

SECONDARY MARKET LIABILITY: IMPACT ON CLASS ACTIONS

By William E. McNally* **

Introduction

Historically there has been limited secondary market liability for misrepresentation and nondisclosure regarding security instruments in Canada, primarily because of the refusal of the Canadian courts to allow for some sort of “deemed reliance” to prove one of the essential elements of the tort of misrepresentation, such as has been developed through the “fraud on the market” theory in the United States. With the recent proclamation into force of the secondary market liability provisions in the Bill 198 amendments¹ in Ontario, which allow for “deemed reliance”, there is much anticipation as to the potential for class actions in this area.

In this paper I will commence by discussing why there has been limited secondary market liability in Canada to date, will review the developments in the United States, and then will turn to a discussion of some strategies for future secondary market liability through the vehicle of class actions in Canadian courts and through the vehicle of international class actions commenced in the United States.

The Difference Between Primary and Secondary Markets for Securities

*Groia et al.*² review the difference between the primary and secondary markets as a basis for understanding liability in Canadian securities law, and note that the fundamental distinction between the primary and the secondary markets is from whom the security is purchased. In the

* Bill McNally is the senior partner of McNally Cuming Raymaker in Calgary, Alberta and practices extensively in the areas of securities litigation, class actions, personal injury and medical negligence.

** Presented at the Insight Conference on Secondary Market Liability held in Calgary on March 6, 2006.

¹ *Keeping the Promise for a Strong Economy Act (Budget Measures), 2002*, S.O. 2002, c. 22 Part XXVI

² Joseph Groia, Kellie Seaman and Chris Nitsis, “Class Actions and the Capital Markets: More Than a Shareholder’s Remedy” (2004), 1 *Can. Class Act. Rev.* 107 at 108

primary market securities are bought from the issuer, or its underwriter, in an initial distribution through an initial public offering, are issued as a new class or type of securities by an already public company, or are issued as further securities of an existing class. The secondary market, on the other hand, deals with subsequent trades between purchasers and sellers of securities that have already been issued and distributed to the public.

Liability for Misrepresentation in the Secondary Market

There is a statutory framework in effect across Canada which deems reliance for purchases made within the primary market. This is not the case within the secondary market, however. In the event there is misrepresentation in the secondary market, (prior to the enactment of Bill 198 in Ontario, and continuing to be the case across the rest of Canada), an action must be commenced at common law under the principles established by *Queen v. Cognos Inc.*³ This case established that in order to establish a claim of negligent misrepresentation the plaintiff must demonstrate:

- (a) That there was a duty of care based on a “special relationship” between the representor and the representee;
- (b) That the representation was untrue, inaccurate or misleading;
- (c) That the representator acted negligently in making the representation;
- (d) **That the representee reasonably relied on the representation;** and
- (e) That the reliance was detrimental to the representee in the sense that damages resulted.

Historical Failure to Develop Liability in Canada for Negligent Misrepresentation in the Secondary Market

The reason why there has been a failure to develop liability for negligent misrepresentation in the secondary market in Canada is that the courts have not developed an equivalent to the “deemed reliance” provision that exists in the primary market by way of statutory provisions, or in the United States pursuant to the “fraud on the market” theory, such that reliance need be

³ [1993] 1 S.C.R. 87

proven in each case. A deemed reliance provision or theory facilitates the use of class actions and could establish secondary market liability by allowing investors to bring actions based upon misrepresentations without having to show that each member of the class relied on those misrepresentations. In view of the relatively small amount at stake for each individual plaintiff member of the class, the need to prove reliance for each security purchaser is prohibitive, and a viable class action cannot be effectively mounted.

The American “Fraud on the Market” Theory

In the United States this difficulty has been addressed through the development of “deemed reliance” pursuant to the “fraud on the market” theory. This theory has its origins in Rule 10b-5 of the 1934 *Securities Act*.⁴ While the Rule was not intended to give shareholders a civil remedy for improper disclosure, American courts have said that it contains an implied right of private action that can be activated by anyone who purchases or sells a security on the basis of misrepresentation.⁵

Rule 10b-5 states:

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or any facility of any national security exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

⁴ 48 Stat. 881, 15 U.S.C. 78

⁵ Jeffrey S. Leon and Sarah J. Armstrong, “ In the Market for Fraud and Other Corporate Failures: Recent Developments in Securities-Related Class Actions in Canada” (2003), 27 *Advocates’ Quarterly* 259

in connection with the purchase or sale of any security.”

The “fraud on the market” theory was prefaced by the development of the “efficient markets” theory first espoused in the Ninth Circuit decision of *Blackie v. Barrack* in 1975.⁶ Under this theory the court acknowledged the largely impersonal nature of exchange trading of securities and began to assume the efficiency of these public markets. The efficient market theory assumes that the market price of a security at any point in time reflects not only the disclosures made to date, but also incorporates anticipated future developments.⁷ In *Blackie*, the “efficient markets” theory was expressed as follows:⁸

“A purchaser on the stock exchange is either unaware of a specific false representation or may not directly rely upon it; he may purchase because of a favourable price trend, price earnings ratio, or some other factor. Nevertheless, he relies generally on the supposition that the market price is validly set and that no unsuspected manipulation artificially inflated the price, and thus indirectly on the truth of the misrepresentations underlying the stock price – whether he is aware of it or not, the price he pays reflects material misrepresentations.”

The “fraud on the market” theory was first espoused in the seminal case of *Basic Inc. v. Levinson*⁹ wherein Blackmun J. adopted the “efficient markets” theory, and stated:¹⁰

“The “fraud-on-the-market theory” is based on the hypothesis that, in an open and liquid market, the price of a company’s stock is determined by the company and its business . . . Misleading statements will therefore defraud purchasers of stock even if the purchaser does not directly rely on the misstatements . . . The causal connection between the plaintiff’s purchase of stock in such a case is no less significant than in the case of direct reliance on misrepresentations.”

⁶ 524 F. 2d 890 (9th Cir. 1975)

⁷ Jeffrey S. Percival, “Statutory Civil Liability And Securities Class Actions: A Balanced Antidote to the Excesses of the Enron Era?”, Poonam Puri and Jeffrey Larsen (eds.), *Corporate Governance and Securities Regulation in the 21st Century* (Markham, Ontario: LexisNexis Canada Inc., 2004) at p. 272

⁸ At page 891

⁹ 485 U.S. 224 (U.S. Ohio 1988)

¹⁰ At pp. 241-242

Justice Blackmun then further stated that an investor's reliance on any public material misrepresentation could be presumed for the purposes of Rule 10b-5.

Blackmun J. articulated the following requirements that a plaintiff must demonstrate in order to establish the fraud on the market theory:

- (a) The defendant had a degree of *scienter*, (which means intentional or willful conduct intended to deceive or defraud investors);
- (b) There was a purchase or sale of securities;
- (c) The misrepresentation was material; and
- (d) There was detrimental reliance on the misrepresentation.¹¹

Following the articulation of the “fraud on the market” theory, there was an explosion of securities class actions in the United States, to the extent that the legislators felt that there should be some legislative intervention. Therefore, in 1995, Congress enacted the *Private Securities Litigation Reform Act* which, among other things, shored up the pleading requirements and made it a little harder and less desirable to be a representative plaintiff.¹² In 1998 Congress again enacted legislation. The *Securities Litigation Uniform Standards Act* established uniform national standards, and one of the results was that litigants began to shift from the federal to the state courts to avoid the new requirements. Thus in February, 2005, Congress enacted the *Class Action Fairness Act* which had the effect of compelling class actions back to the federal courts in certain circumstances. The new Act also required defendants to provide notice and copies of settlement documents to government officials for review and to wait a minimum of 90 days after sending the notices for an order approving the settlement.

