

**SECURITIES CLASS ACTIONS IN CANADA:  
HAVEN OR HINTERLAND?**

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## SECURITIES CLASS ACTIONS: THE NEW THREAT

### I. INTRODUCTION

Class actions provide a powerful tool to Plaintiffs and their counsel. Actions that would previously not have been brought suddenly make sense when many small claims can be efficiently aggregated. With the passage of class action legislation, anyone with responsibilities to a diffuse group is now at greater risk. Issuers, directors and officers are no exception.

### II. THE U.S. EXPERIENCE

Actions against issuers, their officers and directors are among the most popular areas for class actions in the United States. Most common are claims of fraud under section 10(b) of the *Securities Exchange Act of 1934*.<sup>1</sup>

If a director or officer fails to ensure that the company discloses adverse material information, they are likely to find themselves part of a class action lawsuit by shareholders who purchased in the secondary market during the period of the material non-disclosure. The action will claim the difference between the price at which the shares were purchased, and what the shares were actually worth.

These class actions are assisted by the "fraud on the market" theory, which essentially removes the necessity to establish reliance on any particular misrepresentation by the company, so long as the Plaintiff can establish that the failure to disclose had an impact on the market price.<sup>2</sup> Further, the court may be willing to certify the class action even if the claim requires an assessment of documents produced over an extended period of time, so long as the documents were part of a common scheme to defraud shareholders.<sup>3</sup> Both these principles reduce the individuality

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<sup>1</sup> 15 U.S.C. 78j(b)

<sup>2</sup> *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975)

<sup>3</sup> *Newberg on Class Actions*, (West Publishing, 1992), para.22.19.

associated with the claims, and keep the focus on the issuer=s conduct. Certification is essentially automatic in such class actions.<sup>4</sup>

Defendants whose share price takes an unexpected dip will usually face a spate of actions by many different law firms. For example, Cendant Corp. alone was hit with 70 different lawsuits in 1998. Usually the various Plaintiff=s counsel will eventually congeal around one lawsuit. In other cases, the courts have ordered an auction for the right to represent the class.<sup>5</sup>

Defendants faced with such actions find it difficult to maintain a defence on the merits. The resources required to defend the lawsuit and the negative impact on the company=s ability to raise further capital (coupled with certain class counsel=s willingness to resolve claims for cents on the dollar) create an environment that is very conducive to settlement. The settlements= percentage of the potential investor losses has been found to range from 2-21% in one recent study (depending on the means of calculation).<sup>6</sup>

So many class actions were filed in the early 1990s that legislators came to believe that remedial legislation was required. Congress passed the *Private Securities Litigation Reform Act* in 1995. This legislation:

- a. heightens the pleading requirement - more specificity, in relation to the fraud allegation;
- b. creates a presumption that the best representative Plaintiff is the person with the largest financial interest in the case;
- c. requires that each Plaintiff seeking to serve as a representative party file a sworn

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<sup>4</sup> *Newberg on Class Actions, supra*, para.22.01

<sup>5</sup> *In re Oracle Secs. Litig*, 131 F.R.D. 688 (N.D. Cal. 1990)

<sup>6</sup> See Bajaj, Mazumdar, and Sarin, *Securities Class Action Settlement: An Empirical Analysis* (Nov. 16, 2000) at <http://secuties.standord.edu/report>

certification that:

- (i) the Plaintiff did not purchase the shares at the direction of counsel or in order to participate in a lawsuit;
  - (ii) identifies any other action filed during the preceding three-year period in which the Plaintiff sought to serve as a representative Plaintiff; and
  - (iii) the Plaintiff will not accept payment for serving as a representative party on behalf of a class beyond the Plaintiff's pro rata share of any recovery, except as approved by the court;
- d. assigns joint and several liability for damages only if the trier of fact specifically determines that the Defendant knowingly violated securities laws; otherwise, damages are restricted to that portion of the judgment that corresponds to the percentage of each individual Defendant's responsibility for the Plaintiffs' losses;
- e. provides certain issuers a safe harbor from liability for forward-looking statements regarding a security's projected performance or operations, if: (1) the statement is immaterial or is identified as a forward-looking statement and accompanied by certain cautionary statements; or (2) the Plaintiff fails to prove that the statement was made with either actual knowledge of its false or misleading nature by a natural person, or actual approval by an executive officer.

