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Plaintiffs drive to overcome Securities Act protections for issuer and underwriter class actions

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In 2016, plaintiffs continued their attempts to circumvent the protections offered to defendants under the Ontario *Securities Act* against secondary market claims. These attempts were largely unsuccessful, and the protections provided to defendants from unmeritorious securities class actions continue to be relatively robust.

Plaintiffs attempts to undermine the statutory protections

The secondary market right of action in Part XXIII.1 of the Ontario *Securities Act*was built on a balancing of interests and includes safeguards – such as a merits-based leave stage and liability limits – which are designed to protect issuers and other defendants from unmeritorious litigation and devastating liability.

In recent years, the most significant securities class action developments centered on the statutory leave test for bringing a secondary market claim. The interpretation of this test was largely settled by the Supreme Court of Canada's 2015 decisions in *Theratechnologies* and *CIBC*.

As a result, developments in 2016 tended to address other issues arising from creative plaintiffs' attempts to undermine the protections offered by the *Securities Act*. These were largely unsuccessful. Several decisions in 2016 should give many market participants confidence that Ontario courts are prepared to recognize and uphold the hard-won protections in Part XXIII.1.

In particular, plaintiffs' counsel sought to circumvent the statutory protections by:

1. seeking to bring claims of secondary market purchasers under the primary market right of action, which lacks many of the same protections for issuers and other market participants;
2. seeking to bring claims against underwriters under the secondary market right of action, which could expose underwriters to significantly increased liability; and
3. seeking to frame secondary market claims against less conventional defendants like investment banks on the basis that they are "influential persons".

Primary vs. secondary market rights of action

The primary market right of action relates mainly to misrepresentations affecting the price of securities issued under, for example, a prospectus (Part XXIII of the Ontario *Securities Act*).

The secondary market right of action relates mainly to misrepresentations in an issuer's continuous disclosure obligations that affect the price of securities purchased or sold in the secondary market (Part XXIII.1 of the Ontario *Securities Act*). Part XXIII.1 provides certain safeguards to defendants in secondary market claims, including the requirement that plaintiffs obtain leave of the Court before commencing an action, and liability limits.

In two recent decisions, Ontario courts have confirmed the crucial distinction between the two rights of action and denied plaintiffs' attempts to circumvent the protections in the respective rights of action.

In *Rooney v. ArcelorMittal SA*, the Court of Appeal for Ontario confirmed that security holders who sell shares in the secondary market in the face of a takeover bid cannot bring a primary market claim under Part XXIII alleging misrepresentations in a takeover bid circular.

In *LBP Holdings v. Allied Nevada Gold Corp.*, the Ontario Superior Court of Justice denied the plaintiff's attempt to commence a statutory secondary market claim against underwriters in relation to alleged misrepresentations in an offering document. Justice Belobaba held that underwriters could not be sued as "experts" in a secondary market claim covered by Part XXIII.1. The *Securities Act* distinguishes between experts and underwriters and Part XXIII (primary market claims) provides a 'complete code' for underwriter liability.

Investment banks as promoters – "something more" is required

Plaintiffs' counsel have also tried to frame claims against less conventional defendants, particularly where the issuer is facing current or potential insolvency.

In *Goldsmith v. National Bank of Canada*, the Court of Appeal for Ontario confirmed important limitations on the exposure of investment banks and other advisors. The Court refused to extend the meaning of the term "promoter" in Part XXIII.1 (secondary market claims) to cover conventional banking and advisory services.

Under Part XXIII.1, a right of action for alleged misrepresentation lies against a promoter that "knowingly influenced" the issuer or its directors and officers to, for example, release a document containing a misrepresentation or fail to make timely disclosure. The Court held that, to come within the definition of "promoter," a person or entity must take a leading role in the organization or reorganization of the company. This means that the person must be active and autonomous and have meaningful control. Merely providing advice to the company's decision-makers is not sufficient, regardless of the importance of that advice. As the Court of Appeal put it, "something more" than advice and banking services is required for a capital market participant such as National Bank to qualify as a "promoter."

Reasonable investigation defence

A question that remains to be determined is the level of evidence that is needed to dispose of unmeritorious secondary market claims at an early stage – for instance, at the leave stage – by establishing a statutory defence such as the reasonable investigation defence under Part XXIII.1 of the Ontario *Securities Act*.

In *Rahimi v. SouthGobi Resources*, the Ontario Superior Court of Justice held that the directors and officer defendants had conducted a reasonable investigation by, among other things, relying on the advice of the company's auditors. The Court therefore denied the plaintiff's motion for leave to commence a secondary market action against the directors and officers, but allowed the motion against the issuer. The Court held that the issuer, which had restated its financial statements and admitted weaknesses in internal controls, had not met the high threshold needed to make out the reasonable investigation defence at the leave stage.

In May 2016, the issuer was granted leave to appeal to the Divisional Court on the basis that there is reason to doubt the correctness of the order. In particular, Justice Stewart reasoned that if the directing minds of the issuer had conducted a reasonable investigation, then the issuer must also have conducted a reasonable investigation. The defence bar is keeping a close eye on this appeal. If the court confirms that there will be instances in which the issuer can establish a reasonable investigation defence on the evidence filed at the leave stage notwithstanding the lower "reasonable possibility of success" standard, it would be a powerful tool for defendants seeking to dismiss unmeritorious litigation at an early stage.

There will be other developments in 2017 and beyond that could affect the question of whether it is sufficient to rely on auditors' advice to make out the reasonable investigation defence – and what boards of directors should do to lay the groundwork for this defence. The appeal to the Supreme Court of Canada in the *Livent* case may clarify issues relating to audit standards and the audit process. There will certainly be more litigation and clarification surrounding the application of the reasonable investigation defence in the context of reliance on auditors' advice.

Conclusion

Although securities class actions remain a meaningful risk for issuers and others, market participants have reason for optimism that Ontario courts have generally recognized the protections in Part XXIII.1, including a meaningful leave stage and statutory defences.