The Ontario Civil Liability Regime, Not Quite 10b-5 North

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On December 31, 2005, a new regime of civil liability for secondary market disclosure came into force in the province of Ontario. While there has yet to be any meaningful use of the provisions, and while most other provinces expected to introduce similar regimes have not yet done so, the measure constitutes a significant legislative development for participants in the Canadian public market that merits, and has already been the subject of, detailed analysis.

Much has already been said and written about the new Ontario civil liability regime and its potential application and repercussions will no doubt be the subjects of ongoing debate. The purpose of this Perspective is not to analyze all aspects of the regime, but rather to compare the new regime to Rule 10b-5 under the U.S. Securities Exchange Act of 1934 (“10b-5”). In implementing the regime, the Ontario legislator had the benefit of decades of judicial application and analysis of 10b-5 in the United States and, as is discussed below, made a conscious choice not to import the rule into Canada in its U.S. form. It remains to be seen whether the Ontario regime will be more effective than 10b-5 in policing and deterring misrepresentations and omissions or whether it will lead to a rash of abusive and speculative litigation including class actions, despite the regime’s built-in protective mechanisms.
It should be noted that 10b-5 is also the principal rule with respect to criminal insider trading in the United States and one of the pillars of liability for misrepresentations or omissions in the context of an offering of securities by prospectus or registration statement in the United States. However, as the focus of this Perspective is on civil liability in the context of secondary market disclosure, these aspects of 10b-5 are not discussed below.

While they share certain similarities, the Ontario Civil liability regime is not quite “10b-5 North”. The provisions do share the same basic purpose, to establish a basis for statutory civil liability for misrepresentations or omissions. However, in their scope and application, the regimes are much more cousins than they are siblings.

Proof of Mental State

One of the principal areas where the Ontario regime has intentionally gone further than its cousin is in connection with the requirement to prove a culpable state of mind. In developing the Ontario civil liability provisions, the legislator chose to go beyond both the wording of 10b-5 and the American judicial application of the provision.

In the United States, liability under 10b-5 requires evidence of “scienter”, a mental state ranging from actual fraudulent intent to recklessness. Under the Ontario civil liability regime, with respect to certain “core documents” (which include certain information circulars, annual information forms, annual financial statements, interim financial statements and material change reports), there is no requirement whatsoever for a plaintiff to prove any culpable state of mind or recklessness or even to prove facts from which recklessness can be presumed or inferred. There are, however, defences available to a defendant to prove that he or she acted with due diligence. With respect to non-core documents and certain oral statements, a plaintiff will be required to prove the defendant’s knowledge of a misrepresentation, deliberate avoidance of knowledge or gross misconduct. Therefore, the burden of proof with respect to core documents shifts to the defendant to prove that a misrepresentation or omission occurred notwithstanding the defendant’s due diligence.

Reliance and Causation

One of the most significant aspects of the Ontario civil liability regime is the lack of any requirement of the plaintiff to prove reliance on a defendant’s misrepresentation or failure to disclose. The plaintiff is not even required to provide evidence from which the court can infer reliance. If an investor bought or sold securities of the issuer during a time when a document containing a misrepresentation was outstanding (i.e., not corrected) or when there was a failure to make timely disclosure by the issuer, the investor will be able to sue. Notwithstanding that reliance need not be proven, there will be no liability if the defendant proves that the plaintiff was aware of the misrepresentation or failure to disclose.
In the United States, there is no deemed reliance under 10b-5. American courts have, over the years, developed a theory of “fraud on the market” pursuant to which a plaintiff does not have to prove reliance where the plaintiff traded in securities in circumstances where the misrepresentation affected or could have affected the price of the securities. However, the presumption is rebuttable and can be overcome by the defendant presenting evidence that contradicts the effects of the misrepresentation, by presenting evidence proving insufficient reliance, by demonstrating an inefficient market for the securities or by showing that the truth had made its way into the market such that the plaintiff cannot be said to have relied on the misrepresentation (the so-called “truth on the market” defence). This is quite different from the Ontario regime where there is an automatic, statutorily imposed burden placed on the defendant to establish its entitlement to one of the defences available under the regime, none of which includes the above-mentioned grounds.

In addition, under the Ontario regime, there is no requirement to prove one of the principal requirements of civil liability at common law, that the misrepresentation or omission caused the plaintiff to suffer damages (“causation”). The plaintiff need only prove that the misrepresentation or omission existed and that he or she bought or sold securities. In the United States, a plaintiff suing under 10b-5 must prove that but for the fraud or misrepresentation, the transaction in the securities would not have occurred and that the fraud or misrepresentation rather than other events (for example general economic or market conditions) caused the loss. In Ontario, it is up to the defendants to prove that the loss occurred due to other circumstances. In this regard, the Ontario regime goes beyond the provisions and judicial application of its cousin to the south.