The desire to shift control of securities class action litigation to institutional investors was a driving force behind the enactment of the legislation.<sup>7</sup>

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<sup>7</sup> *Lurette v. Shiva Corp.*, 1998 U.S. Dist. LEXIS 18525 (Mass.D.C.)

Has the legislation succeeded in deterring securities class actions? The answer is clear from the following headline at Stanford's *Securities Class Action Clearinghouse* website<sup>8</sup>:

**SECURITIES FRAUD LITIGATION SETS RECORD IN 1998 --- Companies Sued at a Rate Close to One-A-Day --- A**

Although the figure dipped in 1999, it has still not fallen to levels appreciably different from that which occurred prior to the 1995 legislation.<sup>9</sup>

It is generally accepted that the legislation failed to achieve the purpose of reducing the number of cases.<sup>10</sup> Class actions continue unabated. While settlements have slower to achieve following the reforms, the absolute value has been larger. The settlements= percentage of the potential loss has not changed significantly.<sup>11</sup>

Congress responded to this failure by passing the *Securities Litigation Uniform Act of 1998*. This legislation creates further restrictions by attempting to ensure that the U.S. Federal Court is the exclusive jurisdiction for these types of actions. Evidence suggested that class counsel were seeking to circumvent the new federal requirements by filing actions in state courts rather than federal court. It remains to be seen whether this latest effort will have any lasting effect.

### III. THE CANADIAN EXPERIENCE

Has the U.S. experience been imported into Canada? Canada has seen a reasonable amount of recent securities class action activity, but there are presently limitations on how far the area can expand. A review of the case law to date will show the opportunities and pitfalls associated with

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<sup>8</sup> <http://securities.stanford.edu>. This website is an amazingly comprehensive site of cases, statutes, and academic material.

<sup>9</sup> See Bajaj, *supra*

<sup>10</sup> Tamara Loomis, *Securities Reform: What Went Wrong* (October 27, 2000), found at <http://securities.stanford.edu/report>

<sup>11</sup> Bajaj, *supra*

such litigation.

1. The Prototype - Maxwell v. MLG Ventures

An action based on alleged misrepresentations in an offering circular was certified, and a settlement subsequently achieved on behalf of investors.<sup>12</sup> The class included all former shareholders of Maple Leaf Gardens Ltd. who had tendered their shares pursuant to the Defendant=s offer. The settlement required the offeror to substantially increase its initial offer. Certification was assisted by the fact that the Ontario *Securities Act* provides for deemed reliance on the contents of the offering circular<sup>13</sup>. This provision removes one otherwise difficult individual issue, and thereby, will tip the balance in favour of certification in most cases involving primary market distributions (i.e. distributions direct from the issuer or purchases pursuant to a take-over bid circular).

2. The Glass is Half-Full (or All Empty) - Carom v. Bre-X Minerals Ltd.

This action includes pleas of misrepresentation and conspiracy against Bre-X, a sister company, its insiders and engineer, and several brokers who recommended Bre-X stock. These were Asecondary market@ allegations, not based on a particular prospectus or circular. All Canadian shareholders who purchased shares of Bre-X on various stock exchanges over the course of the alleged fraud were included within the proposed class.

In an earlier pleadings motion, the court specifically declined to import the U.S. Afraud on the market@ concept into such secondary market claims.<sup>14</sup> The court held that the Supreme Court of Canada=s judgment in *Hercules Management* means that reliance must be established in every

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<sup>12</sup> [1995] O.J. No. 2698 (Gen.Div.)

<sup>13</sup> *Securities Act*, R.S.O. 1990, c.S.5, s.131. The same rule applies to misrepresentations in a prospectus: s.130. Both provisions also exist in B.C.=s *Securities Act*.

