

CLASS ACTION DEFENCE QUARTERLY

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CLASS ACTIONS IN ONTARIO: 20 YEARS OF A GROWTH INDUSTRY — PART 2



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Part I of this article, published in the December 2010 issue of the *Class Action Defence Quarterly*, reviewed the history of the creation of Ontario’s *Class Proceedings Act, 1992 [CPA]*. We noted that the debate over the *CPA*, both inside and outside the Legislature, was conducted predominantly from the perspective of potential plaintiffs, with relatively little focus on the concerns of potential defendants or on the legislation’s potential effects on the courts and justice system generally. While this plaintiff-centered focus might be understood as a function of the fact that the *CPA* was drafted primarily to respond to genuine weaknesses in the existing justice system (illustrated by rulings such as *General Motors of Canada Ltd. v. Naken*),¹ it arguably produced legislation whose impacts on corporate defendants, judges and the court system were not given the attention they deserved.

In Part II, we argue that the *CPA*, after 20 years of vigorous advocacy by the class action plaintiffs’ bar, has been stretched beyond what was contemplated by the Legislature in 1990-92 and beyond what a reasonable conception of the demands of justice would require. In particular, expansive interpretations of waiver of tort, aggregate damages and *cy près* damages distributions, among other developments, have occasionally (and increasingly) appeared to turn the courts into quasi-regulators — a function for which they are institutionally unsuited. They have also turned plaintiffs into “private Attorneys General” and have arguably turned procedural legislation into something that significantly affects substantive legal rights. As a result of this tension between judicial and

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regulatory roles, the class action system may be at risk of providing neither good justice nor good regulation. We conclude that the best solution is to limit — and, to the extent necessary, reverse — the growth of the regulatory function of the courts under the *CPA*.

An Evolving Story:

Ontario's Class Actions Regime as a Regulatory Instrument

The Rise of the “Private Attorney General”

The *CPA*'s evolution as a quasi-regulatory statute is the result of a number of discrete steps that have collectively weakened the traditional links in the litigation process among parties, harm and remedy. Among these is a clear connection between the plaintiff's instigation of an action and an (alleged) antecedent injury or loss to the plaintiff. Under the *CPA*, the plaintiffs' role as “driving force” of an action (having already been formally delegated in the legislation to a “representative plaintiff”) has often in practice been usurped by the plaintiffs' class action counsel. Traditionally, a representative plaintiff or a lawyer who assumed such a role would have risked running afoul of rules against champerty and maintenance,² but the *CPA* exempts class actions from those prohibitions, following a contemporary trend (also seen in the acceptance of “intervenor” in constitutional law cases) toward allowing a greater role in the litigation system to those whom Anglo-Canadian courts might once have derided as “officious”.

While champerty and maintenance may sound obscure, they reflect a fundamental conviction that civil suits are intended to provide parties with an orderly means of resolving disputes that have affected them to the point that they are motivated to seek such a resolution. Traditionally, the principal exceptions to the idea that the “injured” party itself ought to be the motivating force of legal proceedings have been criminal and regulatory law. In criminal law, for example, misconduct serious enough to strike at the fabric of the social order is prosecutable by the state (through the agency of the Attorney General) with little or no regard for the opinions or wishes of the party or parties alleged to have been directly harmed, and usually without a compensatory element. Regulatory law deals similarly with conduct that, while not necessarily bad in itself or the product of an “evil mind”, nevertheless also causes

(or has the potential to cause) harm to health or social order in the context in which it takes place. That the CPA might turn the courtroom into a place in which private parties could pursue what were essentially regulatory goals was clearly the concern of Ian Binnie, Q.C. (as he then was) when he observed in 1992 that the representative plaintiff contemplated under the new Act amounted to “a kind of private Attorney General” who would “perform a quasi-regulatory function”.³

To the Ontario legislators of all parties who supported the CPA, allowing the representative plaintiff to assume an “Attorney General” role undoubtedly sounded sensible insofar as it permitted the courts to deal more effectively with situations similar to *Naken*. So conceived, this private Attorney General would have been limited to playing the part of a “litigation quarterback” who would overcome the traditional “co-ordination problem” among defendants by bringing before the court a wrong that had created a broadly distributed, but individually small, harm (doing so on behalf of others who had been harmed by it but who, like him or her, did not suffer a loss sufficiently large to justify the cost of a court action on an individual basis).⁴ Unless such a representative plaintiff was (improbably) unlucky enough to suffer a second such injury, he or she would not likely be a recurring participant in class actions and would not be in any danger of becoming, over time, a private Attorney General in the much broader sense of a maker and implementer of policy who — among other things — is trusted by society with the exercise of prosecutorial discretion.

