Recent Developments in Canadian Securities Class-Action Law

By Emily C. Cole

Two recent decisions of the Ontario Superior Court of Justice, *Silver v. IMAX Corporation*[1] and *McKenna v. Gammon Gold Inc.*,[2] are breaking ground in Canadian securities class-action law. Five years ago, Ontario introduced a statutory right of action against responsible issuers,[3] their directors and officers, and other related parties based on misrepresentations in secondary market disclosure. The other Canadian provinces quickly followed suit. *IMAX* was the first decision to interpret the test for leave to proceed with a statutory class action. *IMAX* and *Gammon Gold* each involved motions that raised issues of whether to certify a global class and whether plaintiffs must prove individual investor reliance at the certification stage.

The relatively low threshold for leave to proceed with a class action established in *IMAX* may make it easier for investors to commence securities class actions in Canada. In addition, if the Ontario appellate courts reject the restrictive approach to certification taken by the court in *Gammon Gold* and instead embrace the *IMAX* rationale for certifying a global class, investors *outside* Canada, particularly American investors, may be more likely to pursue (and/or be swept into) Ontario-based class actions.

Continuing cooperation and coordination between American and Canadian plaintiffs' counsel in the commencement and management of securities class actions will be essential as the two jurisdictions collide with increasing frequency. Conflict-of-laws issues will undoubtedly become more pronounced as overlapping classes emerge, particularly as parallel American and Canadian actions reach the settlement and enforcement stage.

IMAX

IMAX is a public company that sells and leases 3D theater systems, which are installed in theaters throughout the world. Its shares are listed on the Toronto Stock Exchange (TSX) and on the NASDAQ in the United States. On August 9, 2006, IMAX issued a press release announcing that it was responding to an inquiry from the U.S. Securities and Exchange Commission (SEC) about the timing of its revenue recognition. The next day, IMAX's share price plunged by 40 percent.

Shareholders sued IMAX and its current and former officers and directors for the devaluation of their shares, which they alleged was caused by misrepresentations made by IMAX in its continuous disclosures in 2005 and 2006. The alleged misrepresentations included overstating its 2005 revenue, stating it had complied with U.S. generally accepted accounting principles, and stating it had completed 14 theater-system installations in the fourth quarter of 2005.

The plaintiffs pled a statutory claim for secondary-market misrepresentation under the Ontario Securities Act,[4] in addition to claims based on common-law causes of action, including negligence, negligent misrepresentation, "reckless" misrepresentation, and conspiracy.

There were three motions before the court. The first considered whether the plaintiffs could proceed with a statutory cause of action under the Ontario Securities Act (the Leave Motion). The second dealt with certification of the action as a class proceeding under the Class Proceedings Act, 1992,[5] in particular, whether the case should be certified as a global class (the Certification Motion). The third was a motion to strike certain of the common-law claims, which was heard along with the Certification Motion.

The Leave Motion

The Leave Motion presented the first opportunity for judicial consideration of section 138.1 of the Ontario Securities Act. Section 138.1 provides that an action for statutory secondary-market misrepresentation cannot be commenced without leave of court. The court's discretion is circumscribed, and it shall grant leave only where it is satisfied that the action is being brought in good faith, and there is a reasonable possibility that the action will be resolved in favor of the plaintiff at trial.[6]

In *IMAX*, the Ontario Superior Court of Justice stated that leave is *mandatory* if the plaintiffs establish that the action is brought in good faith, and there is a reasonable possibility of success at trial. Thus, the statutory-leave test involves a preliminary consideration of the merits of the action.

The good-faith element. The court interpreted "good faith" in the context of section 138.1 to require the plaintiffs to establish that they are bringing 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." Good faith involves a consideration

of the subjective intent of the plaintiffs, determined by considering the objective evidence.

The court rejected the defendants' argument that there was a "high" or "substantial" burden on the plaintiffs for a good-faith showing, such as is required in derivative actions. It held that it was not necessary "to read in a 'high' or 'substantial' onus requirement for good faith in this type of proceeding." The court stated that another purpose of the statutory remedy is to enforce corporate-disclosure obligations to protect and enhance the integrity of the markets, and the court found that the plaintiffs were pursuing this objective in good faith.