<sup>14</sup> (November 4, 1999) 97-GD-39574 (Ont.Ct.Gen.Div.)

case alleging negligent misrepresentation.

Without the benefit of the "fraud on the market" concept, the negligent misrepresentation tort is usually quite personal - it begins with an analysis of exactly what was said to each individual, and it ends by requiring confirmation that each person relied on the particular statement challenged.

At the certification stage, the trial court in *Carom* refused to certify the negligent misrepresentation claims, based in large measure on the complexity created by the need to establish reliance in each case.<sup>15</sup> However, the court did certify the fraudulent misrepresentation claim against the company and its insiders given that the focus of this claim was an overarching fraud permeating every statement rather than a series of individual representations. The court also certified the conspiracy and *Competition Act* claims against the same parties. The Ontario Court of Appeal subsequently found that the negligent misrepresentation claims could proceed against the insiders and Bre-X, given that the fraudulent misrepresentation claim had already been certified against these parties, and there was insufficient legal distinction between the nature of the two claims to justify different treatment.

Therefore, in relation to secondary market claims, unless you have a strong case of fraud against the issuer itself, it will be difficult to achieve certification. The problem facing the Plaintiff in *Carom*, which will not be infrequent, is that the issuer is left with little in the way of exigible assets once a fraud is uncovered.

It may be possible to justify certification of secondary market claims if there is one press release or statement that will obviously have been heard or relied upon by all shareholders, but such situations will be rare.

### 3. Misrepresentation Difficulties, What Misrepresentation Difficulties? -

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<sup>15</sup> 44 O.R. (3d) 173 (Gen.Div.), aff'd (1999), 46 O.R. (3d) 315 (Div.Ct), appeal allowed (October 31, 2000) C33905 (C.A.)

***Menegon v. Philip Services Corp.***

A settlement class was certified against the issuer in *Menegon v. Philip Services Corp.*<sup>16</sup>, in which secondary market misrepresentation claims were advanced by the shareholder class. However, there was little analysis of the concerns raised in *Carom*. The certification seemed to be driven by the particular circumstances of that case. The issuer required settlement approval in order to achieve a restructuring under the *Companies = Creditors Arrangement Act*. The court specifically held that certification against the issuer was without prejudice to any arguments the remaining Defendants might wish to make in opposition to certification at some later date.

4. Oppression Class Actions: The Form is Fine, but what about the Content? -  
*Stern v. Imasco Ltd.* and *Joncas v. Spruce Falls Power and Paper Co.*

There is a variety of corporate activity that takes place outside the framework of prospectuses or takeover bids. The oppression remedy is meant to provide a remedy for all situations in which shareholders have been unduly prejudiced. Can the class action vehicle be used effectively to advance such claims?

In *Joncas v. Spruce Falls Power and Paper Co.*<sup>17</sup>, the court approved an oppression claim relating to a share issuance by the company to employees. Certification was not actively contested by the Defendant however, only the existence of a cause of action.

In *Stern v. Imasco Ltd.*<sup>18</sup>, the Plaintiff sought to bring an oppression-based class action alleging that the issuer, its directors, and de facto controlling shareholder were entering into an improvident transaction which had the effect of freezing out minority shareholders at a price that did not properly reflect the value of the shares. All shares were to be transferred to the de

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<sup>16</sup> [1999] O.J. No. 4080 (S.C.)

<sup>17</sup> (April 13, 1999) No.97-CV138924 (Ont.Ct.Gen.Div.)

<sup>18</sup> (1999), 38 C.P.C. 4<sup>th</sup> 347 (Ont.S.C.J.)

facto controlling shareholder, BAT plc.

The Defendants argued that an oppression-based class actions are barred through the operation of section 37(a) of the Ontario Act.

Section 37(a) provides that the Act does not apply to a proceeding that may be brought in a representative capacity under another act. The Defendants argued that an oppression action could be brought in a representative capacity under the applicable corporate statute, and therefore certification under the Ontario Act was not appropriate. The court rejected this argument stating that although an oppression proceeding can sometimes have the characteristics of a representative action in its effect, it is not brought in a representative capacity. The court found that use of the class proceedings legislation can be complementary to the objectives of the oppression remedy.

