

OFF TO THE RACES

Emerging issues in Canadian securities class action litigation

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The enactment of legislation creating secondary market liability in most Canadian jurisdictions has led to a steady increase in the number of securities class actions filed in Canada over the last few years. According to a recent study, a total of 18 new cases were filed in 2008 and 2009, compared to a total of 38 cases filed in the preceding decade. Of the 23 outstanding cases as of January 2010, eight involved parallel proceedings in the United States (Berenblut, M.L. & Heys, B.A. [NERA Economic Consulting], “Trends in Canadian Securities Class Actions: 2009 Update,” January 2010).

This, of course, pales in comparison to the number of cases in the United States. In contrast to the extensive US jurisprudence in this area, Canadian courts are only beginning to address the ground rules for Canadian secondary market class actions. In a sense, securities class actions in Canada are like horses poised in the chute at the start of the race.

This paper reviews recent securities class action decisions in Ontario, briefly addressing three issues that present challenges in cross-border litigation: (i) the evidentiary requirements on motions for

leave to pursue secondary market liability claims and the potential for abuse of process in concurrent proceedings in Canada and the United States; (ii) the certification of common law negligent misrepresentation claims contrary to the established jurisprudence that such claims are generally not amenable to class certification in Canada; and (iii) the extraterritorial applicability of securities laws (and the certification of global classes) where the plaintiff or proposed class members purchased shares of a foreign issuer outside of Canada.

The Pace Setters: Statutory Framework

Part XXIII.1 of the Ontario *Securities Act*, R.S.O. 1990, c. S.5 (OSA), which came into effect on December 31, 2005, provides statutory causes of action for investors who buy or sell securities in the “secondary market” by granting a right of action for (i) a misrepresentation made by or on behalf of a responsible issuer in a publicly disclosed document or public oral statement, and (ii) a responsible issuer’s failure to make timely disclosure of a material change.

These provisions have since been replicated in

almost all other Canadian jurisdictions. Prior to these enactments, securities acts provided a statutory cause of action only to investors who purchased securities sold to them pursuant to a prospectus, offering memorandum or securities exchange take-over bid circular (commonly known as the “primary market”) (see OSA, ss. 130 and 131).

Because of the potentially far-reaching scope of this liability and to curtail American-style “strike suits,” the statutes provide that a prospective plaintiff may only commence a proceeding with leave of the court (OSA, 138.8). In addition, the statutes provide a number of defenses and include mechanisms to limit the amount of damages that can be claimed through strict monetary caps for different classes of defendants and prescribed formulae for calculating damages.

Entering the Chute: Evidentiary Requirement for Leave

In order to provide some measure of gatekeeping for secondary market misrepresentation claims, the OSA provides that leave will only be granted to commence a claim under Part XXIII.1, if the court is satisfied that: (i) the action is being brought in good faith; and (ii) there is a “reasonable possibility” that the action will be resolved in favor of the plaintiff (s. 138.8(1)).

The OSA provides that upon an application for leave, “the plaintiff and each defendant shall serve and file one or more affidavits setting forth the material facts upon which each intends to rely,” and that the maker of such an affidavit may be examined on it in accordance with the rules of the court (ss. 138.8(2) and (3)). There is conflicting jurisprudence in Ontario on whether this imposes a mandatory obligation on all parties to file affidavits.

The first case to consider this provision in Ontario was *Silver v. Imax Corp.* ([2008] O.J. No. 1844) (*IMAX*). Silver alleged negligence, negligent and reckless misrepresentation, conspiracy and a statutory claim for secondary market misrepresentation. In advance of the leave motion, the plaintiff moved to compel the defendants to answer questions refused on cross-examination on the defendants’ affidavits. In ordering the defendants to answer most of the questions, van Rensburg J. took a very broad approach to the evidentiary requirement on a leave motion. The court held that a “shareholder who seeks leave to commence a claim under s. 138.8 has special powers that are available in the context of such a claim and not generally” and that the procedure under s. 138.8 is

“a mandatory requirement for each plaintiff and each proposed defendant.”

However, in *Ainslie v. CV Technologies Inc.* ([2008] O.J. No. 4891) (*CV Technologies*), Lax J. took a more restrictive approach to the evidentiary requirement. In this proposed class action against CV Technologies and three former or present officers, the plaintiffs alleged that the company’s financial statements contained misrepresentations. In response to the leave motion, the defendants did not file any affidavits other than from expert witnesses. The plaintiffs argued, based on *IMAX*, that s. 138.8 created a mandatory obligation on the part of the defendants to each file a sworn affidavit upon which they could be cross-examined.

