that some of the purchasers were outside Ontario and a class proceeding had already been commenced in the United States in respect of US purchasers. The Court rejected this argument as premature, finding that there was a real and substantial connection between the subject of the action and Ontario, notwithstanding the fact that only approximately 15 per cent of the proposed

class members were resident in Canada. Justice van Rensburg viewed the fact that an action had already been commenced elsewhere to be immaterial for the purposes of the Ontario proceeding. In any event, the Court concluded that it was not clear that the defendants would be relying on foreign laws in their defense and the Court preferred to "wait and see" how these issues developed.

### Certification of Common Law Misrepresentation Claims

The second noteworthy issue in the *IMAX* certification ruling is the Court's approach to the plaintiffs' claims of common law misrepresentation (as opposed to the statutory misrepresentation claims available under the *OSA*). Common law representation requires that a plaintiff establish the following five elements: (i) the defendants owed a duty of care to the plaintiffs on the basis of a "special relationship" between them; (ii) the defendants made an untrue, inaccurate or misleading representation; (iii) the misrepresentation was made negligently; (iv) the plaintiff reasonably relied on the misrepresentation; and (v) the plaintiff suffered damages due to the misrepresentation.

At issue on the certification motion was whether the plaintiffs could establish whether they were owed a duty of care and that the class members had reasonably relied on the alleged misrepresentations. The defendants argued that while a duty of care was owed, public policy reasons should be applied to engage the duty as, otherwise, issuers and their officers and directors, would be exposed to indeterminate liability which was inconsistent with the remedial provisions in the *OSA*. Justice van Rensburg found that a duty of care may be owed in the circumstances but refused to limit any such duty on the basis of public policy or indeterminate liability concerns.

With regards to reasonable reliance, the plaintiffs argued that individual reliance by

class members did not need to be proved and, instead, the plaintiffs could rely on the "efficient market theory" to establish reliance. The efficient market theory assumes that the market for IMAX shares was efficient insofar as all the share price accurately represented all public information. The plaintiffs agreed that they therefore relied on the misrepresentation by purchasing shares during the period in which the misrepresentations were public and uncorrected. The defendants argued this theory was tantamount to a "fraud on the market theory" which has not been recognized by Canadian courts as a means of establishing reliance on misrepresentations. Justice van Rensburg, however, sided with the plaintiffs and found that, while the efficient market theory had not been taken to trial, it was conceivable that this theory could sustain a claim. In short, the plaintiffs were not required to prove direct reliance at the certification stage and this could be addressed at trial.

At least one decision subsequent to *IMAX* has taken a contrary view to whether or not plaintiffs can avoid a demonstration of actual reliance at the certification stage of a proceeding. In the recent ruling of *McKenna v. Gammon Gold Inc.*, (which is not statutory secondary market claim) Justice Strathy of the Ontario Superior Court of Justice rejected the approach to common law reliance taken in the *IMAX* case for the purposes of certification and held that the need to prove actual reliance was a necessary element of a negligent misrepresentation claim and the inability to establish this as a common issue made negligent misrepresentation claims unsuitable for certification. Accordingly, Justice Strathy refused to grant certification on the issue. Furthermore, Justice Strathy rejected a world wide class (as had been certified in *IMAX*) and narrowed the class to only Canadian purchasers, or shared purchased through a Canadian underwriter.

Given these conflicting decisions,

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whether or not the “efficient market” or similar theories of reliance can be used to make reliance a common issue for the purposes of certifying misrepresentation claims in a class proceeding will require the ruling of an appellate court to finally determine. If the decision in *IMAX* stands, and plaintiffs are able to rely on an efficient market theory to establish reliance as a common issue for the purposes of certification, the threshold for certifying common law misrepresentations has been considerably lowered and directors and officers may face an increase of such class action claims being advanced against them. At the time of writing, both decisions are subject to appeal however.

### Implications of *IMAX*

Pending the disposition of the *IMAX* defendants' attempts to appeal these rulings, it appears as though the threshold for commencing a securities claim on behalf of secondary market purchasers will be relatively low. Accordingly, directors and officers of public issuers whose shares trade on a Canadian stock exchange or who have shareholders resident in Canada, can expect an increase in exposure to improper disclosure-based claims.

