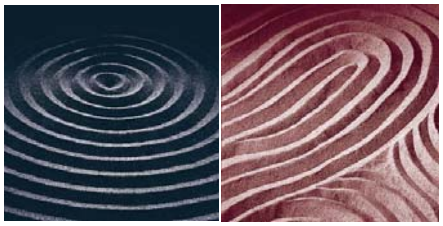
MILLER THOMSON LLP
Barristers & Solicitors
Patent & Trade-Mark Agents

Robson Court
1000-840 Howe Street
Vancouver, BC V6Z 2M1

3000, 700 - 9th Ave. S.W.
Calgary, AB T2P 3V4

www.millerthomson.com



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Expanding Liability Horizons – Civil Liability for Secondary Market Disclosure

J.N. Thom, Q.C.
J.R. Shewfelt
B.D. Frydberg

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EXPANDING LIABILITY HORIZONS – CIVIL LIABILITY FOR SECONDARY MARKET DISCLOSURE

ONTARIO and ALBERTA

Following closely on the heels of Ontario, Alberta is the third province to enact a regime of statutory civil liability relating to the secondary securities market. The changes are part of Bill 25, Securities Amendment Act, 2006 ("the Alberta Act"). The Alberta Act is virtually identical to Ontario's Bill 198 ("the Ontario Act"), which came into effect on December 31, 2005. The Alberta Act received Royal Assent on May 24, 2006 and will come into force upon proclamation (which may happen at any time).

Historically, under existing statutes public companies which list their securities on stock exchanges have only incurred civil liability for misrepresentation and nondisclosure to those persons who buy securities directly from the company (the "primary market"). This trading constitutes less than 5% of the securities purchased by the public. The other 95% is comprised of securities acquired other than directly from the issuing company, in the so-called "secondary market."

Both the Alberta Act and the Ontario Act add a maze of provisions under which civil liability may be imposed for a misrepresentation contained in a publicly released document or in a public oral statement and for a failure to make timely disclosure of any material change.

The effect of the new provisions will be to expand the liability exposure of various market participants. The extension of liability into the secondary market will dramatically increase the number of potential civil claimants. The much wider grounds of liability contained in Bill 25 will also significantly broaden the spectrum of potential defendants.

Issuers, directors, officers, control persons, insiders, accountants, actuaries, appraisers, auditors, engineers, financial analysts, geologists, and lawyers are all expressly subject to liability. This list is not exhaustive. Anyone who might be termed an "influential person" or an "expert" also falls into the net of potential liability. However, the expansion of liability is tempered by a range of enumerated defences and by the imposition of liability caps.

Prior to both the Ontario Act and the Alberta Act**,** the only liability was at common law, and there were many obstacles to members of the public bringing common law actions, including a requirement that there must be personal reliance by every Plaintiff who purchased the securities on the exact statement or misrepresentation alleged, in order to found liability (e.g. *Carom* v. *Bre-X Minerals Ltd.* (1994) 44 O.R. (3d) 173). These strict requirements did not easily lend themselves to class actions, or to anything but extensive and protracted litigation.

The regime under both the Ontario Act and the Alberta Act is detailed and replete with strict technicalities. The summary below omits details that may be important in particular circumstances.

The Ontario Act applies to all companies who list on the TSX, and the TSX V, where 20% of the shareholders (or 10% if management is in Ontario) are Ontario residents. The Alberta Act applies to reporting issuers, which are defined as issuers reporting to the Alberta Securities Commission.

However, both Acts can apply extra-provincially. The Ontario Act applies to any issuers with "substantial connection" to Ontario, and the Alberta Act also applies to any issuer with a "real and essential connection" to Alberta, in both cases where the issuers have publicly traded securities.

WHO MAY SUE?

A right to sue is conferred upon any person or company who acquires or disposes of a security in the secondary market between the time when a misrepresentation is publicly made and the time when it is publicly corrected. With respect to undisclosed material changes, the right to sue is conferred for the time period between when the material change was required to be disclosed under the applicable Act and the subsequent disclosure of the material change.