What has actually transpired, however, is not quite what the future Justice Binnie foresaw. The Attorney General function has not been filled by the representative plaintiff so much as by his or her counsel, who is typically a member of the specialist class actions bar that has developed since 1992. One consequence that we might expect to result from this is that, through repeated involvement in instigating and litigating class actions, such plaintiffs’ counsel would progressively push the limits of the CPA, arguing for reduced burdens of proof and relaxed standards for awards of damages — a campaign that could be expected to enjoy better-than-average success given that it related to a novel and untested area of law. The pressure applied by determined class counsel would be (and has been)

particularly effective in the case of the CPA, which in the view of many (including many judges) exists to a significant degree for the express purpose of helping “little guy” plaintiffs to impose “behaviour modification”⁵ on “bad guy” corporate defendants.⁶

Waiver of Tort: As Courts Waver, Defendants Settle

As a consequence of rulings giving ground to the expansive arguments of plaintiffs’ counsel, the traditional burdens of proof and standards for awarding damages have shown signs of wear. The rise of the “waiver of tort” doctrine — which if established in Canadian law would considerably relax standards of proof in class action negligence cases, among others — is an excellent example. Waiver of tort can be traced back through the centuries to the common law form of action called *assumpsit*,⁷ but it stepped into the class actions limelight only in 2004, when Justice Cullity identified it in *Serhan Estate v. Johnson & Johnson* as the proper legal characterization of that aspect of the plaintiffs’ claim that attempted to establish liability in the absence of proof of individual reliance and damages. Because waiver of tort has those characteristics, and because it would also arguably relieve the plaintiff of any requirement to prove a loss,⁸ the job of plaintiffs’ class action counsel would be made much easier were it to be recognized as an independent cause of action. But, at the same time as it made the plaintiffs’ case easier to establish, waiver of tort would shift the class action regime further into the quasi-regulatory realm, with defendants required to pay “damages” (in addition to substantial legal fees) in the absence of proof of harm or loss to any member of the plaintiff class.

In his 2004 ruling, issued in the context of a certification motion, Cullity J. acknowledged only the bare possibility that waiver of tort could constitute a stand-alone cause of action (a decision upheld in 2006 by a divided Divisional Court panel). Because *Serhan* subsequently settled before the common issues were determined,⁹ we are still waiting (as of early 2011) for a Canadian court to tell us whether waiver of tort is, or is not, an independent cause of action. Although there is reason to doubt that such an unorthodox cause of action will ultimately be sustained,¹⁰ real-life defendants still must decide whether to invest the time and money required to defend a waiver of tort claim that, if successful, would give the plaintiff class the advantage of skirting

most of the usual requirements of proof in negligence law (and which, if unsuccessful, would likely still cost the defendant years of effort and a considerable amount of money). The natural result, for corporate defendants that put a premium on certainty, is settlement.

By way of digression, it is important to note that the waiver of tort issue illustrates a key problem that can arise whenever courts become quasi-regulators. The uncertainty and duration of the litigation process, combined with its considerable up-front costs (in both defence-related expenses and publicity) create a “vicious circle” in which risk-averse (and typically deep-pocketed) corporate defendants, unable to evaluate the strength of their legal position with sufficient confidence to proceed to trial, settle at an early stage, thereby perpetuating the very doctrinal indeterminacy that motivated the settlement. Looked at another way, one could say that the CPA has replaced a plaintiff-side co-ordination problem with a defendant-side co-ordination problem. Before the CPA was enacted, there was often no practical means by which plaintiffs could co-operate in the litigation of broadly distributed harms — a problem that the CPA has solved, but only at the cost of incentivizing defendants faced with novel claims (such as waiver of tort) to settle without resolving the novel issue. They are incentivized to do so because it is unlikely to be in the individual interest of any particular defendant to take such a claim through a trial and years of costly appeals, even though it would be very much in the interest of all such defendants and potential defendants collectively that one of them should do so.

Cy Près: Courts of Charity?

