

RULE 10B-5 VERSUS PART XXIII.1: WHERE ARE THE RIGHTS OF INVESTORS BEST PROTECTED?

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INTRODUCTION

In January 2006, Bill 198, which embodied Ontario's new secondary market liability regime finally, went into effect. The law's coming into force was delayed for years by intense opposition from Canada's business community.

Bill 198 is supposed to have ushered in a new era of investor rights law in Ontario, one that offered remedies comparable to those available under United States federal law. While there are similarities between them, the Ontario and United States legal regimes offer different advantages and disadvantages. Plaintiffs wishing to assert misrepresentation claims against cross-listed companies may have the option of choosing one or the other regime, and should carefully consider the differences between the two regimes, having due regard to the facts of their particular case.

OVERVIEW OF THE ONTARIO REGIME

Bill 198, now embodied within Part XXIII.1 of the Ontario *Securities Act*,² was a response to the perceived failure of the common law to provide an effective remedy for secondary market misrepresentation. The Ontario model eliminates the need to prove detrimental reliance.³ It also creates liability in cases of mere negligence.⁴ Generally speaking, damages are presumptively the difference between the post- and pre-corrective disclosure price.⁵

The Ontario regime nevertheless requires that a plaintiff obtain leave of the Court to bring an action. Leave will be granted only if the plaintiff demonstrates that: (1) the action is brought in good faith; and (2) there is "a reasonable possibility that the action will be resolved at trial in favour of the plaintiff".⁶ The Ontario regime mandates that adverse costs be awarded against the losing litigant,⁷ thus eliminating the discretion otherwise available to the Court under the *Class Proceedings Act, 1992*⁸ not to award costs. Finally, the Ontario regime places arbitrary caps on the liability of the defendants.⁹ In certain circumstances, explored below, these caps are lifted.

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² R.S.O. 1990, c. S.5 ("*Securities Act*").

³ *Securities Act*, s. 138.3(1)(2)(3).

⁴ *Securities Act*, s. 138.3(4).

⁵ *Securities Act*, s. 138.5(1).

⁶ *Securities Act*, s. 138.8(1).

⁷ *Securities Act*, s. 138.11.

⁸ *Class Proceedings Act, 1992*, S.O. 1992, c.6, s. 31(1).

⁹ *Securities Act*, s. 138.7.

OVERVIEW OF THE UNITED STATES REGIME

The U.S. federal regime for secondary market liability derives from the *Securities Exchange Act of 1934* (the "1934 Act"). More particularly, Rule 10b-5 promulgated under the *1934 Act* bars secondary market misrepresentation, and has been deemed by U.S. Courts to imply a private right of action. However, liability arises under Rule 10b-5 only if the defendant acted with *scienter*, which essentially means an intent to deceive or recklessness with respect to the truth.¹⁰ Under Rule 10b-5, a showing of mere negligence will not suffice. Further, it was established by U.S. courts many years ago that, in the case of a security the market for which is efficient, a purchaser will be presumed to have relied upon the misrepresentation.¹¹

In 1995, litigation under Rule 10b-5 was transformed by the enactment of the *Private Securities Litigation Reform Act* (the "PSLRA"). The *PSLRA* emerged from Newt Gingrich's "Contract with America", and survived a veto by President Clinton. Among other things, the *PSLRA* required the plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind", and it imposed a stay of discovery during the pendency of a motion to dismiss.¹² Since the enactment of the *PSLRA*, class actions filed under Rule 10b-5 are routinely confronted by a motion to dismiss for failure to plead with adequate particularity. A recent study found that nearly 38% of securities class actions filed under Rule 10b-5 from 1999 to 2004 were dismissed, and that the dismissal rate has nearly doubled since enactment of the *PSLRA*.¹³ The *PSLRA* did not, however, impose liability caps, although recent rumblings in the United States suggest that liability caps for auditors could soon be incorporated into the U.S. regime. Finally, the *PSLRA* contains provisions for costs awards, but only in the case of actions deemed to have been frivolous.¹⁴

THE ADVANTAGES AND DISADVANTAGES OF THE UNITED STATES REGIME

Perhaps the most significant advantage of the current U.S. regime is the absence of liability caps. Ironically, the cases most deserving of relief, those in which the fraud occurs on a massive scale, are the cases in which liability caps are likely to have the greatest negative impact on investors in search of a remedy.

In addition, the absence of a requirement that costs always be imposed upon the losing litigant is a major benefit to plaintiffs. Although U.S. securities class action litigation is generally funded by plaintiffs' counsel, the resources of even the largest U.S. plaintiffs' firms are generally dwarfed by those of the defendants and their insurers.