Reliance is irrelevant. The right to sue exists without regard to whether the plaintiff relied upon the misrepresentation or upon the issuer to comply with its disclosure duties. In other words, plaintiffs may recover damages for misrepresentations that they did not know about. However, actual knowledge of the true facts may defeat a plaintiff's right to sue.

WHO MAY BE SUED?

If an issuer, or a person with actual, implied or apparent authority from the issuer, releases a document or makes a public oral statement that contains a misrepresentation, or if the issuer fails to make timely disclosure of a material change, liability may be visited upon the following potential defendants:

- The issuer;
- Each director of the issuer at the time the document was released, and each director who authorized, permitted or acquiesced in the making of the public oral statement or failure to make timely disclosure;
- Each officer of the issuer who authorized, permitted or acquiesced in the release of the document, or in the making of the public oral statement or in the failure to make timely disclosure;
- Each "influential person" (e.g., a control person, a promoter, or an insider who is not a director or officer of the issuer), and each director and officer of an influential person, who "knowingly influenced" those directly responsible for the release of the document or the making of the public oral statement or the failure to make timely disclosure;
- Any professional expert from whom an actionable misrepresentation originates, but only if the misrepresentation was released, summarized or quoted with the expert's prior written consent; and
- The person who made the public oral statement that relates to the business or affairs of the issuer, and that contains the misrepresentation.

Liability for the public oral statement of a person with only apparent authority will extend to other defendants only if those defendants knew, or ought to have known, of the misrepresentation.

MISREPRESENTATIONS

An actionable misrepresentation is an untrue statement of fact that would reasonably be expected to have a significant effect on the market value of securities. Liability may also arise from an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading.

Oral Misrepresentations

The extension of liability to public oral statements is among the more salient changes to the law. Although common law liability encompasses oral misrepresentations, the common law is constrained by the principle that a plaintiff must prove individual reliance and sufficient proximity. Subject to the enumerated defences and liability caps, an oral misrepresentation under both the Alberta Act and the Ontario Act might render a defendant liable to literally thousands of plaintiffs.

An oral statement may result in liability if it is made in circumstances in which it would be reasonable to conclude that the statement would become generally disclosed. Public oral statements include, but are not limited to, statements made at annual meetings, analyst conference calls and statements to the press.

Documentary Misrepresentations

The range of documents that may contain an actionable misrepresentation extends beyond those that are filed with an exchange, or a securities commission or other similar agency. Any type of document, including electronic documents (websites and emails), may give rise to liability. The new regime applies to any written communication that would reasonably be expected to have a significant effect on the market price or value of securities.

Both the Alberta Act and the Ontario Act make an important distinction between “core” and “non-core” documents. The significance of a “core” document is that defendants may be held strictly liable for misrepresentations in such documents, without regard to whether they knew or ought to have known of the misrepresentation (see “State of Mind” under “Defences” below). For a director, an influential person and a director or officer of an influential person, “core” documents include the following: a prospectus, a take-over bid circular, an issuer bid circular, a directors’ circular, a rights offering circular, management’s discussion and analysis (MD&A), an annual information form, an information circular, and annual financial statements. For officers, core documents include all of the foregoing and material change reports. Also noteworthy is that both the Alberta Act and the Ontario Act empower the Securities Commission to prescribe additional “core” documents.

DEFENCES

Despite the apparent reach of the new liability regime, both the Ontario Act and the Alberta Act contain a large array of defences, some of which are as follows:

- **State of Mind**: a defendant is not liable for a misrepresentation contained in a non-core document or an oral statement, or for a failure to make timely disclosure of a material change, unless the plaintiff proves that the defendant (1) knew of the misrepresentation or material change, or (2) deliberately avoided acquiring knowledge of the misrepresentation or material change, or (3) was guilty of gross misconduct in connection with the release of the document or the making of the public oral statement that contained the misrepresentation. For misrepresentations contained in "core" documents, there is no state of mind defence. Experts are not entitled to this defence for misrepresentations. Issuers, investment fund managers, and their respective officers may not use this defence in relation to failures to make timely disclosure of material changes.