Reasonable possibility. The court interpreted a "reasonable possibility that the action will be resolved at trial in favour of the plaintiff" to denote "something more than a de minimis possibility or chance that the plaintiff will succeed at trial" and stated that it must be based on a reasoned consideration of the evidence.

This time, the court reached different conclusions on the issues of reliance and certification of a global class.

The plaintiffs have the burden to put forward the evidence concerning the alleged misrepresentations, the extent of knowledge and participation required for non-core documents,[7] and liability for officers. The court interpreted this burden in the context of the purpose of the legislation, which was designed to prevent an abuse of process and purely speculative claims, including strike suits.

The court granted leave for the plaintiffs to proceed with their statutory claims against all named defendants and all but two of the proposed defendants. The court applied the test individually to each defendant, stating that if, on the evidence at the leave-to-proceed stage, the plaintiffs do not meet the test with respect to a specific individual, the statutory action will not be permitted to proceed against that person. As support for this approach, the court pointed to the requirement that, like the plaintiffs, each defendant is similarly required to file affidavits asserting the material facts on which they intend to rely.

In summary, the test for leave to proceed will be satisfied if the plaintiffs establish that (i) they are bringing their action in good faith (i.e., an 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; and (ii) there is more than a de minimis possibility or chance that the plaintiff will succeed at trial.

The Certification Motion

The second motion dealt with whether the class proceeding should be certified. The plaintiffs, Ontario residents who purchased shares in IMAX on the TSX, proposed a global class consisting of persons who acquired securities of IMAX on the TSX and/or NASDAQ on or after February 17, 2006 (the date of the IMAX press release announcing that it had completed 14 theater-system installations in Q4 2005), and held some or all of those securities at the close of trading on August 9, 2006 (the date of the press release announcing the SEC inquiry).

The court is required to certify a proceeding as a class if: (a) the pleadings disclose a cause of action; (b) there is an identifiable class of two or more persons that would be represented by the representative plaintiff; (c) the claims or defences of the class members raise common issues; (d) the class is the preferable procedure for resolving the common issues; and (e) there is a representative plaintiff who would fairly and adequately represent the class, who has produced a litigation plan, and who does not have a conflict.[8]

The Certification and Leave Motions were heard together, and there was little argument on the certification issue, as the focus was on whether leave should be granted to proceed. The court determined that there was a cause of action for the statutory claim of misrepresentation under the Ontario Securities Act and common-law claims of negligence *simpliciter*, negligent and reckless misrepresentation, and conspiracy.

Duty of care. The defendants conceded, for purposes of the motion, a prima facie duty of care but argued that it should be limited or precluded for policy reasons. The court rejected the defendants' argument that to recognize such a duty would lead to indeterminate liability to an unlimited number of persons, that the recognition of such a duty was unnecessary in light of the statutory remedy for secondary-market misrepresentation, and that it may conflict with the statutory remedy. The court held that there may be a duty of care—as the representations were made as part of IMAX's continuous-disclosure obligations, which are prescribed by the Ontario Securities Act—and that the intended recipients of such disclosure were the investing public.

Common-law misrepresentation and reliance. The defendants argued that the failure to plead individual and direct reliance by each of the plaintiffs was fatal to their

common-law negligent-misrepresentation claim. The plaintiffs countered that they had pled individual reliance by the representative plaintiffs, as well as reliance by each class member through the act of purchasing or acquiring IMAX securities. In addition, the plaintiffs pled the "efficient market theory." This theory holds that the price of a share accurately reflects all public information. The plaintiffs asserted that this theory has been accepted by courts in Canada as a sufficient pleading of reliance in securities cases alleging misrepresentation to the investing public. The court distinguished between the fraud-on-the-market theory that creates a rebuttable presumption of reliance, which has been rejected by Canadian courts, and the efficient market theory.

The court certified the negligent-misrepresentation claim, notwithstanding the absence of pleading of direct individual reliance by each class member, leaving it open for the plaintiffs to establish reliance at trial through the efficient-market theory.