Further, a vast body of case-law under Rule 10b-5 has been developed, providing greater certainty to litigants. Certainty is crucial in any legal regime: predictable results encourage settlement and provide clear guidance to market participants.

There is one other benefit to the U.S. regime that is worthy of mention. The *PSLRA* ushered in the requirement that the Court appoint the plaintiff "most capable of adequately

¹⁰ *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

¹¹ *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

¹² 15 U.S.C. § 78u-4(a)(9)(b)(2).

¹³ "Federal Class Action Filings Plummet But Settlement Amounts Rise", *The Insurance Journal*, February 21, 2007.

¹⁴ 15 U.S.C. § 78u-4(a)(4).

representing the interests of class members"¹⁵, and stipulated that the prospective lead plaintiff having sustained the largest loss is presumptively best able to represent the class. The result, particularly in larger U.S. securities class actions, is that institutional investors are frequently appointed as lead plaintiffs. As some commentators have observed:

Institutions with the largest stakes in class actions are better situated than plaintiffs' attorneys or courts to protect class members' interests. Those institutions' interests parallel the interests of the plaintiff class much more closely than do the interests of plaintiffs' attorneys or district judges, the parties now responsible for protecting the class. Moreover, the size of those institutions' stakes suggests they are likely to be reasonably diligent in seeking to ensure that plaintiffs' counsel represent effectively their interests and the interests of the plaintiff class.

The largest benefit of institutional supervision of class actions is likely to be settlement terms that are more favorable to the plaintiff class, on average, than those now negotiated by essentially unsupervised plaintiffs' attorneys.¹⁶

Nevertheless, the United States is hardly a plaintiff's panacea.

First, in order for a class action to be certified, the common issues must predominate over the individual issues.¹⁷ Much has been made in Canada of the U.S. fraud-on-the-market theory, but its availability under Rule 10b-5 is contingent upon a showing that the market for the security in question is efficient. As was demonstrated by the recent decision of the 2nd Circuit in the massive IPO Securities Litigation,¹⁸ U.S. federal courts are applying increasing scrutiny to claims of market efficiency.

In addition, and as stated above, the plaintiff in an action under Rule 10b-5 must demonstrate that the defendants acted with scienter, and must plead, without the benefit of any discovery, particularized facts giving rise to a "strong inference" of scienter.¹⁹ Generally, scienter can be successfully pleaded if there is either strong circumstantial evidence of scienter or a confluence of motive and opportunity to defraud.²⁰ The motive must rise to beyond what is the case in the normal course of business.²¹ Nevertheless, the failure to plead scienter with adequate particularity may be the most important factor in substantially increased rates of dismissal under the *PSLRA*.

15 15 U.S.C. § 78u-4(a)(3)(B)(i).

16 Weiss and Beckerman, *Let The Money Do The Monitoring: How Institutional Investors Can Reduce Agency Costs In Securities Class Actions*, 104 Yale L.J. 2053 at 2121

17 FRCP Rule 23(b)(3).

18 *In re Initial Public Offering Securities Litigation*, 471 F.3d 24 (2nd Cir. 2006).

19 15 U.S.C. § 78u-4(b)(2).

20 *In re Digital Island Securities Litigation*, 357 F.3d 322,328-9 (3d Cir. 2004).

21 *Digital Island*, 357 F.3d at 331.

THE ADVANTAGES AND DISADVANTAGES OF THE ONTARIO REGIME

The Ontario regime eliminates the need to prove detrimental reliance, and relief from the burden of proving reliance is not conditional upon a showing of market efficiency.

Further, the Ontario model does not require a showing of scienter. Given the difficulties in demonstrating that a defendant possessed a particular state of mind, this constitutes a significant advantage over the U.S. regime.

The Ontario regime has distinct disadvantages as well. In contrast to the U.S. model, it is immature. Only one action, the IMAX class action, has been brought under the new regime, and a decision on the leave motion is not anticipated until early 2008, over two years after the coming into force of Part XXIII.1. It thus remains unclear how onerous will be the plaintiff's burden under the leave provisions of Part XXIII.1. As stated above, Part XXIII.1 requires that a potential plaintiff demonstrate that it is acting in "good faith" and that "there is a reasonable possibility that the action will be resolved...in favour of the plaintiff". A "reasonable possibility" has previously been defined (albeit in other contexts) as "something more than a bare possibility yet something less than a probability... a result which may within reason happen or come to pass or one which is capable of being conceived or thought of as happening"²². Between these two poles, however, lies a considerable margin of manoeuvre.

Further, Part XXIII.1 caps damages at 5% of the pre-stock drop market cap of the defendant issuer. This may present a substantial reason to avoid bringing actions in Ontario. These caps may modify how settlement negotiations are conducted and their outcomes. That said, a review of settled U.S. securities class actions indicates that few settlements are valued above 5% of the issuer's market cap.