Lax J. considered the purpose behind the leave requirement, which was intended as a “screening mechanism,” and concluded that s. 138.8(1) “was not enacted to benefit plaintiffs or to level the playing field for them in prosecuting an action under Part XXIII.1 of the OSA. Rather, it was enacted to protect defendants from coercive litigation and to reduce their exposure to costly proceedings.” The defendants were, therefore, not required to file affidavits.

Unfortunately, whether each named defendant is obligated to file an affidavit in response to a leave motion remains unresolved. Although leave to appeal was granted to the plaintiffs in *CV Technologies* based on the apparent conflict, with the *IMAX* decision ([2009] O.J. No. 730), that appeal was not heard as the case settled in the interim.

The courts are certain to provide guidance on this issue as more cases proceed to the leave stage. Such guidance is indeed necessary as providing invasive and far-reaching investigatory powers over *potential* defendants may lead to a practice by plaintiffs of naming numerous parties as defendants in an attempt to obtain as much discovery as possible, as early as possible.

There are also important practical implications for cross-border litigation where “copy-cat” class actions in Canada follow shortly after similar, if not identical, claims are filed in the US. In the US, all discovery is stayed until the conclusion of all motions to dismiss, which are usually a defendant’s first line of defense. The potential availability of wide-reaching discovery early in Canadian proceedings presents plaintiffs’ counsel in the US, who often coordinate with Canadian counsel, with the opportunity to use Canadian discovery in defending motions to dismiss, where they would not otherwise have access to any discovery. In Canada, defendants’ counsel should

consider obtaining sealing or confidentiality orders in respect of the evidentiary record on leave motions.

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Lifting the Gate: The Test for Leave

The only judicial interpretation of the test for leave in Canada thus far has been in the *IMAX* proceeding ([2009] O.J. No. 5573). In December 2009, van Rensburg J. granted plaintiffs leave to proceed with their action under s. 138.8 against all defendants except for two outside directors, and certified the action on the basis of both statutory and common law claims. Both of these decisions are presently under appeal.

In addressing the first prong of the test, the *IMAX* defendants took the position that (i) the plaintiffs had a heavy onus to establish good faith, which requires that the action be brought for the benefit of the corporation and not for the plaintiffs' benefit, and (ii) the plaintiffs must demonstrate a reasonable belief in the merits of their claim. Justice van Rensburg rejected this argument and determined that the plaintiffs were only required to establish that they brought the action in the honest belief that they have an arguable claim and for reasons that are consistent with the purpose of the statutory cause of action and not for an “oblique or collateral purpose.” As the plaintiffs had brought the action to permit shareholders to recover damages and to enforce *IMAX*'s continuous disclosure obligations, which van Rensburg J. determined was consistent with the statutory scheme for secondary market liability, Her Honor concluded that the plaintiffs had met the first branch of the test for leave to assert their statutory claim.

In respect of the second branch of the leave test, i.e., whether there is a “reasonable possibility” that the action will be resolved in favor of the plaintiffs, all parties acknowledged that a preliminary consideration of the merits of the plaintiffs' case was necessary. The court held that the “reasonable possibility” requirement was a low threshold, requiring only that a “reasoned consideration of the evidence” yield “something more than a *de minimis* possibility or chance that the plaintiff will succeed at trial.”

Justice van Rensburg also placed a high onus on the defendants in respect of their statutory claims by holding that to establish these defenses at the leave stage, a “defendant must submit evidence that would foreclose the plaintiffs' reasonable possibility of success at trial.”

And They're Off: Certification of Common Law Claims in Negligent Misrepresentation

Historically, securities class actions in the secondary market context were rarely certified because common law claims for misrepresentation in Canada require the plaintiff to prove individual reliance on the misrepresentation, which is difficult, if not impossible, to do on a class-wide basis. Plaintiffs generally continue to plead these causes of action together with statutory claims, presumably in an effort to circumvent the statutory caps on damages.

In *IMAX*, the plaintiffs pleaded common law claims in misrepresentation in the alternative to the statutory secondary market claim. In certifying the action as a class action, van Rensburg J. certified both the statutory and common law misrepresentation claims. With respect to reliance, the plaintiffs argued that the “efficient market” theory could be used to establish that by the act of purchasing or acquiring *IMAX* securities the plaintiffs relied on the alleged misrepresentations.