Concerns remain, however, with respect to the perceived aggressiveness of the “strike bar” in the United States. The “strike bar” is best described by Steven Sharpe and James Reid as follows:¹³

¹¹ *Supra* at footnote 2, at p. 111

¹² *Ibid*, at p. 113

¹³ Steven Sharpe and James Reid, “Aspects of Class Actions Securities Litigation in the United States” (1997), 28 *Can. Bus. L.J.* 348 at p. 353

“In the United States, the availability of class action procedures combined with a contingency fee structure for plaintiffs’ lawyers has led to the creation of an entrepreneurial sector of the legal profession known as a “strike bar”. U.S. strike bar lawyers are motivated by sizable contingency fees and relative freedom to direct litigation according to their own interests. Even defendants who have done nothing wrong face Hobson’s choice: to pay for a very expensive battle in the courts and eventually risk a potentially exorbitant jury damage award, or settle. Most defendants eventually swallow their indignation and make the prudent economic choice and, as a result, settlement has become the typical outcome of class action securities litigation in the United States.”

This abhorrence of the “strike bar” has been expressed in Canada by Cumming J. of the Ontario Superior Court in *Epstein v. First Marathon Inc.*¹⁴ As reviewed by Leon¹⁵, the *Epstein* case arose out of a “friendly” takeover of First Marathon Inc. by National Bank of Canada and the merger agreement provided that National Bank would purchase all of the shares of First Marathon and then merge the acquired corporation with a wholly owned subsidiary. Mr. Epstein was a First Marathon shareholder and commenced his class action against First Marathon and its directors on the date the merger agreement was reached, claiming that the price offered by National Bank for the takeover was insufficient and that First Marathon and its directors had breached the fiduciary duties owed to the minority shareholders. The class action asked for damages in the amount of \$300 million. A settlement was reached with class action counsel and an application was made to Cumming J. to approve the settlement, which would provide \$190,000 to be paid to the plaintiff’s lawyers. Cumming J. held that the settlement did not provide for any benefit to be conferred on any shareholder of First Marathon, and only the lawyers would benefit.

In the result Cumming J. refused to approve the settlement agreement and made the following comments with respect to “strike suits”:¹⁶

“ . . . “strike suits” may effectively transform the class-action mechanism from a shield into a sword. When fashioned into a sword by profit-motivated lawyers

¹⁴ (2000), 2 B.L.R. (3d) 30; [2000] O.J. No. 452

¹⁵ *Supra* at footnote 5, at pp. 294-296

¹⁶ At para. 52

and shareholder-plaintiffs posing as class representatives, the class proceeding becomes a means of harassing corporate defendants. Such harassment constitutes an abuse of process and a violation of the very goals that the class-action mechanism is expected to further.”

And further:¹⁷

“...In my view, the plaintiff’s class proceeding constitutes an example of litigation of the kind the CPA (the Ontario *Class Proceedings Act*) was never designed to reward. Approval of the settlement would violate the public-policy objectives underlying the Legislature’s enactment of the CPA. The important policy objectives of the statute are to foster access to justice, judicial economy and behavior modification. The plaintiff’s class proceeding is counter-productive to all of these objectives. Mr. Epstein’s action is in the nature of a “strike suit” seen more commonly in the United States.”

Rejection of the “Fraud on the Market” Theory in Canada

Perhaps in revulsion of the strike suits brought in the United States, Canadian courts have been clear that they will not adopt the “fraud on the market” theory in Canada, and thus they will not import “deemed reliance”, in the absence of statutory provisions, and allow class action liability in the secondary marketplace on this basis.

The first Canadian case to articulate this appears to be *Kripps v. Touche Ross & Co.*¹⁸ As reviewed by Leon,¹⁹ this case involved the defendant Victoria Mortgage Corporation Ltd. issuing a series of debentures by way of several prospectuses. However, the Company stopped making payments on the debentures and was eventually ordered to cease trading. A group of debenture holders brought claims in negligence against the accountants who had audited the company and against the British Columbia Superintendent of Brokers who had issued receipts for the prospectuses. In support of their claim for liability the plaintiffs argued that the “fraud on

¹⁷ At para. 69

¹⁸ (1990), 52 B.C.L.R. (2d) 291, affirmed on other grounds at 69 B.C.L.R. (2d) 62

¹⁹ At p. 270

the market” theory should be adopted to presume that they detrimentally relied on the audits and receipts.

Boyd J. rejected the “fraud on the market” theory, and this was upheld by the British Columbia Court of Appeal, with the appellate court stating that even if the “integrity of the market” and related theories were capable of being imported into Canadian law, they were not appropriately applied in the plaintiff’s case.

The seminal Canadian case which has explicitly rejected the “fraud on the market” theory, however, is *Carom v. Bre-X Minerals Ltd.*²⁰ In this case Bre-X Minerals was a junior mining company with shares listed on the Alberta Stock Exchange. It touted that it had discovered a massive gold deposit in Indonesia and its shares rose astronomically.²¹ When the fraud was discovered the share price collapsed and a class action was sought to be certified on behalf of the Canadian investors.

Winkler J. explicitly considered whether the “fraud on the market” theory should be adopted by the Canadian court in order to presume reliance. In rejecting this theory, he stated:²²

“The plaintiffs submit that the fraud on the market theory which underpins the requested amendment is a “novel point” and “open question” in Ontario. I disagree. The theory is advanced out of the statutory context in which it was developed. It is put forward absent the surrounding qualifications and conditions with which it is circumscribed in the United States. Moreover, the plaintiff’s submission would require a redefinition of the common law of torts of fraudulent and negligent misrepresentation as developed by the Supreme Court of Canada.”

Leon has reviewed this rejection by Winkler J., as follows:²³

²⁰ (1998), 41 O.R. (3d) 780

²¹ As reviewed by Leon at pp. 271, 272

²² At p. 786

²³ At pp. 271, 272

“Winkler J. rejected the application of the theory in this case for three main reasons. First, there is no general statutory private right of action for securities disclosure in Canada that is similar to SEC Rule 10b-5. In other words, the “nexus” between the plaintiffs’ claims and the theory does not exist outside of the statutory framework out of which the theory was created.

It should be noted that the plaintiff in *Bre-X* also argued that the defendants had breached s. 52(1) of the *Competition Act*, thereby giving rise to a civil cause of action pursuant to s. 36(1) of the same Act. The plaintiff argued that these provisions provide a statutory framework similar to the framework in the United States in which the fraud on the market theory was created and that, therefore, the fraud in the market theory is applicable to the private right of action under s. 36 of the *Competition Act*. Justice Winkler rejected this argument. He explained: “The *Competition Act* is not specific securities legislation, nor is it restricted to claims based in fraud. Rather it requires a false or misleading representation to the public that is made negligently but need not be made fraudulently.” Justice Winkler went on to reject the plaintiff’s suggestion that reliance is not an element of an action under s. 36 of the *Competition Act*.

Second, Winkler J. rejected the adoption of the theory because the plaintiffs were advancing the theory without any of the corresponding limitations that go along with it in the United States, such as the limitations period and the unavailability of punitive damages. These limitations are necessary, he said, to discourage strike-suits. Finally, Winkler J. rejected the doctrine because adopting it would be tantamount to “redefining” the torts of fraudulent and negligent misrepresentation in Canadian common law, as they currently require proof of reasonable reliance on the representation to succeed.”