**Basis for Application**

One of the things to note in comparing the two regimes is their respective potential basis for civil liability. Canadian securities legislation generally requires an issuer to make immediate public disclosure of any material change by way of a press release and related report. U.S. securities law does not impose the same general obligation to disclose material changes (although recent amendments to the U.S. Form 8-K do mandate prompt disclosure of a broader range of specified events than previously existed under the U.S. regime). In certain circumstances there is a duty in the United States to disclose corporate developments, such as when a filing with the Securities and Exchange Commission is required (for example, an annual, quarterly or current report), when the issuer is buying or selling its own securities, when prior statements of the issuer were incorrect when made or that become incorrect and are still being relied upon by the market, or when material non-public information has been selectively disclosed to a shareholder or market participant but not to the market as a whole. In addition, stock exchange requirements in the United States may impose a more general disclosure duty on listed issuers, but a breach of such disclosure duty pursuant to such listing standards does not, in and of itself, give rise to a 10b-5 liability.
Therefore, while the two regimes provide for a remedy in the event of a misrepresentation or failure to disclose, the basis or potential for liability is different. The general requirement in Canada to make public disclosure of material changes, in addition to all of the more specific reporting obligations of public issuers, creates a basis for liability that is potentially broader in its application than that that exists under 10b-5 because of the lack of a general obligation under U.S. law to disclose material corporate events, although disclosure may have to be made at some stage as set forth above.

Another difference between the two regimes is with respect to forward looking information or statements, which include forecasts and earnings guidance. The Ontario regime, while not requiring an issuer to provide updates with respect to such information or statements, does provide that disclosure of the material assumptions or factors on which they are based is one of the necessary elements in avoiding liability under the regime in respect of such information or statements. No equivalent provision with respect to the required disclosure of assumptions or factors on which forward looking statements are based exists under the 10b-5 regime.

**Other Provisions of the Rules – Protective Measures of the Ontario Regime**

A comprehensive review of all of the provisions of the Ontario civil liability regime and their implications is beyond the scope of this *Perspective*. However, certain of the provisions are, at least ostensibly, meant to deal with the potential for baseless or abusive litigation. In implementing the Ontario regime, the legislator was mindful of the U.S. experience and sought to balance the objectives of the regime with the risks of an unwanted surge in abusive and speculative securities class action litigation. However, it is too soon to tell whether these protective mechanisms will actually serve their intended purpose.

Unlike in the United States, leave of a court is required to bring suit under the Ontario civil liability regime. This aspect of the regime is meant to allow the courts to act as gatekeepers to screen out speculative or abusive actions. However, it is not clear how much comfort this requirement will provide to those that may be in the position of a defendant under the regime. In order to grant leave, a court must be satisfied that the action is being brought in good faith and that there is a reasonable possibility that the action will be resolved at trial in favour of the investor. While these standards have not yet been tested, they may not produce the results intended. As plaintiffs file materials in support of their claim as part of the leave process, issuers, directors and other defendants will feel compelled to file materials in response in an attempt to have the court deny leave and potentially as part of a public relations strategy seeking to address the harm done by the mere allegations or filing of a suit. Plaintiffs’ counsel may be able to examine the defendants with respect to the materials filed during the leave process, giving them a potential running start in laying the groundwork for their arguments at trial.
The Ontario civil liability regime provides for a list of potential defendants (namely, the issuer, someone with actual, implied or apparent authority to act on the issuer’s behalf, an “influential person” including a controlling shareholder or a person with actual, implicit or apparent intent, to act on behalf of the influential persons). Influential persons and their directors and officers can be held liable if they “knowingly influenced” the deficient disclosure. It remains to be seen how this standard will be interpreted in Ontario including the degree of involvement on the part of the influential person in board or management decisions. Similarly, Rule 10b-5 provides for a remedy against “any person” that commits an act triggering 10b-5 liability and Section 20(a) of the U.S. Securities Exchange Act of 1934 imposes liability, in cases where there is a primary violation of 10b-5, on controlling persons that induced or participated in the alleged illegal activity. Whether a person is a controlling person and whether that person induced or participated in the alleged illegal act are questions of facts and circumstances on which there already exists considerable caselaw.

With respect to the amount of damages that plaintiffs may claim, the Ontario regime does provide for proportional liability and for caps on the liability of certain defendants, including a cap for individuals equal to the greater of $25,000 and 50% of the individual’s aggregate compensation from the issuer or the influential person in the preceding 12 months. There is no limitation on damages recoverable from any individual defendant under 10b-5. However, the applicable caps under the Ontario civil liability regime do not apply in the case of knowing involvement in a misrepresentation or failure to disclose. Given the infancy of the regime, it remains to be seen how the courts will interpret the exclusion from the cap in particular circumstances, but it is expected that, once a misrepresentation or omission is proven, a defendant such as a director or officer will have a heavy burden in disproving the defendant’s knowledge of the misrepresentation or failure to disclose. There are additional limitations on liability under the Ontario regime including, for example, where a defendant can demonstrate that a portion of the damages is attributable to a change in market price that is unrelated to the misrepresentation or failure to disclose.

**Conclusion – Not Quite 10b-5 North**

While the Ontario civil liability regime and 10b-5 were enacted for the same basic purpose, protecting the public investor from fraud, misrepresentation and material omissions, there are significant differences in their respective scope and application. The American rule has been subject to decades of judicial application and scholarly analysis. The legislator in Ontario had the luxury of examining the many years of U.S. experience before making the choices it did in departing from some of the aspects of the U.S. Rule. Will Ontario’s answer to 10b-5 strike an appropriate balance between protecting investors and fostering confidence in the market with having an economically vibrant and efficient market place and a viable pool of executive and directorial talent? We will only be able to answer that question once litigation under the Ontario regime has made its way through trial and
appellate courts and the effects of the regime on participants in the Canadian public market place begin to set in.

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