- **Due Diligence Defence**: a defendant may escape liability if they conducted a prior reasonable investigation and had no reasonable grounds to believe that the document or public oral statement contained a misrepresentation.

- **Plaintiff Knowledge**: a defendant is not liable to a plaintiff who acquired or disposed of the issuer's security while knowing of the misrepresentation or material change.

- **Forward-looking information**: A forecast or future projection will not constitute an actionable misrepresentation, provided that it has a reasonable foundation and has cautionary language stating the assumptions and the material factors that might cause the actual results to differ. This defence is not available for a misrepresentation contained in a financial statement required to be filed under the applicable Act, or in a document released in connection with an initial public offering.

- **Expert Reliance**: No liability will arise from a misrepresentation that originated from an expert, unless the defendant knew or had reasonable grounds to believe that there had been a misrepresentation. The expert's consent to public release must be granted (or withdrawn) in writing and before the misrepresentation is released. Under this defence, the expert report, statement or opinion must have been fairly and accurately presented.

- **Republication**: Merely repeating a misrepresentation that is contained in a document filed by someone else with a securities regulator or stock exchange will not result in liability, provided that the republication expressly references the source of the information. A defendant must not know and must not have reasonable grounds to believe that they are repeating a misrepresentation, to rely on this defence.

- **Inadvertent Release**: A defendant may escape liability for a misrepresentation contained in a document by proving that they did not know and had no reasonable grounds to believe that the document would be released.

- **Whistle-Blowing**: A person or company, other than the issuer, who becomes aware of an uncorrected misrepresentation or undisclosed material change may

avoid liability by notifying the issuer's board of directors. If the board fails to take corrective action within two days, the person or company wishing to avoid liability must promptly notify the Commission in writing, unless prohibited by law or professional confidentiality rules (e.g., solicitor-client privilege).

- **Proportionate Liability**: This is a partial defence that limits a defendant's liability to the proportion of damages that corresponds to his or her degree of responsibility, as determined by the court. However, this defence will not apply to any defendant who knowingly participates in a misrepresentation or a failure to disclose a material change.

LIABILITY CAPS

The total damages payable by each defendant are subject to maximum amounts. The liability limit for a director, an officer, a non-corporate "influential person," or a person who makes an actionable public oral statement, is the greater of:

- $25,000; or
- 50% of the compensation received from the issuer (or influential person, as the case may be) in the 12 months preceding the actionable wrong, including deferred compensation.

The liability limit for the issuer or for a corporate "influential person" is the greater of:

- $1 million; or
- 5% of its market capitalization.

The liability limit in the case of an expert is the greater of:

- $1 million; or
- The total revenue earned from the issuer during the prior 12 months.

LEAVE TO PROCEED

The legislatures have attempted to address the concern about unmeritorious claims by requiring plaintiffs to obtain leave of the court before commencing an action. The court may only allow an action to proceed if it is satisfied that it is being brought in good faith and that there is a reasonable possibility of success. Court approval is also required for any settlement or other form of early disposition short of judgment on the merits.

COSTS

Both the Ontario Act and the Alberta Act mandate a "loser pays" costs rule. Despite all other laws governing the judicial discretion to award costs, the prevailing party in an action is entitled to costs. The purpose of this rule is to further discourage unmeritorious claims by increasing the risks faced by potential plaintiffs.

OTHER PROVINCES:

Alberta and Ontario are not alone in striving for civil liability in the secondary market. Manitoba has also enacted (but not yet proclaimed) legislation which is practically identical to Ontario's and Alberta's legislation.