Since *Carom v. Bre-X*, Justice Winkler’s rejection of the “fraud on the market” theory has been consistently applied in Canadian jurisprudence.

Strategies to Support an Action for Secondary Market Liability for a Canadian Class

(1) A National Class Commenced Under the Ontario “Civil Liability for Secondary Market Disclosure” Provisions in the Ontario Securities Act

The Bill 198 amendments have statutorily mandated “deemed reliance”²⁴ such that secondary market liability is now viable on a class action basis in Ontario. Query whether these statutory

²⁴ *Securities Act*, R.S.O. 1990, c. S.5, as amended, s. 138.3(1)

provisions could enable a class action for secondary market liability across Canada through Ontario certification of a national class? While one can hope, in view of the case of *Pearson v. Boliden Ltd.*,²⁵ to be discussed further herein, this does not appear to be a viable strategy.

There are various difficulties with commencing an action under the Bill 198 amendments, including the numerous defences available to the defendants which could reduce the efficaciousness of such an action. These defences include:²⁶

- There is a “safe harbour” for forward-looking information;²⁷
- The plaintiff knew that there was a misrepresentation or failure to make timely disclosure at the time of the relevant transaction;²⁸
- There was reasonable reliance on an expert;²⁹
- A material change was confidentially disclosed to the Ontario Securities Commission;³⁰
- Corrective action was taken;³¹
- Reasonable reliance or representations were made on a third party’s public filing;³²
- The defendant conducted a reasonable investigation;³³ and
- The defendant did not know the document would be released.³⁴

Perhaps most significant, however, is the fact that the damages payable are restricted by the legislation, seemingly on the basis that the purpose of the legislation is compensatory, rather than punitive.³⁵

A “deep pocket” defendant is not made to bear the whole responsibility. The Act provides for proportional liability.³⁶ The defendant will be fully responsible, on a joint and several basis, however, if the misrepresentation is “knowingly” made.³⁷

²⁵ (2002), 222 D.L.R. (4th) 453; leave to appeal to the Supreme Court of Canada dismissed at [2003] 2 S.C.R. ix

²⁶ Bradley Davis, “Bill 198 Will Bring a New Era in Class Action Litigation in 2006”, 25:22 *The Lawyers Weekly*

²⁷ *Securities Act*, R.S.O. 1990, c. S.5, as amended, s. 138.4(9)

²⁸ *Ibid*, s. 138.4(3)

²⁹ *Ibid*, s. 138.4(11)

³⁰ *Ibid*, s. 138.4(8)

³¹ *Ibid*, s. 138.4(15)

³² *Ibid*, s. 138.4(14)

³³ *Ibid*, s. 138.4(6)

³⁴ *Ibid*, s. 138.4(13)

³⁵ Douglas Worndl, “Shareholder Class Actions: Still Waiting for Ontario’s Bill 198”, 24:7 *The Lawyers Weekly*

Further, and importantly, there is a cap on the damages assessable, which varies by defendant.³⁸ For example, an issuer's liability may not exceed the greater of \$1 million or 5% of its market capitalization. There are also liability limits for individual directors and officers, experts, "influential persons" and other defendants. These liability limits will also not be in place if the defendant knowingly made the misrepresentation.³⁹

Other impediments to secondary market liability include:⁴⁰

- Leave of the court is required to commence an action, and the court must be satisfied that the action (i) is being brought in good faith and (ii) has a reasonable prospect of success at trial;⁴¹
- There must be court approval before any action can be stayed, discontinued, settled or dismissed;⁴²
- There are loser pay costs consequences, in accordance with the Rules of Civil Procedure;⁴³
- There are circumstance-specific limitation periods, which do not incorporate the discoverability principles;⁴⁴
- There is a national application of the liability/damages cap such that a defendant normally pays damages reduced by the amount of any prior award made against the defendant, or any settlement paid by the defendant, relating to the same misrepresentation.⁴⁵

The efficacy of a national class action relying upon the deemed reliance provisions of the Bill 198 amendments is doubtful, however, in view of the British Columbia Court of Appeal case of *Pearson v. Boliden Ltd.*,⁴⁶ which held that the Securities Act statutory provisions of one province would not be imported into the jurisdiction of another province. In this case, in connection with

³⁶ *Securities Act*, R.S.O. 1990, c. S.5, as amended, s. 138.6(1)

³⁷ *Ibid.*, ss. 138.6(2), (3)

³⁸ *Ibid.*, s. 138.1 definition of "liability limit"

³⁹ *Ibid.*, s. 138.7(2)

⁴⁰ *Supra* at footnote 7, at pp. 282, 283

⁴¹ *Securities Act*, R.S.O. 1990, S.5, as amended, s. 138.8(1)

⁴² *Ibid.*, s. 138.10

⁴³ *Ibid.*, s. 138.11

⁴⁴ *Ibid.*, s. 138.14

⁴⁵ *Ibid.*, s. 138.7

⁴⁶ (2002), 222 D.L.R. (4th) 453, leave to appeal to the Supreme Court of Canada dismissed at [2003] 2 S.C.R. ix

an initial public offering of shares in a mining company, the appellant corporation filed a prospectus with securities authorities of ten Canadian provinces. Shares were purchased throughout Canada and in Europe and the United States. Shortly after the offering had closed, a tailings dam operated by the mining company collapsed, releasing toxic waste and resulting in a major loss of revenue. As a result, the price of the shares dropped substantially. A class action was commenced, alleging that the prospectus did not contain full and true disclosure. The defendants argued that the plaintiffs who had purchased their shares in Alberta, New Brunswick and the Northwest Territories should have been excluded from the subclasses of plaintiffs. The Alberta *Securities Act* imposed a shorter, one year limitation period which would have barred the Alberta claimants from the class action. The New Brunswick *Securities Fraud Prevention Act* did not have a similar provision to that of the British Columbia statute, and there was also no comparable legislation in the Northwest Territories.

The Chambers judge initially refused to exclude the group's challenged by the defendants and ruled that the question should be tried pursuant to a summary trial rule.

This was overturned on appeal, with the appellate court holding that the Chambers judge should have decided the issue on the pleadings as they stood. It was not open to a plaintiff to choose to apply the Act of one province providing a cause of action for misrepresentation for a plaintiff who was solicited in and purchased shares pursuant to a distribution in another province. The court should follow the constitutional principle that the province in whose territory the securities were distributed had the jurisdiction to regulate the distribution and to attach civil consequences to noncompliance. Therefore, any Alberta purchaser was time barred; the purchasers in New Brunswick should be excluded because the legislation of that province did not have a similar cause of action; and the purchasers in the Northwest Territories should also be excluded on this basis.

Newbury J.A., for the appellate court, characterized this as a question of “choice of law”, and stated:⁴⁷

“I also take from the foregoing cases that the *lex loci delicti* choice of law rule is not directly applicable to the question of which provincial Act or Acts may found a statutory cause of action for misrepresentation in a prospectus. As La Forest J. observed in *Tolofson*, courts are limited in exercising their powers (as to choice of law issues) to the same extent as the provincial legislatures. Thus, with all due respect to Mr. Klein’s argument, I do not agree that it is open to a plaintiff, or a court of law, to choose to apply the Act of one province that will provide a cause of action in misrepresentation for a plaintiff who was solicited in and purchased his or her shares pursuant to a distribution in another province. Once the Act of a province applies to regulate (by means of a prospectus requirement) the “distribution” of securities taking place within the province’s boundaries, the same Act must surely be looked to for any statutory cause of action for misrepresentation contained in the document. Its forms, contents and filing are all mandated by the Act; the creation of a right to civil damages for infringing the Act must also be found in that Act.

