

**Class Actions and the Capital Markets:
More than a Shareholder's Remedy**

A Paper for the Canadian Class Action Review

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I see in the near future a crisis approaching that unnerves me and causes me to tremble for the safety of my country. ... corporations have been enthroned and an era of corruption in high places will follow, and the money power of the country will endeavor to prolong its reign by working upon the prejudices of the people until all wealth is aggregated in a few hands and the Republic is destroyed.

Abraham Lincoln (1809-1865)

As corporate fiascos in the United States continue to garner tremendous attention well beyond US borders, the aftermath of these corporate failures are playing out in the courts with US shareholder class actions at the forefront. Indeed, shareholder class actions have become a major component of US securities laws, used by American shareholders to shape and reform corporate behaviour at both the corporate and director levels. Canada, to be sure, has had its fair share of high profile securities cases (think YBM and Bre-X) and yet, to date only a handful of securities class actions have been certified by the Canadian courts. This paper seeks to address two questions that arise as a natural consequence of the relative scarcity of class actions in this country: firstly, why are we not having the class action experience of our neighbours to the south; and secondly, when is it going to change. The why answer stems largely from Canada's rejection of the fraud on the market theory and the requirement that each investor prove individual reliance on a material misrepresentation. The when answer is, likely, not as soon as it should.

The first portion of our paper will provide a brief overview of the current securities law component for class actions in Canada and specifically the distinction between primary

market and secondary market liability created by the civil liability provisions of the Ontario *Securities Act*.¹ The second will review the extraordinary US experience with shareholder class actions; with particular emphasis on the fraud in the market theory. Finally, we will briefly examine the recent common law and legislative developments relating to shareholder class actions, to determine what effect, if any, these changes will have on expanding the ambit of shareholder class actions into the secondary market.

Primary and Secondary Market Liability

In order to consider shareholder class actions it is necessary, particularly in the Canadian context, to understand the primary/secondary market dichotomy that is so central to Canadian securities law. The fundamental distinction between the two is from whom the security is purchased. In the primary market securities are bought from the issuer (or its underwriter) having been issued for the first time from a private company to the public through an initial public offering (IPO); issued as a new class or type of securities by an already public company; or, issued as further securities of an existing class. In secondary market trades, on the other hand, we are considering subsequent trades² between

¹ R.S.O. 1990, c. S.5, *as amended*. Part XXIII – Civil Liability.

² ‘Trade’ or ‘trading’ is broadly defined in s. 1 (1) to include,

- (a) any sale or disposition of a security for valuable consideration, whether the terms of payment be on margin, instalment or otherwise, but does not include a purchase of a security or, except as provided in clause (d), a transfer, pledge or encumbrance of securities for the purpose of giving collateral for a debt made in good faith,
- (b) any participation as a trader in any transaction in a security through the facilities of any stock exchange or quotation and trade reporting system,
- (c) any receipt by a registrant of an order to buy or sell a security,
- (d) any transfer, pledge or encumbering of securities of an issuer from the holding of any person or company or combination of persons or companies described in clause (c) of the definition of ‘distribution’ for the purpose of giving collateral for a debt made in good faith, and
- (e) any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of any of the foregoing.

purchasers and sellers of securities that have already been issued and distributed to the public.

The radically different statutory framework that exists for each type of trade reflects the ease with which liability rests with the issuer in the former, and the hurdles to establishing such liability in the latter. Shareholder claims in the primary market more often than not stem from allegations of inadequate or fraudulent disclosure by the issuer. In Ontario, for instance, the *Securities Act* requires that a prospectus provide “full, true and plain disclosure of all material facts relating to the securities.”³ Failure to adhere to this statutory standard gives rise to a cause of action against the issuer for negligent and/or fraudulent misrepresentation.

Perhaps the most significant aspect of Canadian securities law, for shareholders seeking redress in the primary market, can be found in the so-called ‘deemed reliance’ provisions. In Ontario, the civil liability provisions of the *OSA* provide, *inter alia*, that persons who purchase securities through a prospectus, offering memorandum, or a take-over bid circular, are deemed to have relied on the misrepresentations contained in those documents.⁴ These provisions, then, facilitate the use of class actions in the primary market by allowing investors to bring actions based upon misrepresentations without having to show that each member of the class relied on those misrepresentations.

³ *OSA*, s. 56(1).

⁴ Sections 130, 130.1, and 131.