British Columbia has also enacted legislation on civil liability for secondary market disclosure which, like Alberta's and Manitoba's, remains unproclaimed into force. However, British Columbia's 2004 *Securities Act* (the "BC Act") contains many significant differences, some of which are as follows:

- The Alberta, Manitoba and Ontario Acts draw an important distinction between core and non-core documents, while the BC Act does not. Instead, the BC Act contains a defence not found in the Alberta, Manitoba or Ontario Acts. The defence arises from having a reasonable system in place to ensure compliance with the legislation and a process to monitor the effectiveness of the system. It is important to note that this defence is only available to the issuer and its directors.

- In the Alberta, Manitoba and Ontario Acts, a director is liable for failure to make timely disclosure only if the director authorized, permitted or acquiesced in the failure. In the BC Act, directors are liable for a failure to make timely disclosure subject only to the "reasonable system" defence described above.

- The BC Act has a defence available to experts who make a misrepresentation if the misrepresentation was based on information provided to the expert and it was reasonable for the expert to rely on the information. Under the Alberta, Manitoba and Ontario Acts, this specific defence is not available. However, under these latter Acts, the expert can be found liable only if he or she consented in writing to the public release of the document/statement containing the misrepresentation before the misrepresentation occurred. As well, under the Alberta, Manitoba and Ontario Acts, the expert report, statement or opinion must have been fairly presented for the expert to be liable.

- The BC Act has a potentially stricter vetting process for unmeritorious claims because it requires the court to be satisfied that the claim has a reasonable "prospect" of success, while the Alberta, Manitoba and Ontario Acts require only that the court to be satisfied that there is a reasonable "possibility" of success.

- As discussed above, the Alberta, Manitoba and Ontario Acts mandate a "loser pays" principle which should limit unmeritorious claims. No such loser pays principle exists under the BC Act.

The many notable differences between the BC Act and the Acts of Alberta, Manitoba and Ontario has resulted in the BC Act becoming a target of criticism. It will be interesting to see whether the BC legislature will conform to the uniform model adopted in Alberta, Manitoba and Ontario, or stand strong and proclaim into force legislation that many interested parties fear to be more Plaintiff-friendly than the model adopted elsewhere.

HELPFUL HINTS

In light of the legislation soon coming into force, or already in force, issuers should consider the taking the following actions:

- Review and revise existing policies, controls and procedures for oral and written disclosure, to ascertain whether they are sufficient to establish due diligence, which requires effective compliance systems;

- Adopt a written disclosure policy describing processes to ensure and verify the accuracy of public documents or written statements. Such a policy should identify responsibility and lines of communication, contain guidelines for material changes, and account for the requirements of both the Ontario and the local provincial legislative scheme,;

- Adopt a policy for public oral statements that identifies the persons authorized to make oral statements, controls the information disclosed by such persons, and clearly imposes restrictions upon all other persons who might be seen to have "apparent authority" to speak for the company;

- Review record retention and security policies;

- Consider the need for formal disclosure committee meetings;

- Create a culture of compliance to ensure that the policies are actually followed;

- Review corporate disclosure policies and security policies;

- Consider whether directors will want more protection, and review their insurance and indemnification arrangements;

- Officers should be encouraged to document procedures used to reach disclosure decisions and establish a formal chain of responsibility and communication;

- Officers and directors should be encouraged to use and rely upon expert opinions where practicable;

- Ensure that there is a system in place which will support an effective due diligence defence;

- Review and revise practices for the preparation of forward looking information to qualify for the forward-looking information defence;

- Exercise care when responding to regulatory inquiries, given that disclosures to regulators can in some cases be used by plaintiffs in civil proceedings.

The Alberta, Manitoba, Ontario and BC Acts are complex and extensive. This article is not intended to be relied upon as a legal opinion or legal advice. For purposes other than general information, reference should be made to the entire legislation rather than to this article.

AUTHORED BY JEFFREY N. THOM Q.C. of the Miller Thomson LLP Calgary office AND JOHN R. SHEWFELT of the Miller Thomson LLP Vancouver office AND BRYANT D. FRYDBERG of the Miller Thomson LLP Calgary office.