This is not to suggest that a provincial Securities Act may not have extra provincial aspects or that activities in one province may not be incidentally affected by legislation in another...Nor do I suggest that an issuer or market intermediary may not be subject to more than one Act in carrying on business. But in respect of a misrepresentation contained in a prospectus circulated in a province and deemed to be relied on by a person in purchasing securities offered thereby, **a court would be bound to follow the constitutional principle that it is the province in whose territory the securities are distributed which has the jurisdiction (in the constitutional sense) to regulate the manner in which the distribution is carried out and to attach civil consequences to the non-compliance.**

There are also practical reasons that support this choice of law. In an industry in which certainty and predictability are important, it avoids the complexity and uncertainty of rules such as the *lex loci delicti* rule applied to torts and the “most substantial connection” rule applied to contracts. It provides a principled way through the thicket of many extra-provincial aspects that will be involved in any national securities distribution – the vagaries of where the issuer carries on business or maintains its share register, where the prospectus was prepared, where the issuer’s directors reside, where the stock exchange (or now, the securities depository) is located (if electronic records can be said to be located

⁴⁷ At paras. 64-68

anywhere), or where a particular plaintiff or defendant resided or carried on business at any particular time . . . As well, it comports with what a reasonable investor would expect – that when he or she purchases shares offered under a distribution taking place in a province, the securities legislation of the province will govern the filing of the prospectus, its contents, and the rights and obligations of the parties thereunder.

Finally, this approach seems to comport with the assumptions that underlie current regulatory practice in Canada: . . .

It follows in my view that the Chambers judge erred in holding open the possibility that a *lex loci delicti* rule might have applied to the statutory causes of action before him, and that he should have applied to the first three contested subclasses of plaintiffs the Act of the province in which the respective “distribution” (as defined) occurred. . . .” (Emphasis added.)

Thus it seems that *Pearson v. Boliden Ltd.* gives sustenance to an argument that, as only the Ontario *Securities Act* has a “deemed reliance” provision regarding the secondary market to date, only misrepresentations made regarding securities traded in Ontario can be subject to these provisions, and a national class could not be constituted with the Ontario statutory provisions being applicable outside of its jurisdiction.

There is another recent Ontario decision of concern in that it has been heralded as indicating a reticent judicial approach to secondary market liability. The Ontario Court of Appeal has recently reversed a \$10 million damage award to shareholders of Danier Leather Inc.’s initial public offering in May 1998. In *Kerr v. Danier Leather Inc.*⁴⁸ Danier had forecasted projected revenue and earnings for the last quarter of its fiscal year in its initial public offering in May 1998. An internal company analysis, prepared a few days before the offering was to close, showed that the revenue and earnings were lagging behind the forecasted figures. Danier did not issue a revised forecast until it did a second analysis about two weeks after the initial public offering closed, however, and as a result its share price declined from \$11.25 to \$8.90. However, the sales rebounded, and by the end of the fiscal year Danier’s revenue and earnings figures were substantially in line with the original forecast in the prospectus.

⁴⁸ [2005] O.J. No. 588

Justice Lederman initially found Danier and its two offers liable for prospectus misrepresentation, holding that, because of Danier's failure to disclose the material facts, its implied representation that the forecast was objectively reasonable became false on the closing date – even though it was true when the prospectus was issued. He awarded the class member shareholders \$2.35 per share, for a total award of some \$10 million.

This was recently overturned on appeal, with the appellate judges primarily distinguishing between “material facts” and “material changes” as the basis of their decision. The appellate court held that the Act obliged Danier to make full, true and plain disclosure of all material facts in its prospectus; however, it had no continuing obligation to disclose material changes. They overturned the judge's award.

This has been interpreted⁴⁹ as showing a certain potential restraint of the Ontario courts in imposing secondary market liability pursuant to the new legislation.

(2) A National Class Based on a Theory of “Inferred Reliance”

Another potential strategy is to argue to have the Canadian courts accept the “fraud on the market” theory through the back door by way of a theory of “inferred reliance”, suggested by the Ontario Superior Court of Justice decision of Cumming J. decision of *CC & L Dedicated Enterprise Fund (Trustee of) v. Fisherman, sub nom. Mondor v. Fisherman* (“Mondor”).⁵⁰

As reviewed by Leon,⁵¹ this case involved a class action launched by shareholders in YBM Magnex International Inc. on behalf of all persons in Canada who purchased or acquired common shares in YBM distributed by a November 1997 prospectus. The plaintiffs claimed that members of Russian organized crime caused YBM to enter into a series of contracts and

⁴⁹ John Jaffey, “Danier Decision May Affect Interpretation of Ontario Securities Act Amendments”, 25:34 *The Lawyers Weekly*

⁵⁰ (2001), 18 B.L.R. (3d) 260

⁵¹ *Supra* at footnote 5, at pp. 264, 265

transactions that merely disguised a larger plan to siphon cash out of YBM. The plaintiffs alleged negligence and negligent misrepresentation in a prospectus as well as in public statements, announcements and press releases against the auditors, underwriters, lawyers, directors and officers who were involved in the public offering of YBM shares.

In advance of the eventual court-approved settlement of the action some of the defendants brought a motion to strike the claims of two of the named plaintiffs as disclosing no reasonable cause of action. In the result Cumming J. held that it was not “plain and obvious” that the plaintiffs did not have a reasonable cause of action, and in the course of this judgement raised the potential “inferred reliance” theory.

Groia reviews this “inferred reliance” theory, as follows:⁵²

“The plaintiffs asserted that the issue of reliance as it related to the negligent misrepresentation matter was a question of fact for the court to determine. Since the market price of the shares of YBM reflected the representation made in the expert opinion (think efficient market theory, with a twist), the plaintiffs claim that a court can conclude that each class member relied upon these representations. A motion to strike the claim as disclosing no reasonable cause of action was brought by the defendant auditors on the basis that the plaintiffs were in reality advancing the fraud on the market theory. Justice Cumming cited the rejection of the theory in Canada, yet noted that the plaintiffs were not expressly advancing the theory. He held that the issue of whether a given plaintiff actually relied upon a misrepresentation was a question of fact that could be inferred from all the circumstances. If the question was one of fact, then a court could conclude, as a question of fact, that each member of the class relied upon the representation in purchasing shares in the secondary market. Justice Cumming summarized his findings as follows:

“Had the plaintiffs simply pleaded the “fraud on the market theory” I would have foreclosed that consideration. Given, however, that the case law recognizes that a person’s reliance upon a representation may be inferred from all the circumstances, in my view it would be premature to foreclose the consideration of this issue in the case at hand beyond the pleading stage.”

⁵² *Supra* at footnote 2, at pp. 115, 116

While Cumming J. reaffirmed the rejection of the fraud on the market theory, he allowed the action to proceed on the basis of inferred reliance, stemming from the effect of the misrepresentation upon the market price of the securities. In this respect, the decision may very well have the effect of opening the door to future class proceedings by allowing plaintiffs to overcome the obstacle of having to prove individual reliance on a misrepresentation by using the “inferred reliance” argument.”