Certification of a Global Class. The plaintiffs proposed a worldwide class—to include all persons who acquired IMAX securities during the class period. The definition of the class is significant because it determines who is entitled to notice, who is entitled to relief (if any is awarded), and who is bound by the judgment. The defendants' primary objection to the proposed class definition was that it was overbroad because it included non-residents of Canada whose claims may depend on the application of the laws of other jurisdictions. The court certified the global class, dismissing the defendants' arguments about conflicts of laws as premature prior to the defendants' assertion of reliance on laws of another jurisdiction in their statement of defense.

The court was also not deterred by the defendants' argument that, according to IMAX's records, only 10–15 percent of its shareholders were Canadian residents, with the balance of the outstanding common shares held by American and other non-Canadian residents. Nor did the court consider the existence of a parallel, yet-to-be-certified class proceeding in the United States to be an obstacle, noting that it is not unusual for class proceedings to be commenced contemporaneously in different jurisdictions.

The court considered its ability to certify national and international classes and recognized that it must have jurisdiction over the plaintiffs through a real and substantial connection between the jurisdiction and their claims, and that assertion of jurisdiction must be consistent with the principles of "order and fairness." Finally, the court noted that the defendants' position on this certification motion contradicted arguments they had made in opposition to certification in the U.S. proceedings. The court stated that while it was not determinative, it was revealing, and suggested that the defendants' opposition to certification in Ontario was not based on bona fide concerns about the Ontario court determining the claims of non-residents.

McKenna v. Gammon Gold

On March 19, 2010, just three months after *IMAX* was decided, the Ontario Superior Court of Justice released *Gammon Gold*, another securities class-action certification decision. This time, the court reached different conclusions on the issues of reliance and certification of a global class. Despite recognizing that such a cause of action had been pled, the court declined to certify the common-law claim of alleged negligent misrepresentation in Gammon Gold's prospectus and continuing disclosures. The court also declined to certify a global class.

Gammon Gold Inc. is a public company incorporated in Quebec and based in Nova Scotia. It is a gold and silver producer, and its mining operations are based in Mexico. Ed McKenna sued Gammon Gold, a number of its senior officers and directors, and the underwriters of the company's securities offered under the prospectus. McKenna purchased 1,000 shares of Gammon Gold in the public offering and alleged that the value of those shares was inflated in the prospectus.

Common-Law Misrepresentation and Reliance

The court in *Gammon Gold* held that the claim for common-law negligent misrepresentation in the secondary market could not be sustained because pleading individual reliance is necessary for such a claim at the certification stage. The court also distinguished *IMAX*, stating that McKenna did not plead section 138.1 of the Ontario Securities Act, and as a result, the deemed-reliance provision in section138.3 was unavailable to him. Only those purchasers who purchased the shares under the prospectus would have the benefit of the deemed-reliance provision in section 130 of the Ontario Securities Act.

The Refusal to Certify a Global Class

The court also failed to find a real and substantial connection with Ontario. It again distinguished *IMAX*, noting that the defendant Gammon Gold was a company incorporated in Quebec and based in Nova Scotia, whose only real connection to Ontario was that it filed its prospectus with the Ontario Securities Commission. Whereas in *IMAX*, the court had found a real and substantial connection with Ontario; IMAX had its head office in Ontario; it was a reporting issuer under

the Ontario Securities Act; and its shares were traded on the TSX. Additionally, the alleged misrepresentation was made in Ontario, and the conduct of some of the defendants was alleged to have taken place in Ontario. However, at this juncture in the decision, the court in *Gammon Gold* did not acknowledge that Gammon Gold is also a reporting issuer in Ontario, its shares are traded on the TSX, and it filed its prospectus and its continuing disclosure with the Ontario Securities Commission.

The court described the issue as whether it should extend its jurisdiction to adjudicate the claims of class members outside the jurisdiction who do not opt out of the class action. It declined to certify a global class, limiting the class to those who purchased shares directly from underwriters in Canada under the prospectus. The court stated that the acquisition of those shares in a jurisdiction outside of Canada would not give rise to a reasonable expectation that the acquiror's rights would be determined by a court in Canada. It went further and stated, had it considered it appropriate to certify the secondary-market claim, it would have similarly limited the class to those who purchased their shares on the TSX.

It is unlikely that the relatively low threshold established in *IMAX* will cause a run on the border by wronged American investors.