### General Status of Securities Class Actions in Canada

While *IMAX* is currently the only secondary market securities class action under the new legislation that has proceeded through the leave stage and through a contested certification hearing, it is by no means the only proceeding which has been commenced. As at the time of writing this article, the authors are aware of at least 17 different proposed class proceedings in which statutory secondary market claims have been commenced against issuers and their directors and officers. While some of these matters have been stayed by the courts or have settled, it is nevertheless clear that secondary market securities class actions are becoming a fixture in Canadian legal system and

represent a new area of potential exposure for directors and officers.

Directors and officers will want to watch the continuing developments in this area over the coming months as a number of notable decisions are expected from the courts, both in respect of the outcome of the *IMAX* appeals and in respect of certain decisions which are expected to determine the jurisdictional reach of the *OSA* and its provincial counterparts. In particular, the Ontario courts are expected to hear a challenge to the jurisdiction of the Ontario courts in *Juniper v. American International Group Plc* Ont. S.C.J. File No. C-1094-08 (“*AIG*”), a proposed class action brought by, and on behalf of, secondary market securities purchasers of *AIG*'s securities against *AIG* and certain of its current and former directors and officers. The defendants in that action are expected to challenge the plaintiffs' motion for leave to bring the claim under the *OSA* on the basis that Ontario does not have jurisdiction over them as *AIG* is not a reporting issuer in Ontario and the plaintiffs did not purchase their securities on a Canadian stock exchange given that *AIG* is not listed to trade on any Canadian stock exchange. The outcome of this proceeding, will have significant implications for foreign issuers and will impact the extent to which directors and officers outside of non-Canadian public companies risk civil liability for disclosure violations in Canada.

### III. The New Corporations Act (Québec)

On December 4, 2009, the Québec legislature enacted the *Business Corporations Act* (Québec) (the “*QBCA*”) which will come into force on a date to be set by the government and which is anticipated to come into effect in January 2011. The majority of companies currently incorporated in Québec will automatically become “business corporations” under the *QBCA* and the relatively small number of companies which will remain under the current *Business Companies Act* (Québec)

will have a five year grace period after the *QBCA* comes into force to either file articles of continuance in accordance with the *QBCA* or face dissolution.

The *QBCA* represents a major legislative reform to Québec's current companies legislation and is the product of a broad consultative process dating back to 2007. The purpose of the reforms is to modernize the province's corporate law framework, which has not been significantly amended since the 1980s, as well as to bring the legislation in line with its federal and provincial counterparts. Among the reforms included in the *QBCA* are increased protections for minority shareholders, improved governance practices and a shift towards more flexible administrative processes and the increased use of technology in carrying out those procedures.

While a detailed review of the sweeping changes that will occur when the *QBCA* comes into force is beyond the scope of this article, it is important to note that the new legislation will alter and clarify the rights and obligations of directors subject to the *Act*. Under the *QBCA*, directors will now be subject to the same obligations that are required of a director of a legal person under the *Civil Code of Québec*. In particular, the *QBCA* establishes that directors are under the obligations to act with prudence, diligence, honesty and loyalty in the interests of the corporation. In addition to clarifying directors' duties, the *QBCA* also expands the defenses open to directors. Specifically, the *QBCA* provides that directors are entitled to benefit from the presumption that they have acted prudently and diligently if, in good faith and on reasonable grounds, the director relies on a report, information or an opinion provided by an officer, legal advisor, accountant or other expert retained by the corporation or by a committee of the board of directors.

In addition, the *QBCA* provides a new framework for directors and officers engaging in interested transactions with

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the corporation and requires the disclosure of the nature of such interest by the director or officer.

The indemnification provisions for directors and officers have also been enhanced and corporations will now be required to indemnify a director or officer of the corporation and a former director of officer of the corporation (amongst others), against all costs, charges and expenses reasonably incurred in performing their functions and including settlement

amounts or judgments in which the person is involved if:

- i) the person acted with honesty and loyalty in the interest of the corporation;
- ii) in the case of a proceeding enforced by a monetary penalty, the person had reasonable grounds for believing that his or her conduct was lawful.

These changes to directors and officers

rights and duties listed in this article are not meant to be exhaustive of all such changes that will result under the *QBCA*. Individuals who are or may be subject to the *QBCA* when it comes into force are encouraged to review the new legislation in detail and to consult with their legal advisors as to the full extent of the changes that will occur when the Act comes into effect. ■



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