Without a deemed reliance provision Canadian investors are left having to prove reliance. For example, deemed reliance does not apply to the civil liability imposed on persons and companies in a special relationship with a reporting issuer for failure to disclose material facts or changes.⁵ This is because the applicability of the section hinges on whether or not each seller or purchaser, as the case may be, knew or ought to have known about the material fact or material change, rendering the protection unassailable on a class basis.

In contrast to the primary market, investors seeking indemnity resulting from misrepresentations made in the secondary market cannot rely on the deemed reliance provisions of the Act. Canadian common law insists that individual plaintiffs show reasonable reliance in order to substantiate a claim for misrepresentation. For example in *Hercules Management*⁶ the Supreme Court of Canada held that, in the case of a claim founded in negligent misrepresentation, it must be established that the individual claimant/shareholder actually relied on the misrepresentation complained of in making his or her investment decision. Moreover, such reliance must have been reasonable.

Given the fact that the vast amount of securities trading occurs in the secondary market, and given the anonymous quality of this trading, this has proven to be a significant impediment to the certification of class actions based on misrepresentations made in the secondary market.

⁵ Section 134.

⁶ *Hercules Management Ltd. v. Ernst & Young*, [1997] 2 S.C.R. 165.

In the United States the difficulties encountered by the secondary market claimant in Canada have been circumvented by the development of the 'fraud on the market' theory.

Fraud on the Market: A Distinctly US Experience

The fraud on the market theory developed in the US to address the need to establish individual reliance that creates such angst in the Canadian plaintiff. The theory essentially does away with the requirement that each shareholder demonstrate that they relied on the issuer's representations and assumes that any information distributed in the capital markets about an issuer has been incorporated into the price of the particular security. The rationale here is that in an efficient market the price of a given security will reflect its true value. Consequently, if there has been a misrepresentation in material information distributed about an issuer that has resulted in a change in the price of a security, an individual shareholder is neither required to show that he or she was aware of the information, nor that they depended on it in their decision to invest in the particular security. All security holders are automatically assumed to have relied on the misrepresentation, as the price of the security is deemed to be reflective of the misrepresentation. Nevertheless, there are elements of the fraud on the market theory that still need to be proven in order for the doctrine to have effect.

The fraud on the market theory is based on Rule 10b-5⁷ of the *Securities Exchange Act of 1934* and the judicial interpretation thereof. The rule was not actually intended to give shareholders an express civil remedy, however, the US Supreme Court was quick to interpret the provision so as to suggest such an implied right of action.⁸ In 1988, Mr. Justice Blackmun enunciated in *Basic Inc. v. Levinson*⁹ the requirements that a plaintiff must demonstrate in order to establish the fraud on the market theory. Specifically, the plaintiff must show that:

- i) the defendant had a degree of scienter (intentional or wilful conduct intended to deceive or defraud investors);
- ii) there was a purchase or sale of securities;
- iii) the misrepresentation was material; and
- iv) there was detrimental reliance on the misrepresentation.

The materiality of the misrepresentation is of particular significance both in the development of the fraud on the market theory and to the regulation of securities as a whole. It will be noted that Rule 10b-5 does not come into play for just any misrepresented facts – they must be ‘material’. The US Supreme Court first defined

⁷ Rule 10b-5 – Employment of Manipulative and Deceptive Devices, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
- b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

⁸ *Kardon v. National Gypsum Co.*, 69 F. Supp.512(E.D.Pa. 1946).

⁹ 485 U.S. 224 (1988).

materiality, in reference to the proxy rules, in *TSC Industries Inc. v. Northway Inc.*¹⁰

Here the court held that a fact is material if:

[T]here is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.¹¹

In *Basic v. Levinson* the US Supreme Court extended this definition of materiality to Rule 10b-5 while recognizing the difficulties inherent in defining such a subjective standard.

In particular, the Court acknowledged that where the “impact of the corporate development on the target's fortune is certain and clear, the *TSC Industries* materiality definition admits straight-forward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the ‘reasonable investor’ would have considered the omitted information significant at the time.”¹²

Once the *Levinson* criteria are established, a plaintiff can then rely on the fraud on the market theory and it will be assumed they relied on the misrepresentation and that the misrepresentation affected the value of the security. Blackmun J. went on to rationalize the theory on the basis that:

... in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements... The causal connection between the defendant's fraud and

¹⁰ 426 U.S. 438 (1976).

¹¹ *Ibid*, at 449.

