

What's Fraud Got to Do with It? Early Dispatches from the Part XXIII.1 Frontier

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Part XXIII.1 of the Ontario *Securities Act* turned three just as we were popping corks this last New Years Eve. In that time, one Part XXIII.1 case, *Stastny v. Southwestern Resources Corp. et al.*, settled and two other cases produced important judgements: *Silver v. Imax Corporation*, 2008 CanLII 21905 (ON S.C.) and *Ainslie v. CV Technologies Inc.*, 2008 CanLII 63217 (ON S.C.). Now that Part XXIII.1¹ is a toddler and is finally getting to its feet, it is time to survey the lay of the land and to see where we have been and where we are going.

Our firm, Siskinds LLP, is lead or co-lead counsel to the plaintiffs in nearly all of the securities class actions brought under the new regime. This paper covers our experience litigating under Part XXII.1. The first section surveys the major decisions to date and tries to tease out lessons for which way the Courts seem to be heading. Unfortunately, the case law to date is contradictory, and lessons for the future are scant and difficult to judge.

The second section discusses the application of s. 138.7's "damage caps" to the practice of securities class actions. These caps will influence the structure of securities class action resolutions. In practice, however, they have not proven to be a significant obstacle. We canvas some of the reasons why.

¹ *Securities Act*, R.S.O. 1990, c. S.5 (the "*Securities Act*"), Part XXIII.1

Many of the questions presented by Part XXIII.1 are unresolved and will remain that way for the foreseeable future. Simply, the majority of class actions settle or are dismissed before the merits are considered, and this pre-empts the possibility of Court decisions on many of these issues. Nevertheless, at this early stage it is clear that Ontario Courts are concerned with protecting investors and have interpreted the *Securities Act* accordingly.

Early Reports: Conflicting Interpretations

*It may seem to you that I'm acting confused
When you're close to me
If I tend to look dazed I've read it someplace
I've got cause to be*

So far, two Courts have issued substantive decisions in Part XXIII.1 cases. We expect Courts to issue more decisions in the near future as cases work their way to resolution.

Predictably, these cases deal with the early stages of secondary-market litigation. The typical path for a securities class action commences with the filing of a Statement of Claim asserting common law claims and/or primary market claims pursuant to the *Securities Act*. The plaintiff then seeks leave pursuant to s. 138.8 to plead the causes of action in Part XXIII.1, often while simultaneously moving for certification. This is the path that both the *IMAX* and *CV Technologies* cases took. Some other cases, such as the

nascent AIG litigation (*Juniper v. American International Group, et al.*), proceed directly to leave via an Application.²

In either situation, the first major battle will be the leave motion. Part XXIII.1 reads:

- 138.8 (1) No action may be commenced under section 138.3 without leave of the court granted upon motion with notice to each defendant. The court shall grant leave only where it is satisfied that,
- (a) the action is being brought in good faith; and
 - (b) there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.
- (2) Upon an application under this section, the plaintiff and each defendant shall serve and file one or more affidavits setting forth the material facts upon which each intends to rely.
- (3) The maker of such an affidavit may be examined on it in accordance with the rules of court.
- (4) A copy of the application for leave to proceed and any affidavits filed with the court shall be sent to the Commission when filed.

The early cases focus on subsections two and three – on what needs to be submitted during a leave application and what cross examination can be carried out. Underlying these questions is the broader concern: just how complex are these leave applications meant to be?

IMAX, decided before *CV Technologies*, was a refusals motion arising out of a cross examination conducted in a leave motion. It was the first case to tackle how the leave motion would work. Van Rensburg J. took a more expansive view than Justice Lax, who decided *CV Technologies*, would, noting that, at the leave stage:

² The *AIG* case is the first case brought under the *OSA*'s jurisdiction over non-reporting issuers (the "real and substantial" prong in the definition of "responsible issuer," *OSA*, s. 138.1. We expect that a jurisdictional battle will occupy at least the first year and a half of this action.