When it came to assessing the merits, however<sup>19</sup>, the court adopted the traditional business judgment rule and held that: "The directors of Imasco have an arguable basis for facilitating a decision by Imasco's public shareholders on BAT's proposal." The business judgment rule as interpreted to date by Ontario and B.C. courts have provided officers and directors with a great deal of latitude in terms of structuring transactions<sup>20</sup>. As a general matter, it would appear that U.S. courts are more inclined to adopt a degree of healthy scepticism when considering the motives of a corporation's principals.

The Court in *Stern* also struck the personal claims against the directors, and those against the de facto controlling shareholders. This left only the issuer as subject to the oppression action. These findings illustrate two points: (1) the broad scope of the business judgment rule in Canada, and

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<sup>19</sup> The Plaintiff had asked for interim disclosure orders, which required the court to consider the merits of the Plaintiff's position generally.

<sup>20</sup> *Brant Investments Ltd. v. KeepRite Inc. et al.* (1991), 3 O.R.(3d) 289 (C.A.) at 320; *Brio v. Clearly Canadian Beverage Corp* (1995), 8 C.C.L.S. 1 (B.C.S.C.) at para. 17; *CW Shareholdings Inc. v. WIC Western International Communications Ltd. et al* (1998), 160 D.L.R. (4th) 131 (Ont. Gen. Div.) at 150 to 153

(2) the need to carefully assess the scope of any securities claim to ensure that only the bare minimum of parties necessary to assure full recovery at the end of the day are joined. This is particularly true in Ontario, where costs can be awarded against representative Plaintiffs within the class proceeding.

5. Undermined by an Apparent Alternative - *Millgate v. National Trust Company*

This claim concerned debentures that were issued by National Trust as corporate trustee. Other Defendants named in the action include corporations and senior executives who were alleged to have stripped a company of assets after it sold the debentures.

Class certification was refused, based on the Defendants' agreement to be bound by a resolution of certain legal issues determined in one action<sup>21</sup>. The court did allow that certification could be revisited after a resolution of these legal issues.

One may ask why, if there was a central legal issue, the case could not be certified immediately so that the class members would gain all of the associated procedural advantages under the Act.

6. Recovery of Lost Wages - The Quebec Precedents

In terms of obligations to employees, courts in Quebec have certified several class actions against directors to assist in the enforcement of their responsibility for wages on a company's dissolution.<sup>22</sup>

7. The Exit Strategy - *Epstein v. First Marathon Inc.*

*Epstein v. First Marathon Inc.*<sup>23</sup> illustrates the care courts will take to ensure that securities class

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<sup>21</sup> [1998] O.J. No. 4537 (Gen.Div.)

<sup>22</sup> Branch, *Class Actions in Canada* (Aurora: Canada Law Book), para. 5.1090.

<sup>23</sup> (2000), 41 C.P.C. (4<sup>th</sup>) 159 (Ont.S.C.)

proceedings are not used improperly to prevent commercial transactions from proceeding smoothly.

In Ontario, any discontinuance of a class action must obtain court approval, whether or not the action has been certified.<sup>24</sup> In *Epstein*, the Plaintiff sought to discontinue a proposed securities class action. The action was sought in order to challenge the corporation's decision to enter into a statutory arrangement. Prior to any challenge being advanced however, the Plaintiff agreed to discontinue the action in return for a sum of money on account of fees. No funds were going to be paid to the class, and the agreement was not generally disclosed.

The court refused to approve the fee, concerned that the action had the characteristics of a strike suit advanced solely to obtain the payment of fees rather than in the best interest of shareholders. The court noted that the case on the merits was never advanced by the Plaintiff, and counsel was the only person benefiting from the settlement.

#### **IV. CROSS-BORDER ISSUES**

In the case of *Bre-X*, class actions were brought in both the U.S. and Canada. The U.S. action purported to include Canadian shareholders. The Defendants in the U.S. action opposed the inclusion of Canadians.