While the courts in *IMAX* and *Gammon Gold* reached different conclusions on certification, the causes of action alleged were also different, and the *Gammon Gold* court distinguished *IMAX* on its facts. *IMAX* was a statutory claim for misrepresentation in the secondary market, accompanied by various common-law claims, including negligent misrepresentation arising from the same facts. In contrast, *Gammon Gold* was a statutory claim for misrepresentation in a prospectus under section 130 of the Ontario Securities Act, accompanied by a common-law claim for negligent misrepresentation arising from the same facts. The crux of the difference in the courts' reasoning appears to be that in *IMAX,* the court was content to defer the decision about reliance to the trial court, whereas in *Gammon Gold*, the court found that reliance was required at the certification stage, which resulted in the claim failing to satisfy the cause-of-action and common-issues elements of the certification test.

Conclusion

It is unlikely that the relatively low threshold established in *IMAX* will cause a run on the border by wronged American investors who suddenly want to take advantage of their newfound easy access to Canadian courts. After all, parallel proceedings in the United States and Canada are already common.

In addition, historically lower class-action settlements in Canada and the damages cap of five percent of the issuer's market capitalization[9] imposed by the Ontario Securities Act on statutory-misrepresentation class actions would likely deter American investors from commencing actions in Canada unless it is their only recourse.

In 2009, six securities class-action claims settled in Canada for a total of approximately $55 million, with an average settlement of $9.1 million, and a median settlement of $9.2 million, similar to the median settlement value in U.S. securities class actions.[10] However, the largest single settlement in the United States in 2009 was $925.5 million, up from $750 million in 2008.[11] Whereas in Canada, the largest single settlement in 2009 was $19.4 million, down from 2008, which saw several settlements of more than $20 million and a dramatic plunge from the largest settlement in 2008 of $611 million.

The more likely lasting impact of the *IMAX* decision will be the conflict-of-laws issues that will inevitably be raised when non-resident investors, particularly Americans, are unwittingly caught in a Canadian global class. Defendants may decide to wager a bet that a Canadian settlement will be lower than an American one. Accordingly, we may see defendants arguing strenuously in favor of a Canadian resolution to a global class action. ✺

Emily C. Cole is associate counsel with Miller Thomson LLP in Toronto, Canada. She is grateful for the assistance of Andrew Chong, a 2009–10 student-at-law with the firm.

1. Silver v. IMAX Corp., O.J. No. 5573 (Sup. Ct. J. 2009) (Leave Motion, December 14, 2009); Silver v. IMAX Corp., O.J. No. 5585 (Sup. Ct. J. 2009) (Certification Motion, December 14, 2009). *Silver v. IMAX* Motion for Leave to Appeal to the Court of Appeal for Ontario denied on the ground it is an interlocutory decision; Motion for Leave to Appeal was scheduled to be heard by the Divisional Court in Toronto, likely in June or July, 2010. (Court file no. 171/10).
2. McKenna v. Gammon Gold Inc., O.J. No. 1057 (Sup. Ct. J. 2010) (Certification Motion, March 16, 2010). *McKenna v. Gammon Gold*, Motion for Leave to Appeal was scheduled to be heard by the Divisional Court in Toronto on June 23, 2010. (Court file no. 171/10).
3. Defined in section 138.1 of the Ontario Securities Act as a

reporting issuer, or any other issuer with a real and substantial connection to Ontario, whose securities are publicly traded.
4. R.S.O. 1990, c. S. 5, as am.
5. Section 5 of the Class Proceedings Act, 1992, S.O. 1992, c.6.
6. Section 138.8(1).
7. "Core documents" are defined by section 138.1 to include a prospectus, various circulars, a notice of change or variation, a rights-offering circular, management discussion and analysis, an annual information form, various financial statements, and material change reports.
8. Section 5(1) of the Class Proceedings Act, 1992, S.O. 1992, c.6.
9. Section 138.7. For directors and officers of the issuer, the cap is the greater of $25,000 or 50 percent of the aggregate of the directors' or officers' compensation.
10. Mark L. Berenblut and Bradley A. Heys, *Trends in Canadian Securities Class Actions: 2009 update*, Jan. 2010, NERA Economic Consulting.
11. Ellen M. Ryan and Laura E. Simmons, *Securities Class Action Settlements: 2009 Review and Analysis*, 2010, Cornerstone Research Consulting Services.