In this motion, much more is required of both the plaintiffs and the respondents. The plaintiffs cannot rely on their allegations, but must put forward evidence, which in turn can be tested in cross-examination. Likewise, in opposing leave, each prospective defendant must come forward with its defences, with evidence in support...

The Act provides no guidance as to the interpretation of the threshold test and what type, quality and quantity of evidence a court is to consider in making a determination of the plaintiffs' good faith and the reasonable possibility of the plaintiffs' success at trial. We are left with what the statute prescribes – a mandatory requirement for each plaintiff and each proposed defendant to set out facts by affidavit, with the right to cross-examine the deponents of such affidavits.³

Dealing explicitly with the scope of discovery in the refusals motion, Justice van Rensburg continued: “a question that is potentially relevant to the facts alleged in respect to the statutory claims set out in the proposed statement of claim and in the defences raised in the responding affidavits must be answered even if it might also reveal some other potential issues or wrongdoing not currently contemplated by the statutory claim.”⁴

IMAX, then, contemplated both whether affidavits would be filed, and, if so, the scope of the cross-examination thereon. Justice Lax, in *CV Technologies*, would classify this first conclusion as obiter.

CV Technologies dealt head-on with the question of the meaning of “each defendant shall serve and file one or more affidavits.”

³ *IMAX*, at para.17. Justice Lax characterized this as “obiter.” *CV Technologies*, at para. 23.

⁴ *IMAX*, at para. 20.

The plaintiff argued that the Act required that each defendant (typically the issuer, certain officers and directors and, in some cases, outside experts such as auditors) had to swear and file an affidavit. This would result in the conducting of cross-examinations of the defendants prior to the motion for leave. Defendants complain that expansive disclosure advantages Plaintiffs by increasing the costs to defendants (and thus increasing settlement pressure). In many cases – for example, cases concerning the reasonableness of managerial projections – the ability to compel disclosure is crucial, as the evidence relating to the question of whether there were misstatements of material fact is non-public and in the exclusive possession of the Defendants.⁵

In *CV Technologies*, the defence argued that all that was required was that an affidavit be “filed” by a defendant and not “sworn” by a defendant and, accordingly, all of the defendants could file and rely on the same affidavit, even if sworn by a non-party expert.⁶

Justice Lax noted that the leave provision “was not enacted to benefit plaintiffs or to level the playing field for them in prosecuting an action under Part XXIII.1 of the Act. Rather, it was enacted to protect defendants from coercive litigation and to reduce their exposure to costly proceedings.”⁷ Citing the fear of ‘strike suits’ – which drove the

⁵ Of course, related to this inquiry is exactly what the hurdle for certification is – what “a reasonable possibility that the action will be resolved at trial in favour of the plaintiff” means.

⁶ It is not clear that this approach is worse for plaintiffs. To the extent that the leave motion is lighter and less labour and capital intensive, the plaintiffs can get to leave and certification more quickly (typically the two motions are heard together). Once leave is granted and the action certified, the pressure on the defendants to settle grows substantially.

⁷ *CV Technologies, supra*, at para. 15.

enactment of the provision – Her Honour called the leave provision a “gatekeeper function.”⁸

Justice Lax further ruled that the defendants could file no affidavits if they so choose, though “a defendant who does not file affidavit material accepts the risk that it may be impairing its ability to successfully defeat the motion for leave and is probably foregoing the right to assert the statutory defences under Part XXIII.1 of the Act.”⁹ On February 11, 2009 Justice Bellamy granted leave to appeal the decision, citing the novel nature of the question and its general public importance, which required the attention of an appellate court.

In light of the *CV Technologies* and *Imax* decisions, defendants in Part XXIII.1 actions are on the horns of a dilemma. If they forgo affidavits, they are likely giving up the defences available and substantially increase the risk that they will lose the leave motion. If the defendants swear and file affidavits, however, they will open themselves up to expansive and potentially damaging disclosure of incriminating evidence.¹⁰ Failing to submit affidavits may also signal plaintiffs’ counsel that the defence views their case as weak and is seeking to avoid cross-examination. Further Court treatment of Part XXIII.1, particularly the “reasonable possibility” test, is needed before defendants can properly chart their pre-trial tactics.