This “inferred reliance” theory is illustrated in a discussion by Patrick J. Coughlin, Eric Alan Isaacson and Joseph D. Daley.⁵³ In discussing reliance (“transaction causation”) and proximate cause (“loss causation”), they give the following example:

“Consider a garden-variety fraud, in which the seller of a car – last year’s model – put 85,000 miles on it in just one year of driving, but turns the odometer back to 15,000 miles before placing on the used-car market. Now, who can doubt that turning the odometer back on a late-model car, from 85,000 miles to just 15,000, amounts to a material misrepresentation? That it is a misrepresentation made with scienter is a reasonable inference – indeed, a strong one – for turning an odometer back entails deliberate conduct, calculated to mislead. The fact that a plaintiff purchased the car, paying something approximating the going market rate for a car of that make, model, and (supposed) mileage, raises a reasonable inference of reliance. For we all know that, at common law, reliance may be inferred on the basis of a representation’s materiality combined with purchase of the car. The purchaser’s reliance can easily be inferred from the fact that a car with high mileage is of considerably less value than one with low mileage. Had the plaintiff known the truth, he probably would not have purchased the car – or, at least, not on the same terms. As it happens, then, the same facts demonstrate the plaintiff’s loss, which ordinarily would consist of the difference between the price paid for what appeared to be a low-mileage car, and the value received.”

The case of *Menegon v. Phillips Services Corp.*⁵⁴ is one in which the court declined to breathe life into the inferred reliance theory. In this case the representative plaintiff had bought shares in Phillips Services Corp. on the open market. A month before the purchase Phillips had issued a prospectus for 20 million common shares, 25% of which were to be sold by certain underwriters.

⁵³ Patrick J. Coughlin, Eric Alan Isaacson and Joseph D. Daley, “What’s Brewing in *Dura v. Broudo*? The Plaintiffs’ Attorneys Review the Supreme Court’s Opinion and its Import for Securities-fraud Litigation” (2005), 37 *Loy. U. Chi. L.J.* 1 at pp. 14, 15 (LEXIS)

⁵⁴ (2001), 23 B.L.R. (3d) 151, affirmed at (2002), 31 B.L.R. (3d) 29, application for leave to appeal to the Supreme Court of Canada dismissed at [2003] S.C.C.A. No. 95

Phillips subsequently became insolvent and Menegon brought a claim against Phillips, its auditors and the Canadian Underwriters under s. 130 of the Ontario *Securities Act* (which deems reliance in the primary market) and for negligent misrepresentation at common law relating to matters contained in or omitted from the prospectus. At the application for certification the plaintiff conceded that he did not have a valid cause under s. 130 of the Ontario *Securities Act*, but he argued that he should nonetheless be the representative for a class of purchasers who had a s. 130 action. He based this on the argument that the section 130 claim was in effect a subclass to the common law action for negligent misrepresentation.⁵⁵

Judge Gans held that a “special relationship” was not sufficiently proven and that the creation of a statutory cause of action for misrepresentation for secondary market investors was, without a special relationship, a matter for the legislature and not the courts.

On appeal, *Mondor* was explicitly considered, and Cumming J.’s *ratio* based on “inferred reliance” noted, as follows:⁵⁶

“On the issue of reliance, Cumming J. referred to the American “fraud on the market theory”, which “has been described as a legal fiction which has the effect of overcoming the need to prove reliance”. He noted that this theory was not part of the law of Canada and that proof of reliance is a necessary ingredient of actions based upon negligent misrepresentation. He noted further that the question of whether a plaintiff has actually relied upon a misrepresentation is a question of fact that may be inferred from all of the circumstances and, hence, concluded that “it would be premature to foreclose the consideration of this issue in the case at hand beyond the pleading stage”. Consequently, Cumming J. dismissed the motion to strike the pleading.”

In the result, however, the appellate court held that there was an insufficiency in the pleadings such that a duty of care could not be found to arise, and dismissed the appeal. Leon has interpreted this as holding that there remains an open question as to whether auditors and other

⁵⁵ *Supra* at footnote 5, at pp. 287, 288

⁵⁶ At para. 14

secondary actors owe a duty of care to investors such that they may be liable for misrepresentation in the secondary market.⁵⁷

In *Pearson v. Inco Ltd.*,⁵⁸ a decision of Nordheimer J. of the Ontario Superior Court of Justice, Nordheimer J. distinguished the decision of Cumming J. in *Mondor* and stated:⁵⁹

“. . . “In any event, Cumming J.’s decision in *Mondor*, and the authorities he refers to on this point, make it clear that the question of whether reliance can be inferred is a question of fact . . .”

In *Serhan Estate v. Johnson & Johnson*⁶⁰, a class action was commenced regarding defective meters and strips used by diabetics. The plaintiffs claimed that the defendant manufacturers were liable for damages to every person in Canada, except British Columbia and Quebec, who used the meters or strips after February 1996. Cullity J. of the Ontario Superior Court of Justice granted the motion to certify the action and, in discussing the common issues, stated:⁶¹

“Mr. Strosberg submitted that the question of reliance raised in proposed common issue (g) could be dealt with on a global basis—that reliance might be inferred on the basis of the defendants’ conduct without evidence of actual reliance by each, or any, class member. For this purpose, he relied on [*Mondor*]...The defendants asserted that the plea, in effect, incorporated an American “fraud on the market theory” which is not part of the law of Canada. Cumming J. did not accept this interpretation of the plea and declined to strike it. In so doing, he accepted that the trial judge might infer reliance of the basis of the facts alleged in the statement of claim if they were proven.

In *Mondor*, Cumming J. did not suggest that an inference of reliance drawn from the conduct of class members in purchasing shares after the representations were made could not be rebutted by evidence that there was, in fact, no causal connection between the representation and the decision to purchase. The possibility of such a rebuttal was recognized explicitly in a passage he quoted from the reasons delivered by Finch J.A. in the Court of Appeal for British

⁵⁷ *Supra* at footnote 5, at p. 289

⁵⁸ (2002), 33 C.P.C. (5th) 264, overturned at [2005] O.J. No. 4918 without explicit discussion of this point on appeal, time to apply for leave to appeal to the Supreme Court of Canada granted at [2006] S.C.C.A. No. 1

⁵⁹ At para. 112

⁶⁰ (2004), 49 C.P.C. (5th) 283

⁶¹ At paras. 57-60

Columbia in *Kripps v. Touche Ross & Co.*...Here, however, the question is significantly different. It relates to the commonality of the issue of reliance and not to whether the plaintiffs have any chance of success on that issue. In determining whether any inference of reliance arising simply from the conduct of the class members in purchasing, or using, the devices was rebutted, the defendants would be entitled to inquire into the motivation of, and examine, every member of the class. As Winkler J. stated in *Carom v. Bre-X Minerals Ltd.*

“Reliance is not established by a mere showing that a plaintiff was a recipient of a representation, rather the representation must have caused the recipient to act in a certain manner.”

Whether reliance should be inferred is a question of fact and the answer may differ from individual to individual. *Mondor*, was distinguished on this ground by Nordheimer J. in *Pearson v. Inco*...at paras. 112-113. The defendants may, or may not, have difficulty in rebutting any inference, or presumption, of reliance that is found to arise but the possibility should not be foreclosed on this motion.”