¹² *Basic v. Levinson, supra*.

the plaintiff's purchase of each stock in such a case is no less significant than in a case of direct reliance or misrepresentations.

Without the benefit of the fraud on the market theory, each individual plaintiff would have to show that they reasonably relied on the misrepresentation. According to Blackmun J.:

Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented from proceeding with a class action, since individual issues would have overwhelmed the common ones. The District Court found that the presumption of reliance created by the fraud on the market theory provided a 'practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Rule] 23'.

While the fraud on the market theory has been seen in the US as a necessary step in facilitating class actions based in the secondary market, it has not been without its critics. One of the concerns has been with indeterminate liability. To remedy this, class proceedings legislation imposes various notification and opt-in requirements so as to create a determinable class to whom an issuer may be liable. Another concern that arises as a result of the vast numbers of investors that can be involved, is the artificial enhancement of the 'settlement factor' of a given class action.¹³

The concern, however, was not just with the number of members in the class but also with the number of class actions being commenced, and the vigour with which potential

¹³ This is reminiscent of the American 'strike-suit' phenomenon, whereby the Courts became concerned that class actions were having, as Justice Rehnquist of the US Supreme Court described, "a settlement value to the Plaintiff out of any proportion to its prospect of success at trial.": *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723.

claims and claimants are sought.¹⁴ In 1995 Congress attempted to control the rush of these enormous classes into the courts with the first of two securities litigation acts. The *Private Securities Litigation Reform Act* (PSLRA) was passed in 1995 and, among other things, it shored up the pleading requirements and made it a little harder (and a lot less desirable) to be a representative plaintiff. It was not enough. Perhaps the class action machine was moving too fast, perhaps it was simply a case of too little too late. Either way, by 1998 Congress was taking another kick at the can, this time with the *Securities Litigation Uniform Standards Act of 1998*. The emphasis of this legislation was to establish uniform national standards – evidence indicated that with the introduction of the PSLRA in 1995 a number of securities class action lawsuits shifted from Federal to State courts to avoid the new requirements.

In Canada, the legislature and the Courts have been busy fashioning their own responses to the increasing pressure to allow shareholders to access the coveted class action remedy enjoyed by their southern counterparts. On the one hand, legislatures across the country have been creating class action legislation¹⁵, on the other hand, the Canadian courts have continued to explicitly and fervently reject the US approach to secondary market liability, frustrating shareholders and hampering the evolution of class actions in the process.

The Canadian Experience

¹⁴ There are many websites created for, and dedicated to, the purpose of actively soliciting potential class members and new class actions. For example, check out www.endfraud.com.

¹⁵ The following Canadian provinces currently have class proceedings legislation: Ontario, British Columbia, Saskatchewan, Newfoundland and Labrador, and Quebec.

Carom v. Bre-X¹⁶: Rejection of Fraud on the Market Theory

There is no Canadian equivalent of Rule 10b-5. Note, however, the willingness with which the American judiciary interpreted the Rule to allow secondary market participants to avail themselves of a remedy that Canadian courts have steadfastly maintained can only apply to primary market participants in Canada. The seminal case of *Carom v. Bre-X* is illustrative. In this case investors in the junior mining company complained that they had been deceived about the quantity of gold that had been discovered by Bre-X in Busang, Indonesia, resulting in huge losses of capital. In an attempt to recover their losses claims were commenced against the officers, directors, brokers and engineers of Bre-X, as well as against the research analysts who covered Bre-X for, *inter alia*, negligent and fraudulent misrepresentation, conspiracy, and breach of fiduciary duty.

The plaintiffs then sought to amend their statement of claim to add facts in support of the fraud on the market theory. They argued that it was open to the trial judge to find them entitled to the benefit of reliance as a matter of law grounded in the fraud on the market theory. In addition, the plaintiffs argued that such a presumption could satisfy the common law requirements of reliance for causes of action framed in fraudulent and negligent misrepresentation. Mr. Justice Winkler refused the plaintiff request to amend, stating:

The plaintiffs submit that the fraud on the market theory which underpins the requested amendment is a "novel point" and "open question" in Ontario. I disagree. The theory is advanced out of the statutory context in which it was developed. It is put forward absent the surrounding qualifications and conditions with which it is circumscribed in the United States. Moreover, the plaintiffs' submission would require a redefinition of

¹⁶ *Carom et al. v. Bre-X Minerals Ltd. et al.*, 44 O.R. (3d) 173 (Gen.Div); affirmed (1999), 46 O.R. (3d) 315 (Div.Ct.) appeal allowed; 51 O.R. (3d) 236.

the common law torts of fraudulent and negligent misrepresentation as developed by the Supreme Court of Canada.