⁸ *Ibid.*

⁹ *Ibid.*, at para. 24. The statutory defense include due diligence, *OSA*, s. 138.4.

¹⁰ These considerations take on greater urgency in the case of cross-border litigation. The *Private Securities Litigation Reform Act*, 15 U.S.C. § 78u-4 (the “Reform Act”), stays discovery prior to the filing of the *FRCP* Rule 12(b)(6) motion to dismiss. However, any noteworthy discovery from the Ontario action is likely to find its way into the public record. Sealing orders have been successfully opposed in Ontario securities actions.

Damage Caps: Irrelevant Protection?

*I've been thinking about my own protection
It scares me to feel this way*

One of the protections that the drafters of Bill 198 adopted for the benefit of defendants was to limit damage awards. In essence, damage awards are limited unless the plaintiff can prove that the violation was done knowingly.¹¹ This heightened mental requirement is somewhat similar to the *scienter* requirement in American securities litigation. Even in cases of fraud, however, the issuer's damage cap continues to apply.

At first blush, the damage limitations appear to be a significant shortcoming for investors. While the true impact of the limits will only become apparent as this area of law matures, we do not believe that they present a serious impediment to class recovery.

First, damages as against the responsible issuer are capped at 5% of the *pre-misrepresentation* market cap. Because the issuer's stock price has not yet become depressed by a corrective disclosure and the attendant loss of managerial credibility, the issuer's market capitalization is likely to be higher than the post-correction capitalization.

¹¹ *Securities Act*, s. 138.7(2): “[the damage 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”

Second, the defendants' capacity to pay will sometimes be less than the cap, which deprives the cap of practical significance. The sources from which securities class action settlements are generally funded are directors' and officers' liability policies and the assets of the defendants. If those funding sources amount to less than the liability caps, then it is those funding sources and not the caps that will drive the terms of settlement.

Third, in many cases the evidence of intentional deceit will be sufficiently strong to expose the directors and officers to uncapped liability. The difficulty in such cases, however, is that the aggregate net assets of the culpable directors and officers may constitute a fraction of class damages, and the liability insurer of the directors and officers may be persuaded by the evidence of fraud to take an off-coverage position.

Fourth, the corporate structure of some defendants are such that the caps are effectively a non-issue. For example, where an issuer employs an "income fund" structure, the operating company – which is not the reporting issuer, and thus, as a defendant, not subject to permanent caps – has many, if not all, of the assets of the "issuer." Additionally, the operating company will typically have played a key a role in the formation of the income fund and is thus a "promoter" – and therefore an influential person – under the *Securities Act*. Thus, the corporate entity that has the majority of the assets is not subject to immutable caps, rendering those caps irrelevant.

Finally, s. 138.13 states:

The right of action for damages and the defences to an action under section 138.3 are in addition to, and without derogation from, any other rights or defences the plaintiff or defendant may have in an action brought otherwise than under this Part.

Thus, Part XXIII.1 does not abrogate common law causes of action, which are not subject to arbitrary liability limits.¹²

What's Fraud Got To Do With It?

In crafting the secondary market regime, the Ontario legislature largely rejected the American model, which requires a showing of fraudulent intent in order for the defendants to incur any liability whatsoever. Exactly how our legislation will play out in practice will take years to determine. To date, it appears that Courts are mindful of the need to protect plaintiffs. Compared to the United States, where increasingly business-friendly Courts have been rolling back investor protection at a furious pace,¹³ Ontario's regime seems quite attractive. Provided that the goal of the legislation – “to provide protection to investors from unfair, improper or fraudulent practices” – is kept in mind as the case law develops, we expect this trend to continue.

¹² The only likely impact of the caps will be to decrease the number of suits against smaller (especially venture-listed) companies.

¹³ See *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. ____ (2008), *Tellabs Inc. v. Makor Issues & Rights*, 127 S.Ct. 2499 (2007) and *In re IPO Securities Litigation*, 471 F.3d 24 (2d Cir. 2006), for example.