Our research indicates that caps may:

- increase the proportion of cases that settle;
- decrease the amount of time to reach settlement; and
- decrease the average settlement amount.

In one experiment, where a suit claimed \$1,000,000 in damages, subjects negotiating in a non-capped regime settled, on average, at \$490,000 (SE=27,650). Subjects negotiating under a regime with a \$250,000 cap settled, on average, at \$182,000 (SE=13,500) (p-value=.000). The settlement rate of capped negotiations was 0.73, non-capped settlement rate was 0.57 (SE=.06 and .07, respectively; p-value=.083).²³ It is interesting to note that the settlement amount under the capped regime is closer to the cap (72.8% of the cap) than the non-capped award is to the claimed damages (49% of the damages claimed). It appears that the cap may act as an 'anchor' and draw the final settlement figure up to it.

Though the existence of a cap will affect settlements, it is still worth exploring whether securities suits commonly settle for more than 5% of the pre-disclosure market cap. In order to

²² *Sutt v. Sutt*, [1969] 1 O.R. 169 at para. 14.

²³ Babcock and Pogarsky, "Damage Caps and Settlement: A Behavioral Approach", *Journal of Legal Studies*, Vol. 28, No. 2, p. 341 at 362.

measure this, we reviewed settlement announcements of securities fraud cases posted during 2006²⁴ on the Stanford Law School Securities Class Actions Clearinghouse (“SCAS”)²⁵ and calculated the pre-disclosure market cap based on the formula utilized under Part XXIII.1. While the SCAS service is comprised of data on U.S. suits, it is not clear that it is an exhaustive listing of all U.S. settlements. Thus, subtle forms of bias may be built into this analysis.

24 Defendant companies that were not traded on U.S. exchanges were excluded. Stock data for certain other companies, due to failure or merger, was not available. Such companies were not included.

25 Online at: <http://securities.stanford.edu/>

Defendant Company	Settlement Amount (US\$)²⁶	Pre-Disclosure Market Cap (US\$)²⁷	Settlement-as-Percent of Pre-Disclosure Market Cap
Tenet Healthcare Corp.	\$215,000,000.00	\$22,038,090,000.00	0.98%
Qwest Communications	\$400,000,000.00	\$17,559,300,000.00	2.28%
Bristol-Myers Squibb	\$185,000,000.00	\$99,828,400,000.00	0.19%
Nortel Networks I	\$1,235,000,000.00	\$136,793,686,400.00	0.90%
Nortel Networks II	\$1,235,000,000.00	\$24,284,263,600.00	5.09%
Cornell Companies Inc.	\$7,000,000.00	\$173,219,200.00	4.04%
HealthSouth	\$445,000,000.00	\$1,445,351,600.00	30.79%
Lattice Semiconductor Corporation	\$3,500,000.00	\$1,075,113,800.00	0.33%
Terayon Communication Systems, Inc.	\$65,600,000.00	\$7,209,452,920.00 ²⁸	0.91%
AOL/Time Warner	\$2,650,000,000.00	\$150,902,000,000.00	1.76%
Freddie Mac	\$410,000,000.00	\$41,182,204,000.00	1.00%
KongZhong Corporation	\$3,500,000.00	\$265,574,100.00	1.32%
Liquidmetal Technologies	\$7,025,000.00	\$143,863,800.00	4.88%
Advanced Marketing Services	\$6,000,000.00	\$226,786,000.00	2.65%
Ligand Pharmaceuticals	\$12,200,000.00	\$606,060,000.00	2.01%
Wave Systems Corp.	\$1,750,000.00	\$244,644,000.00	0.72%
Triplos	\$3,150,000.00	\$219,375,200.00	1.44%

²⁶ Total announced consideration, includes cash and, if applicable, stock.

²⁷ Based on the 10-day, market-weighted average pre-disclosure price and the number of outstanding shares as of March 21, 2007. Where companies are cross listed, U.S. valuations are used. Stock data from <http://finance.yahoo.com>. The disclosure date is the first date that news began to leak out, according to the Complaint, generally the last day of the class period.

²⁸ Number of common shares as at June 30, 2005 (last available report).