Although acknowledging that no case asserting the “efficient market” theory had gone to trial, van Rensburg J. held that the reliance issue was not an impediment to certification. According to Her Honor, instead of alleging individual reliance (in the traditional sense) on the part of each class member, it

would conceivably be sufficient that the plaintiffs were alleging that the market for IMAX's shares was efficient (i.e., that the share price reflected all available public information), and that they therefore relied on the misrepresentations by virtue of having acquired their shares during the period the misrepresentation remained uncorrected. To what extent the "efficient market" theory is akin to the American "fraud on the market theory," which was previously rejected in Canada (*Carom v. Bre-X Minerals Ltd.*, (1998) 41 O.R. (3d) 780), will likely be clarified on the appeal.

In a subsequent securities class certification decision in *McKenna v. Gammon Gold Inc.* (2010 ONSC 1591) (*Gammon Gold*), Strathy J. rejected van Rensburg J.'s view that a plaintiff is not required to prove direct reliance at the certification stage and that the issue can be left for argument at trial. In that case, the plaintiff alleged that Gammon, a TSX- and AMEX-traded Nova Scotia company with mining operations in Mexico, together with its senior officers and/or directors made misrepresentations in Gammon's prospectus and other public filings, the effect of which was to overestimate the actual and anticipated production rate at Gammon's Mexican mines.

The plaintiff claimed that he, and other proposed class members who purchased Gammons shares under the prospectus, relied on the misrepresentations contained therein and overpaid for their shares. The plaintiff claimed common law causes of action for negligence, negligence misrepresentation, reckless misrepresentation, conspiracy, unjust enrichment and waiver of tort and statutory cause of action for prospectus misrepresentation pursuant to s. 130 of the OSA. The plaintiff asserted the same common law causes of action on behalf of the secondary market purchasers but did not seek leave to advance a cause of action pursuant to s. 138.3 of the OSA.

In holding that the negligent misrepresentation claim was both an improper cause of action and not a common issue for the class, Strathy J. dismissed the plaintiff's "non-reliance theory of misrepresentation" argument. Strathy J. concluded that there is binding authority that makes proof of reliance a necessary requirement of a negligent misrepresentation claim, which in a proposed class action gives rise to individual issues making the claim unsuitable for certification. Strathy J. concluded that this was consistent with the reasoning behind the legislator's enactment of the "deemed reliance provisions" in sections 130 and 138.3(1) of the OSA, which allow the investing public to side-step the onerous reliance requirement in common law. Leave to appeal Justice

Strathy's decision on this issue was denied.

Rounding the Turn: The Jurisdictional Issues

Although the certification of multi-jurisdictional class actions in Canada has been a much debated topic for many years, the constitutionality of national or international classes has yet to be fully determined under Canadian law. Despite this uncertainty, the Supreme Court of Canada recently refused to intervene, urging the provinces to address the jurisdictional issues raised by national and international class actions through legislation (*Canada Post Corp. v. Lépine*, [2009] 1 S.C.R. 549). In the securities context where statutory claims of class members arise out of potentially varying securities legislation, these issues are sure to become even thornier.

The OSA allows for claims against a "responsible issuer," which is defined as a reporting issuer or any other issuer with a "real and substantial connection to Ontario" that has publicly traded securities. So far, only *IMAX* has been certified in Ontario as a global class against a reporting issuer. There has yet to be any judicial consideration of claims against issuers that are not reporting issuers but have a "real and substantial connection to Ontario." As discussed below, the first case to consider this issue will likely be the proposed class proceeding against American International Group, Inc. (AIG) and certain of its officers and directors.

The *IMAX* certification decision suggests that jurisdiction and conflict of laws challenges are not necessarily a bar to certification. In certifying a global class, van Rensburg J. held that the fact that a similar proceeding had been commenced (but not certified) in the United States was inconsequential to the Ontario action. The court found that the issues raised by the pleading had a "real and substantial" connection to Ontario. With respect to conflict of laws issues, van Rensburg J. held that the issue was premature on certification unless and until the defendants pleaded reliance on laws of other jurisdictions. Consistent with the approach of Ontario courts to "certify now, sort out the complexities later," van Rensburg J. determined that it was appropriate to "wait and see" how the conflict of law issues may develop.

Although not a statutory secondary market case, the decision of Strathy J. in *Gammon Gold* provides further analysis of the jurisdiction issue. In that case, the plaintiff sought to represent a global class with "no geographic boundaries" and which included individuals and institutions, anywhere in the world, that purchased securities of Gammon during the

class period under the prospectus or in the secondary market. Strathy J. found the proposed class to be overly broad and limited the class to residents, and only those non-residents who acquired Gammon shares through the underwriters in Canada and under the prospectus.