Cullity J. has recently commented on the “inferred reliance” theory in *O.P.S.E.U. v. Ontario*.⁶² In this case the plaintiff employee was a care worker who initially worked for a private organization through a municipality, but as part of a government policy was transferred along with several others to public community care access centres. This effected a transfer of their pension plans and they believed that the pension transfer harmed their economic interests. The employee brought an application for certification of a class action against the provincial government, and this application was allowed. The action was framed in misrepresentation, *inter alia*, and on the point of reliance Cullity J. stated:⁶³

“Defendant’s counsel submitted that the question of reliance is an individual issue so that liability for negligent misrepresentation could not be found at a trial of the common issues. I do not believe that is necessarily correct. Although reliance has invariably been treated as an individual issue in class proceedings, the possibility that group reliance might, in some circumstances, be inferred from the facts was recognized by Cumming J. in *CC & L Dedicated Enterprise Fund (Trustee of) v. Fisherman* . . . , and it would seem to be an essential part of the claim in this case. The Union was the bargaining agent of the employees, and in that capacity, it initiated – and subsequently refrained from pursuing – measures to protect the rights of the employees, as a group, in respect of the maintenance

⁶² (2005), 13 C.P.C. (6th) 178

⁶³ At para. 68

of their pension benefits. On the evidence filed, the alleged detrimental reliance of the group could only be considered to have occurred through the agency of the Union. It is my understanding that, to a large extent, it was for this reason that the Union was made a party to the proceedings and why the class is limited to employees who are members of the Union. The question whether reliance occurred can, therefore, be dealt with at trial of the common issues.”

There has been some suggestion that, although not based on an “inferred reliance” theory, a “fraud on the market” theory has been allowed in through the back door in Quebec in *Yves Beaudoin v. Advantage Link Inc.*⁶⁴ Regarding this case, Leon states:⁶⁵

“Recently, in *Yves Beaudoin v. Advantage Link Inc.*, the Quebec Superior Court certified a class proceeding that put forth what has been described as a type of “fraud on the market” theory. Like *Mondor*, the claim was based on an allegation that the share price of the company, Jitec Inc. (now Advantage Link Inc.), was artificially inflated. In their claim, the plaintiffs alleged that the company, its president and certain brokerage houses permitted false and misleading press releases to be used and engaged in insider trading, leading to the stock price being artificially inflated.

Viau J. held that a class proceeding was the appropriate mechanism to determine (a) whether misrepresentations were made by the defendants and (b) whether damages suffered by secondary market investors were the result of the misrepresentations. Viau J.’s reasons for decision do not explicitly discuss the legal basis on which the action was certified or the application of the fraud on the market theory. Nevertheless, the certification of the action by implication suggests the requirement that each individual plaintiff prove reliance on the alleged misrepresentations may not be an absolute bar to the certification of secondary market class actions.”

Thus it would seem, based on the decision of Cumming J. in *Mondor*, that there is the possibility of a back door route to deem reliance and gain secondary market liability in a class action context, based on “inferred reliance”. This theory has not been substantively developed in subsequent jurisprudence, but neither has the door been slammed shut.

⁶⁴ [2002] J.Q. No. 4575

⁶⁵ *Supra* at footnote 5, at pp. 276, 277

(3) *An International Class Action Commenced In the United States*

As reviewed by Ilana T. Buschkin,⁶⁶ class actions are a popular, albeit controversial, procedural device in the United States, and foreign claimants are frequently permitted to be members of the American lawsuit. The main attraction of commencing a lawsuit through the United States, of course, would be to gain a “deemed reliance” with respect to secondary market liability by importation of the “fraud on the market theory”, and, within the context of the Bill 198 amendments, to circumvent the damages caps and other restrictions on damage assessment.

As in Canada, an American judge must certify a class action before the action can proceed to litigation. In the certification application, class counsel do not need to address the merits of the action, but must establish that “the plaintiff’s allegations, if assumed to be true and to state a valid cause of action, are suitable for class treatment and resolution”.⁶⁷

As Buschkin summarizes,⁶⁸ the class motion for certification must prove that the class meets all of the requirements laid out in Federal Rule of Civil Procedure 23. This is a two step process. First, the plaintiffs must demonstrate that the class meets four procedural prerequisites:

- (1) The number of potential claimants must be so large that joinder is impractical;
- (2) There must be common questions of law or fact shared between all members of the class;
- (3) The claims of the lead plaintiffs must be “typical” of the class as a whole; and
- (4) The representation of absent class members by the lead plaintiffs and class counsel must be “fair and adequate”.

Once the plaintiffs establish these four prerequisites, the plaintiffs move to the second prong of the certification test and must prove that the class conforms to one of the categories listed in Rule 23. Most class action lawsuits filed in the federal district court seeking monetary damages

⁶⁶ Ilana T. Buschkin, “The Viability of Class Action Law Suits in a Globalized Economy – Permitting Foreign Claimants to be Members of Class Action Lawsuits in the U.S. Federal Courts” (2005), 90 *Cornell L. Rev.* 1563

⁶⁷ *Ibid* at p. 4 (LEXIS)

⁶⁸ *Ibid* at pp. 4-7 (LEXIS)

are Rule 23(b)(3) actions, which would “achieve economies of time, effort, and expense, and promote uniformity of decision as to persons similarly situated, without sacrificing procedural fairness or bringing about other undesirable results”.

To warrant Rule 23(b)(3) certification it must be established that the questions common to the class as a whole predominate over any questions affecting individual members and that the class mechanism is superior to other methods for bringing suit. “Superiority” is a balancing test and the judges must weigh a number of factors, including the interests of the individual class members in controlling the litigation, the extent and nature of any related litigation already pending in other courts, the desirability of concentrating the litigation in the particular forum, and the difficulties of managing the particular class. If the sum of the factors weighs against class treatment, the judge should deny certification.

Once the judge certifies a class, the class representatives must identify all possible class members and provide them with notice of the pending action. In the class action context, this means that plaintiffs must send actual, individual notice to all reasonably identifiable class members, and when class counsel cannot identify certain class members through reasonable effort, constructive, rather than actual, notice is acceptable. Most courts have held that advertisement in a widely circulated newspaper or magazine constitutes adequate notice.

If a class member does not affirmatively opt-out of the action after receiving adequate notice, the class member will be bound by the final judgment. As noted by Buschkin, the opt-out procedure attempts to create procedural fairness for both potential class members and the defendants forced to defend complex class action lawsuits. On the one hand, due process requires that a potential litigant have some opportunity to opt-out of the lawsuit before being bound by the final settlement or judgment. On the other hand, allowing class members to sue again in another court whenever the class settlement or judgment is not satisfactory to the class member would be fundamentally unfair to the defendants. The opt-out provisions strike a compromise, ensuring that potential claimants have an opportunity to opt-out of the class action lawsuit at an early

stage, but also ensuring that all claimants who do not opt-out by a certain date could not later re-litigate the same issues.

American jurisprudence has established that Rule 23 permits the establishment of an “opt-in” class, which takes on added significance when a class contains a large number of foreign class members. As noted by Buschkin, under an opt-in procedure, the judge gives direct notice to all class members, informing them that they can not share in the final judgment unless they specifically opt-in. By opting into the action, class members agree to be bound and voluntarily submit themselves to the jurisdiction of the court.