The U.S. Court agreed, and dismissed the Canadian claims.<sup>25</sup> The court concluded that there was no jurisdiction in the U.S. court to consider such claims. There was insufficient conduct in the United States relevant to the claims of the Canadians to allow them to rely on the provisions of the U.S. securities legislation.

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<sup>24</sup> Note: This is not the case in B.C. where approval is only required if the case reaches certification.

<sup>25</sup> *McNamara v. Bre-X Minerals Ltd.* (Jan. 7, 1999. E.D. Tex., Texarcana Division)

Conversely, in *Paraschos v. YBM Magnex International Inc.*<sup>26</sup>, a U.S. Court found that there was sufficient activity conducted by the issuer in the U.S. to allow the Canadians to pursue U.S. statutory remedies. The court did not preclude parallel litigation in Canada on any Canadian remedies might also be available.

Given the strength and advantages provided by the fraud on the market remedies in the U.S., it will generally be preferable to pursue claims in the U.S. whenever possible to do so.

Therefore, in the absence of legislative reform, it is likely that most Canadian securities class actions will only involve Canadian issuers, and cases where little of the challenged conduct occurred within the U.S.

## **V. THE NEW WAVE OF LIABILITY ON THE HORIZON**

The Canadian Securities Commissions have published proposed legislative changes which will facilitate bringing class actions by bringing in a form of fraud on the market theory against officers and directors. The proposed changes include the following elements:

- a. Secondary market investors will have a civil right to sue issuers, directors, responsible senior officers, auditors, influential persons, and other experts for withholding information or for releasing misleading information that causes losses which could have been prevented, had complete information been made available.
- b. Secondary investors would not have to prove that they had relied on any specific information. Reliance will be deemed.
- c. Defences: For some types of disclosure, defendants will have a due diligence defence. For other types, it will be necessary to show that the defendants were

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<sup>26</sup> (May 29, 2000, E.D. Penn)

reckless.

- d. **Damage Limits:** Damages against an issuer are limited to 5% of market capitalization or \$1 million, whichever is greater. For defendants other than the issuer, the limits will not apply if they knew of the representation.
- e. **Joint and Several Liability:** Liability will not be joint and several. Each person at fault will only be responsible to the extent that they were responsible for the misrepresentation, unless the misrepresentation is made knowingly.
- f. **Procedural Issues;** Leave of the court will be required to commence the action, and the court will have to approve any settlement. Given that these requirements exist in for class actions already, these requirements do not add any complexity to securities class cases.

Given the market capitalization limits, the incentive will be to pursue larger companies. It is difficult to rationalize why the issuer=s exposure should be limited to 5% when the misrepresentation may have caused far greater losses. The explanation likely lies in the need for a political compromise to ensure that the legislation has a reasonable prospect of being passed.

The author has a real concern whether the limits are sufficiently high to motivate class counsel to bring such difficult and challenging secondary market claims. It may be necessary for class counsel to Adouble up@: invoking the statutory remedies to ensure certification, while maintaining the common law claims to ensure that the company continues to face exposure for the entire loss suffered by shareholders.

To the best of the writer=s knowledge, none of the governments have yet decided whether to proceed with the legislative amendments.

## **VI. CONCLUSION**

The *Class Proceedings Act* does partially even the playing field between issuers and wronged shareholders. Canadian class counsel are learning from their American counterparts. Canadian legislators are learning from their American counterparts.

Launching a securities class action is not for the faint of heart, however. Issuers will retain top-flight counsel, and will confront class counsel with a full array of procedural objections. The speed at which securities transactions and its associated litigation occur requires enormous resources and devotion. The issue of costs for cases brought in Ontario can be daunting. On the merits, the courts will generally grant the corporation a wide latitude in relation to its decision-making.

Nonetheless, at the end of the day, class actions have increased exposure for securities issuers. This should improve both the conduct of issuers, and the lot of shareholders wronged by improper activities. The level of improvement will depend on the courage (or foolhardiness) of class counsel, and the willingness of the legislature to further improve the balance between issuers and their shareholders with new legislation.