Strathy J. relied on the jurisdictional test recently restated by the Ontario Court of Appeal in *Van Breda v. Village Resorts Limited*, 2010 ONCA 84 (*Van Breda*) (which is now the subject of an appeal to the Supreme Court). Strathy J. found that there was a clear connection between Ontario and the plaintiff's claim and that there would be no unfairness to subjecting the defendants to the jurisdiction of the Ontario courts given the underwriting was closed and the prospectus issued in Ontario and the shares were listed on the TSX.

Strathy J. then considered whether principles of order and fairness support the extension of the court's jurisdiction to require class members outside of Ontario to either opt out of the class or be bound by the result. His Honor concluded that out-of-province class members who purchased from underwriters in Canada and under the prospectus were to be included in the class subject to appropriate safeguards with respect to notice and representation. These class members, according to Strathy J., can reasonably expect their legal rights would be subject to Canadian jurisdiction since they purchased shares of a Canadian company, in Canada, through a Canadian underwriter.

His Honor, however, found that it would be inappropriate to include in the class persons who purchased securities outside Canada since persons acquiring securities in another country would not reasonably expect their rights in respect of the purchase of those securities to be determined in a Canadian court. Strathy J. also held that had he certified the secondary market claims, he would have limited the class to those who acquired their shares on the TSX. Leave to appeal Justice Strathy's decision on this issue was also denied.

Another important issue that will have to be addressed by the courts is whether there are circumstances in which Canadian courts do not have jurisdiction over foreign issuers. The defendants in the proceeding commenced by David Juniper against AIG and several of its officers and directors and former officers and directors (Ont. S.C.J. File No. C-1094-08) (*AIG*) have challenged the jurisdiction of Ontario courts over secondary market claims of resident plaintiffs who did not purchase their shares on a Canadian exchange (because AIG is not traded

on any Canadian exchange).

The defendants have brought a motion to dismiss Juniper's application for leave to bring a claim under s. 138.8 on the grounds that Ontario courts lack jurisdiction over the defendants as the subject matter of the proceeding does not have a real and substantial connection to Ontario and that there is no statutory claim against AIG as it is neither a "reporting issuer" nor an issuer with "a real and substantial connection to Ontario."

In the alternative, the defendants claim that New York, where there are already proceedings against AIG, is the proper forum for the class proceeding. This motion, which was scheduled to be heard in July 2010, has now been delayed by the parties until the Supreme Court delivers its decision in the latest jurisdiction case, *Van Breda*.

In the interim, a recent decision of the Supreme Court of the United States provides persuasive authority on the proper approach to jurisdiction that Canadian courts may take in *AIG* and similar cases that will undoubtedly follow.

In *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (*Morrison*), Justice Scalia (writing for the majority) limited the extraterritorial application of US securities fraud legislation, holding that s. 10(b) of the *Securities Exchange Act of 1934* does not reach out to claims of foreign investors trading foreign securities on foreign exchanges (so called "f-cubed claims"). The court set out a "transactional" test for determining whether an investor has a cause of action under US law: "the purchase or sale is made in the United States, or involves a security listed on a domestic exchange." The court rejected the notion that domestic conduct was sufficient to support jurisdiction, commenting that "it is a rare case of prohibited extraterritorial application that lacks all contact with the territory of the United States."

The impact of the *Morrison* decision remains to be seen in Canada. Canadian issuers of securities that have operations in the US but do not trade on US exchanges will now likely only face claims in Canada. Furthermore, by closing the door to claimants whose connection to the United States is highly tenuous, *Morrison* may push more of these cases into Canada if our courts take a more liberal approach to multi-jurisdictional and global class actions (as in the *IMAX* decision). The decision does provide some support to the arguments of defendants, such as AIG, that Canadian courts ought not to assert jurisdiction over claims involving the purchase of shares of foreign issuers on foreign exchanges. Based on an

application of the principles of comity, a Canadian court should decline jurisdiction over such claim if the foreign court would not assume jurisdiction over a mirror claim.

The Finish Line: Conclusion

It is apparent from the handful of recent securi-

ties class action decisions that the ground rules for such actions remain a work in progress. The test for leave to pursue statutory secondary market claims and the evidentiary requirement on such a motion are not yet settled. The appeal decision(s) in *IMAX* and the pending jurisdiction motion in *AIG* promise to be important in the evolution of Ontario's securities class action law.

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