Essentially, the plaintiffs' theory was rejected by the Court for three reasons. First, the want of any legislation in Canada comparable to Rule 10b-5. Second, the plaintiffs were advancing a theory without any of the limitations that coincided with it in the US regime. For example, a shortened and statutorily imposed limitation period. The Court also noted that "neither s. 10(b) or Rule 10b-5 provide for punitive damages and no authority has been provided to this court in which such damages have been awarded in the private right of action."¹⁷ Finally, the theory was rejected because, in Mr. Justice Winkler's words, accepting it "would be to import such a presumption [as] would amount to a redefinition of the torts themselves."¹⁸

Upon its release, the decision in *Carom v. Bre-X* illustrated and confirmed the many impediments to certification of a class action based on secondary market misrepresentations.¹⁹ It meant individual investors would have to continue to prove detrimental reliance on any misrepresentation, except for those covered by the deemed reliance provisions of the OSA and it seemed as though, at least for the time being, the availability of securities class actions based in the secondary market would continue to be severely limited and that change was unlikely.

Mondor v. Fisherman: Inferred Reliance

¹⁷41 O.R. (3d) 780.

¹⁸ *Ibid.*

¹⁹ Ultimately, however, the Ontario Court of Appeal allowed the appeal of the plaintiffs, certifying the action for fraudulent misrepresentation but not for negligent misrepresentation.

In one of the most high-profile securities cases in recent memory, the plaintiff class, purchasers of secondary market securities in YBM, claimed that they had substantial losses as a result of various misrepresentations. Specifically, the plaintiffs alleged that YBM was used to carry out a multi-layered conspiracy and fraud with several objectives, including laundering funds. The defendants included the directors and officers of YBM as well as their auditors, financial officers and even their lawyers!

The plaintiffs asserted that the issue of reliance as it related to the negligent misrepresentation matter was a matter of fact for the court to determine. Since the market price of the shares of YBM reflected the representation made in the expert opinion (think efficient market theory, with a twist), the plaintiffs claimed that a court could conclude that each class member relied upon these representations. A motion to strike the claim as disclosing no reasonable cause of action was brought by the defendant auditors on the basis that the plaintiffs were in reality advancing the fraud on the market theory. Justice Cumming cited the rejection of the theory in Canada, yet noted that the plaintiffs were not expressly advancing the theory. Justice Cumming instead held that the issue of whether the plaintiff actually relied upon a misrepresentation was a question of fact that may be inferred from all the circumstances. If the question was one of fact, then a court could conclude, as a question of fact, that each member of the class relied upon the representation in purchasing shares in the secondary market. Justice Cumming summarized his findings as follows:

Had the plaintiffs simply pleaded the "fraud on the market theory" I would have foreclosed that consideration. Given, however, that the case law recognizes that a person's reliance upon a representation may be inferred from all the circumstances, in my view it would be premature to foreclose

the consideration of this issue in the case at hand beyond the pleading stage.²⁰

While Cumming J. reaffirmed the rejection of the fraud on the market theory, he allowed the action to proceed on the basis of inferred reliance, stemming from the effect of the misrepresentation upon the market price of the securities. In this respect, the decision may very well have the effect of opening the door to future class proceedings by allowing plaintiffs to overcome the obstacle of having to prove reliance on a misrepresentation individually by using the ‘inferred reliance’ argument.

***Yves Beaudoin v. Avantage Link Inc.*²¹: A fraud on the market argument is made, and the class survives to be certified**

In this recently certified, and soon thereafter settled, class action, the plaintiffs were alleging inflated share prices with respect to Jitec Inc. (Avantage Link’s predecessor). The plaintiffs put forward a fraud on the market-type of argument and Justice Viau of the Quebec Superior Court certified the class. Unfortunately, the reasons do not reflect an affirmative acceptance of the theory. Nevertheless, the decision may suggest a willingness by the courts to entertain fraud on the market theory arguments.