The real issue in seeking to enforce an American international class action judgment in a Canadian court is whether the Canadian courts will recognize the American decision and apply the doctrine of *res judicata* to preclude a parallel Canadian procedure. From an American perspective, Buschkin states:⁶⁹

“The biggest problem with permitting foreign claimants to join class action lawsuits [in the United States] is the dubious status of U.S. judgments in foreign courts. The Full Faith and Credit Clause of the U.S. Constitution requires all U.S. state courts to recognize and enforce a valid judgment rendered by the courts of a sister state. This ensures that plaintiffs could not sue successively in different forums to achieve the most desirable outcome, wasting judicial and party resources re-litigating on the same set of facts. Unfortunately, there is no treaty equivalent of the Full Faith and Credit Clause that guarantees the recognition and enforcement of U.S. judgments in foreign countries. While U.S. courts routinely enforce the judgments of foreign nations as a matter of comity, few foreign courts automatically recognize or enforce U.S. judgments. Instead, most foreign courts are skeptical of U.S. judgments, reviewing them carefully and frequently denying enforcement of these judgments on “public policy” grounds. Therefore, while a class judgment may preclude absent class members from suing again in another U.S. court, the same judgment likely would not preclude absent foreign class members from suing again in the courts of their home countries . . .

In addition, most foreign countries disapprove of the U.S. class action device, which amplifies the risk that foreign courts will deny preclusive effect to U.S.

⁶⁹ Supra at footnote 65, at pp. 7-9 (LEXIS)

class action judgments. The greatest point of contention is the opt-out procedure, which, as previously discussed, binds an absent class member to a settlement or final judgment unless the individual affirmatively opts out of the action after receiving notice. While the notice sent to potential class members must warn them that “unless they mail in an opt-out form, they will be bound by the results of the litigation”, notice may be constructive rather than actual. Therefore, “in many . . . class actions where there are insufficient records of purchase”, a large number of class members receive notice “through publication in newspapers, periodicals, radio, television, or through posting in places calculated to be seen by class members”. The idea that courts can bind a claimant to a legal judgment based upon inaction, particularly when the claimant receives notice of the action only through constructive means, is difficult for foreign courts to accept.”

These words seem prescient in view of the recent Ontario Court of Appeal decision of *Currie v. McDonald’s Restaurants of Canada Ltd. et al.*⁷⁰ In this case McDonald’s sponsored a number of promotional contests at its restaurants in North America, retaining the services of Simon Marketing Inc. to organize and operate the contest. A senior employee of Simon Inc. and others were subsequently indicted for embezzling prizes allotted to the contest. A class action in Illinois on behalf of an American and international class of McDonald’s customers, including the customers of McDonald’s Canada, was settled. The Illinois court directed that notice of the class action be given to Canadian class members by means of an advertisement in Macleans magazine. The settlement agreement provided that the settlement was binding on all class members who did not opt-out of the class by the specified date. The releases covered all claims relating to McDonald’s promotional games under common law or statute.

The plaintiff Currie did not participate in the Illinois action. He brought a proposed class action in Ontario against McDonald’s, McDonald’s Canada and Simon Marketing Inc., alleging wrongdoing in relation to the McDonald’s promotional contest. Another proposed class action was commenced by Parsons, who had intervened in the Illinois proceedings to object to the settlement of that action. Both Currie and Parsons were represented by the same law firm.

⁷⁰ (2005), 74 O.R. (3d) 321

The defendants moved to dismiss or stay the actions in Ontario on the basis that the claims had been finally disposed of in the Illinois action. The Ontario Chambers judge dismissed the Parsons action on the basis that, by appearing in the Illinois court to object to the settlement, Parsons had attorned to the jurisdiction of the Illinois court and was therefore bound. The motions judge refused to stay or dismiss the plaintiff Currie's action, however, holding that Currie was not bound by the Illinois judgment or Parsons' attornment, notwithstanding that they had the same attorney, because the notice given to the Ontario class members was inadequate. The motions judge found that the Illinois court had jurisdiction over non-resident Canadian class members but that the notice given was so inadequate that it violated the rules of natural justice.

The defendants appealed the refusal to stay or dismiss the Ontario Currie claim to the Ontario Court of Appeal. In the result the appellate court upheld the motions judge, also holding that the notice was inadequate.

The *ratio* of the appellate decision can be summarized in the following passage, indicating that there are three significant factors that the court will consider in assessing whether they should apply the *res judicata* doctrine to give efficacy to an American judgment. Sharpe J.A., writing for the appellate court, stated:⁷¹

“In my view, provided (a) there is a real and substantial connection linking the cause of action to the foreign jurisdiction, (b) the rights of non-resident class members are adequately represented, and (c) non-resident class members are accorded procedural fairness including adequate notice, it may be appropriate to attach jurisdictional consequences to an unnamed plaintiff's failure to opt out . . .” (Emphasis added.)

In this case it was held that there was a real and substantial connection of the case with Illinois as the alleged wrong had occurred in the United States and Illinois was the site of McDonald's head office.

⁷¹ At para. 30

Sharpe J. recognized, however, that multi-jurisdictional class actions should, in principle, be recognized. He stated:⁷²

“There are strong policy reasons favouring the fair and efficient resolution of inter-provincial and international class action litigation: . . . Conflict of law rules should recognize, in appropriate cases, the importance of having claims finally resolved in one jurisdiction. In some cases, Ontario courts will render judgments affecting the rights of non-residents and in other cases, Ontario residents will be affected by class action proceedings elsewhere. Ontario expects its judgments to be recognized and enforced, provided its courts assert jurisdiction in a proper manner and comity requires that, in appropriate cases, Ontario law should give effect to foreign class action judgments.”

However, as the American court had provided for constructive notice by posting a notice in Macleans magazines distributed in English Canada and in certain newspapers in French Canada, the appellate court agreed that this was inadequate.

These basic principles in *Currie v. McDonald's Restaurants of Canada Ltd. et al.* were recently applied by the Quebec Superior Court in *Lepine c. Société Canadienne des Postes*⁷³ This case involved a class action against the post office resultant from the sale of Cybersurf Corp.'s CD Roms guaranteeing free access to the internet for a certain price. A national class was certified in Ontario and an Ontario judgment rendered which purported to bind all Canadians, except residents of British Columbia, who had purchased the CD Rom through a Canada Post outlet. The plaintiff Lepine then sought to certify an action in Quebec, and an application was made to recognize the Ontario judgement so as to preclude the Quebec action. This application was denied, again on the basis that the Ontario ordered notice which sought to bind Quebec residents was inadequate.

The case of *McIntyre Porcupine Mines Ltd. v. Hammond*⁷⁴, a decision of the Ontario High Court of Justice, gives rise to some concern. In this case Keith J. refused to enforce a judgment

⁷² At para. 15

⁷³ [2005] Q.J. No. 9806

⁷⁴ (1975), 31 O.R. (2d) 452

given under the *Securities Exchange Act, 1934* on the basis that the United States statute had no extraterritorial effect. The defendant, a Canadian citizen, had been found to have violated a trading provision of the *Securities Exchange Act, 1934* and a money judgment was awarded by the American court. An action was then brought to enforce the American judgment in Ontario. Keith J. refused to do so on the basis that there was no Ontario legislative counterpart to the provision of the *Securities Exchange Act*. Much of the judgment seems coloured by Keith J.'s repugnance that the American action was brought by the “strike bar” and its enforcement in Ontario would have the effect of stripping the defendant of a benefit he had contracted for as a term of his employment.

Perhaps any concerns arising as a result of *McIntyre Porcupine Mines* are addressed in that Bill 198 does provide a legislative mandate analogous to the “fraud on the market” theory of liability in the United States, and thus there is now an Ontario legislative counterpart to the American basis of liability in secondary market trading.

It also seems clear, however, that Canadian courts are increasingly receptive to enforcing foreign judgments. The high water statement of this principle was in *Morguard Investments Ltd. v. De Savoye*,⁷⁵ in which a judgment was sought to be enforced intra-provincially. La Forest J., for the Supreme Court of Canada, stated that: “Modern states, however, cannot live in splendid isolation and do give effect to judgments given in other countries in certain circumstances . . .”