TASER International Inc.	\$20,000,000.00	\$1,668,524,500.00	1.20%
Dynacq Healthcare, Inc.	\$1,500,000.00	\$177,704,600.00	0.84%
Cincinnati Bell	\$36,000,000.00	\$1,450,174,200.00	2.48%
Mamma.com	\$3,150,000.00	\$86,757,000.00	3.63%

On average, these actions settled at 3.31% of the pre-disclosure market cap. Two settlements settled above 5% of the pre-disclosure market cap – Nortel II and HealthSouth. Nortel I and II were settled together, though they were discrete cases – this may explain the large discrepancy between the settlement percentages. Also, the vast majority of the settlement fund in Nortel I and Nortel II was comprised of Nortel stock. HealthSouth involved a massive stock drop – 97.19% – and the company was allegedly involved in a massive Medicare fraud. HealthSouth paid \$325 million to the government and a further \$100-million to the S.E.C. in connection with the underlying allegations. Nortel and HealthSouth are thus atypical.

This data indicates that it is only in rare cases that securities class actions settle above 5% of the pre-disclosure market cap. Thus, the practical impact of the damages caps under Part XXIII.1 may be limited.

We are fortified in this conclusion by the fact that the caps may be lifted against non-issuer defendants upon a showing that they acted with fraudulent intent.²⁹ Further, we believe that there is considerable overlap between Part XXIII.1's concept of fraudulent intent and the U.S. concept of scienter. Part XXIII.1 provides:

[The caps do] not apply to a person or company, other than the responsible issuer, if the plaintiff proves that the person or company authorized, permitted or acquiesced in the making of the misrepresentation or the failure to make timely disclosure *while knowing that it was a misrepresentation or a failure to make timely disclosure*, or influenced the making of the misrepresentation or the failure to make timely disclosure *while knowing that it was a misrepresentation or a failure to make timely disclosure* [emphasis added].³⁰

Similarly, under Rule 10b-5, the plaintiff must show that the defendants acted with a "wrongful state of mind" – knowing or intentional misconduct or an intent to deceive, manipulate or defraud.³¹ It will generally suffice to demonstrate extreme recklessness, which is

limited to those highly unreasonable omissions or representations that involve not merely simple or even inexcusable negligence, but an extreme departure from the

²⁹ Securities Act, s. 138.6(2).

³⁰ Securities Act, s. 138.7(2).

³¹ *Wechsler v Steinberg*, 733 F2d 1054, 1058 (2d Cir. 1984).

standards of ordinary care, and that present a danger of misleading buyers or sellers which is either known to the defendant or so obvious that the defendant must have been aware of it.³²

Therefore, most³³ cases that would survive a motion to dismiss brought under the *PSLRA* and Rule 12(b)(6) of the United States *Federal Rules of Civil Procedure* would not be subject to the caps imposed by Part XXIII.1.

It must be borne in mind, however, that the caps under Part XXIII.1 always protect the responsible issuer. Thus, unlimited liability can only be imposed upon directors, officers and “gatekeeper” defendants, such as auditors. This will be of significant value where the non-issuer defendants possess substantial assets or D&O insurance coverage, but otherwise will be of limited utility to aggrieved investors.

In any event, the caps only apply to the statutory regime, and do not modify the common law. Thus, plaintiffs who are successful in claims for negligent misrepresentation, conspiracy, fraud or under another statute, such as the *Competition Act* or *Criminal Code*, will not be bound by the caps. In addition, the recent relaxation of Ontario’s certification standards should facilitate the certification of common law claims sounding in negligent misrepresentation.³⁴

CONCLUSION

Ultimately, both Part XXIII.1 and Rule 10b-5 offer strengths and weaknesses to aggrieved investors.

At this early stage, the Ontario regime is characterized by a high degree of uncertainty. Of course, uncertainty creates risks for defendants as well, but its burden falls disproportionately on the litigant possessing fewer resources.

Whether the liability caps will constitute a serious disadvantage to plaintiffs will ultimately depend upon the facts of the particular case and the question of whether wilful blindness will suffice to satisfy the intent requirements of Part XXIII.1. In any event, in cases of mere negligence, the Ontario regime is clearly superior.

Part XXIII.1, though new, presents an exciting new avenue in cross-border securities litigation and much needed protection for Ontario's investors. In Ontario, there now exists a statutory foundation for Ontario to become a leading forum in investor protection. Only as the law develops, however, will we know if the promise of Bill 198 will be fulfilled.

³² *Nathanson v. Zonagen Inc.*, 267 F.3d 400 at 408 (5th Cir. 2001).

³³ Under Part XXIII.1, the defendant must have knowledge of the misstatement and, at a minimum, acquiesce to its dissemination. While a “known danger” of “misleading buyers of sellers” will likely suffice to lift the caps, it is not clear whether wilful blindness will result in the lifting of the caps. If wilful blindness is held to be insufficient under Part XXIII.1, then the caps are likely to constitute a significant disadvantage in comparison to the U.S. regime.

³⁴ *Cloud et al. v. The Attorney General of Canada et al.* (2004), 73 O.R. (3d) 401, [2004] O.J. No. 4924 (C.A.).