Menegon v. Philip Service Corp.: Two Steps Forward, One Step Back

This is the latest decision in the Philip Services saga, involving allegations of negligent misrepresentations by Philip Services. Here, a purchaser of securities on the secondary market, appealed the decision to dismiss his claim against Philip’s auditors and underwriters for negligent misrepresentation at common law on the basis of a duty of care arising “as a result of the reasonable foreseeability that purchasers of shares in the

²⁰ *Mondor v. Fisherman*, [2001] O.J. No. 4620

secondary market, before and after the public offering under the prospectus, would rely on the document to hold, buy or sell” the shares.²² The plaintiff brought a motion for certification as a class proceeding, even though he purchased on the secondary market, arguing that because he had a common law action for negligent misrepresentation, he could be the representative for the class of purchasers who had purchased in the primary market. The motions judge determined that, absent a special relationship, there was no cause of action against the issuer. The Court of Appeal dismissed the appeal.

Recent Developments

Despite the rejection of the fraud on the market theory in *Carom v. Bre-X*, the recent judicial decisions and legislative initiatives have led some to conclude that change could be imminent. Most importantly in the legislative context, is the passing of Bill 198²³ which, for our purposes, introduced secondary market liability into Ontario securities law.²⁴ The Bill reflects more than a decade of serious discussion about introducing secondary market liability into the Canadian securities regime, accordingly, it is not surprising that neither the secondary market liability provisions, nor the fraud and market manipulation provisions, have been proclaimed into force.²⁵

That is not to say, however, that the secondary market liability provisions are entirely pro-class action – included in the proposed amendments are three mechanisms that may

²¹ [2002] J.Q. No. 4575 (Sup.Ct.).

²² *Menegon v. Philip Service Corp.*, [2003] O.J. No. 8.

²³ *Keeping the Promise for a Strong Economy (Budget Measures) Act, 2002*.

²⁴ Section 185 of Bill 198 amends the Ontario *Securities Act* to include provisions for liability in the secondary market for disclosure of documents released by a responsible issuer (section 138.3(1)) and public oral statements made by a responsible issuer (section 138.3(2)).

discourage the initiation of class actions. The first is a provision requiring leave of the court in order to commence proceedings.²⁶ Pursuant to this provision, leave will be granted only where a court finds that the action has been brought in good faith and where there is a reasonable chance that the action will be resolved at trial in favour of the plaintiff. A merits test is then introduced, thereby imposing a higher burden on potential plaintiffs at an early stage of litigation. Some have felt that these amendments may mean that fewer cases will be certified, and that the cost sustained by the plaintiffs will be higher. In addition, it is unclear how the court is to determine the plaintiff's chances, or what standard will be used to determine 'reasonable' chances of success at trial.

The second potentially discouraging amendment is a limit on the amount of damages recoverable where the misrepresentation or omission was made unintentionally. A responsible issuer will only be liable to the limit of 5% of market capitalization or \$1 million, whichever is greater. Directors, officers, influential persons, an individual or person who makes a public oral statement on behalf of the issuer, are limited to \$250,000 or 50% of their aggregate compensation, whichever is greater.²⁷

Finally, the third potentially discouraging amendment involves costs. Pursuant to proposed section 138.11, the prevailing party will be awarded costs in accordance with the *Rules of Procedure*, and despite the *Courts of Justice Act* and the *Class Proceedings*

²⁵ The Bill 198 amendments to the *OSA* have most recently been reiterated (with minor amendments) in Bill 41, introduced on May 22, 2003.

²⁶ Proposed *OSA* s. 138.8(1).

²⁷ ss. 138.5 and 138.7.

Act, 1992. In real terms this will result in plaintiffs and their counsel having to bear the costs of an unsuccessful action.

Conclusion

There is no doubt that class actions increase access to justice, enhance corporate accountability, and reduce the number of cases that need to be heard in the courts. On the other hand, it is just as arguable that they can result in undue pressure on corporations to settle frivolous actions, thereby endangering the longevity of the corporation. In Canada, where the class action regime is comparatively new and where secondary market liability is still largely a shareholder's remedial dream, it is easy to get bogged down in the pro's and con's of secondary market liability, shareholder rights, and class actions in general. Yet, when we look to the US experience we recognize that if US corporations are being forced to settle multitudes of unmeritorious class actions, they are not looking the worse for wear. In fact, recent corporate governance fiascos aside, corporate America seems to be doing just fine. The bottom line is, if a weighing of the pro's and con's must be done, some consideration must be given to the impact of the Enron's and the Worldcom's on their shareholder's and the reality that a class action for misrepresentations in the secondary market is more than a shareholder's remedy. It is a means of enhancing corporate accountability by hitting corporations where it hurts most – their pocketbooks.

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