The principles of comity are recently illustrated in Ontario by C. Campbell J. in *United States of America v. Levy*,⁷⁶ in which a motion to enforce a U.S. judgment was granted. The American civil judgment held Levy liable for funds obtained by a telemarketing scheme that targeted U.S. residents. Levy was represented by counsel in the American action, filed a defence, made representations, and had the opportunity to testify, but took the Fifth Amendment for fear his testimony would incriminate him in American criminal proceedings arising out of the same fraudulent scheme. It was argued in Ontario that recognition of the American judgment would

⁷⁵ [1990] 3 S.C.R. 1077

⁷⁶ (2002), 1 C.P.C. (6th) 386; [2002] O.J. No. 2298

offend public policy or natural justice. In enforcing the American judgment C. Campbell J. stated: “The trend in Canadian Courts has been in recent years to broaden rather than narrow recognition and enforcement of foreign judgments, particularly those of the U.S. government or its agencies that are restitutionary in nature.”

Causation Within the Context of Security Class Action Litigation in the United States

Certain further features of American jurisprudence should be noted in order to assess the viability of this strategy. In particular, the recent case of *Dura Pharmaceuticals Inc. et al. v. Broudo et al.*⁷⁷ has elevated the importance of causation within the context of security class action litigation.

In *Dura Pharmaceuticals* the plaintiffs relied on a precedential Ninth Circuit decision which had adopted the “inflated purchase price theory”, which allowed plaintiffs to plead loss causation within a securities context by conclusively alleging that the price of a stock had been inflated by the purported fraud. The United States Supreme Court declined to follow the Ninth Circuit decision and instead held that a plaintiff must plead and prove a causal link between any alleged fraud and the plaintiff’s purported loss on the sale of the security. The Supreme Court advanced three reasons for its decision:

“...First, the Court rejected “as a matter of pure logic” the argument that price inflation is the equivalent of economic loss. The court explained that “at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase price is offset by ownership of a share that at that instant possesses equivalent value”. In addition, the Court explained that it is not inevitable that an inflated purchase price will lead to a later loss, because the subsequent resale at a lower price may result from “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events which, taken separately or together, account for some or all of that lower price”.

Second, the Court explained that purchase price inflation theory has no support in the common law of deceit and misrepresentation, which requires a plaintiff to

⁷⁷ 125 S. Ct. 1627 (U.S.S.C 2005)

demonstrate “not only that had he known the truth he would not have acted but also that he suffered actual economic loss”. Finally, the Court held that the Ninth Circuit’s standard contradicted the goals of the Federal Securities Statutes: to maintain public confidence in the securities marketplace and make private securities fraud actions available “not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause”.

Turning to the allegations of the complaint, the *Dura* Court explained that the mere allegation that the plaintiff class purchased their shares at an artificially inflated price did not serve to place the defendants on “fair notice of what the plaintiff’s claim is and the grounds upon which it rests”. The Court further explained that the *Dura* complaint (i) failed “to claim that Dura’s share price fell significantly after the truth became known”, (ii) failed to specify the “relevant economic loss”, and (iii) failed to describe the “causal connection . . . between [the] loss and the misrepresentation”. Accordingly, the Court held that the allegations of the complaint failed to state a claim.”⁷⁸

Although this would seem to be a negative decision for potential class representatives in a securities class action, the plaintiffs’ counsel in *Dura Pharmaceuticals* have made an argument that the decision is not as bad as it appears, and that it is important to look at what the decision does not decide. Patrick J. Coughlin, Eric Alan Isaacson and Joseph D. Daley⁷⁹ stated:

“While the foregoing explains what the Supreme Court’s *Dura* opinion holds, the opinion is also notable for what it does not hold. *Dura Pharmaceuticals* and its amici tried mightily to convince the Supreme Court to raise both the proof and the pleading bars of securities-fraud actions well out of reach of many defrauded investors. A reasoned analysis of the *Dura* opinion shows that their efforts failed.

1. Abandoning the Basic Rule

First, *Dura Pharmaceuticals* and commentators like Professor Coffee [who assisted the defence] hoped the Court might reconsider the holding in *Basic Inc. v. Levinson*. *Basic* created a rebuttable presumption of plaintiffs’ reliance on the integrity of a security’s stated market price. According to Professor Coffee, this presumption could have been significantly curtailed in *Dura*. The Court instead repeatedly cited *Basic* with approval, used *Basic* to lay out a securities-fraud

⁷⁸ Richard A. Speahr and Joseph D. Simone, “The Battleground After “Dura” Decision; Differences Remain Over Implementing Standard for Pleading Lost Causation” (2005), 234 *New York Law Journal* 6

⁷⁹ *Supra* at footnote 53, at pp. 8, 9

action's basic elements, and reaffirmed the provision of a rebuttable presumption of investors' reliance on a stock's public market price.

2. Requiring that Loss Causation be Pleaded with Specificity

Dura Pharmaceuticals and the Solicitor General had urged the Supreme Court to hold that loss causation needed to be pleaded, like falsity and scienter, with Rule 9(b) particularity. The Justices reacted to that argument with skepticism at the January 12, 2005, oral argument, and the Court's opinion does not adopt the argument. In fact, *Dura* reaffirms the vitality of *Conley v. Gibson* and the requirement that, absent special pleading rules, a complaint need only provide a "short and plain statement" of loss causation. "It should not prove burdensome," explained the Court, "for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." That explanation is consistent with the Court's earlier observation that the "tangle of factors affecting price" will be part of the proof of loss causation and a fact-intensive inquiry clearly reserved for trial.

3. Requiring a Direct Link Between A Corrective Disclosure and A Stock Price Drop

Next, the Court declined to adopt the argument, urged by Dura Pharmaceuticals and its amici, that loss causation requires that there always exist a corrective disclosure specifically linked to a final stock drop. Professor Coffee had asserted that absent a dramatic reaction to a disclosure contradicting the defendants' earlier representation, loss determinations are necessarily speculative or hypothetical. Instead, the Supreme Court explained in *Dura*'s "proof" discussion that plaintiffs' economic loss may occur as the "relevant truth begins to leak out," or as truth makes its way into the market place." Importantly, the Court did not require an explicit corrective disclosure as the mechanism by which the truth "leaked" out.

As one of this article's authors explained at oral argument, there are myriad ways in which the truth involving defendants' fraud can be communicated to the market, thereby removing inflation from the stock price and harming investors. In fact, the Justices at oral argument recognized that fraud-induced inflation can be removed in a number of ways. The Supreme Court has now confirmed that plaintiffs need only provide defendants with "some indication" of the connection between that leakage and plaintiffs' claimed economic loss. In requiring a plaintiff to prove economic loss by pointing to factors related to the fraud, the Supreme Court in *Dura* recognized that fraud could cause losses by a variety of means other than explicit corrective disclosures...

Conclusion

It can be seen, then, that notwithstanding the trepidation of defence counsel with the proclamation into force of the Bill 198 amendments in Ontario, liability for secondary market misrepresentation or nondisclosure remains illusory for a national class of Canadians. In view of *Pearson v. Boliden* it is doubtful if the Ontario statutory remedy for secondary market liability will extend beyond the borders of Ontario; an argument to deem reliance based on “inferred reliance” remains embryonic; and an action as a foreign subclass in the United States is fraught with difficulties, not the least of which is whether a Canadian court will enforce a U.S. judgment and preclude parallel Canadian proceedings. True secondary market liability still awaits.