It is hardly surprising that courts are unsuited to the task of acting as quasi-regulators, given that their structure and practices have evolved over many centuries for the specific purpose of resolving disputes between parties alleging harm and parties accused of having been responsible for that harm. The awkwardness that results when courts are called upon to stray outside their traditional territory is evident from the *cy près* distributions that are permitted under subs. 26(4) and 26(6) of the CPA. Traditionally applied to charitable trusts whose stated purposes had become impossible to fulfil, *cy près* permits courts to substitute another purpose that accords “as closely as possible” with the settlor’s objective. Extended to the class action context,

the *cy près* doctrine allows the court to order that settlement funds be distributed to persons other than class members where, in its judgment, this is the best way to ensure that class members are benefitted, at least indirectly, by the settlement.¹¹

The exercise of this “judgment” can require the court to enter into debates with the parties about the worthiness of various proposed recipients of the distributions. In *Cassano v. The Toronto-Dominion Bank*,¹² a settlement agreement hearing, Cullity J. was sceptical about the plaintiff’s proposal to distribute half of a large *cy près* amount to Canadian law schools, purportedly to fund programs to teach law students drafting skills that had supposedly not been applied in the creation of the VISA account agreements that had been the subject of the suit. In addition to the remoteness of the benefits of this proposal for the class members, the court appeared to agree that it was itself placed in an awkward position insofar as it was faced with judging the possible allocation of millions of dollars to institutions with which the courts are closely connected.¹³ Justice Cullity decided instead that the funds should be awarded to an “access to justice” trust fund to be administered by the Law Foundation of Ontario, a determination that appears to have been his own idea,¹⁴ and which for all its inherent merit seems to take courts far out of their traditional area of activity, turning them into players rather than umpires.

In addition to the special difficulties presented by a *cy près* distribution, class action settlements present challenges for the court system in a more general sense. First and most obviously, the court will often be called upon to approve a settlement at an early stage without the benefit of proven facts. While in other situations a negotiated settlement can generally be presumed fair because both sides agreed to it, the class action settlement affects the legal rights of class members and may (on some interpretations) also be required to advance social and policy aims — interests that might not always be directly and forcefully represented in the negotiations. In the end, as in the *Serhan* settlement, the court may have no alternative but to rely on the fact that “class counsel is staking his or her reputation and experience on the recommendation.”¹⁵ While the integrity and good intentions of the vast majority of Canadian counsel cannot be doubted, one might nevertheless question the wisdom of a legislative

scheme that requires judges to take such a significant leap of deferential faith in complex situations involving so many disparate individual interests and (often) so much money.

There may also be an inherent bias in the system. As stated by Justice Horkins in *Serhan*, the relevant test at a settlement hearing is whether, all things considered, the proposed settlement is “fair, reasonable and in the best interests of the class as a whole.”¹⁶ Missing from this formulation is any reference to the fairness of the settlement to the defendant or, more broadly, to its shareholders — the latter in spite of the fact that in many other legal contexts it is recognized that shareholder interests can be harmed by a corporation’s ill-advised expenditures of funds. It is worth noting that in *Cassano*, the issue of whether the charitable donation agreed to by the defendant bank was fair was raised by a dissenting plaintiff class member (apparently also a Bank shareholder), on the ground that this was an inappropriate expenditure of the Bank’s money, which is ultimately its securityholders’ money. While Cullity J. held that the relevant authorities compelled him to dismiss most of the dissenter’s intervention,¹⁷ he nevertheless characterized it as “address[ing] quite fundamental issues relating to settlements”¹⁸ — presumably referring *inter alia* to the class member’s allegation that the *cy près* settlement constituted an improper expenditure of corporate funds. Whether or not settlement agreements perceived as overly generous or hasty might in future attract fiduciary duty claims by disgruntled shareholders, there can be little question but that, in having to act as an advocate for the broad plaintiff class, for the interests of other persons (such as shareholders, perhaps),¹⁹ or for the purposes of the legislation as a whole,²⁰ a court may find itself in an unfamiliar and uncomfortable position.

Aggregate damages: Severing the Link between Harm and Compensation

Some of the more problematic aspects of the CPA are clearly products of the tension inherent in a piece of procedural legislation that is often thought to have been enacted with the “substantive” purpose of improving the legal positions of would-be plaintiffs against corporate defendants. On one side of the procedural-substantive divide are the words of Justice Chapnik in her dissent on the appeal of Cullity J.’s ruling in *Serhan*: “[i]t is a well-settled principle of law that the CPA does

not change the substantive law, but is, rather, a procedural statute. Neither its objects nor its provisions should be given effect in a manner that affects the substantive rights of the parties.”²¹ On the opposite side are the many commentators (including legislators in the 1990-92 period) who have believed the CPA to be a means of vindicating the rights of consumers against the manufacturers of defective products.²² Justice Chapnik’s dictum, while stating what would traditionally have been taken as a truism, is therefore not entirely borne out by the history of the CPA.

The treatment of aggregate damages under s. 24 of the CPA is a good example of this. The key ruling in this area was *Markson v. MBNA Canada Bank*, a credit card “criminal rate of interest” case in which practical problems precluded a determination of which, if any, individual cardholders had suffered an actual loss.²³ Because of the small amounts of the individual overcharges in question, it was evident that members of the plaintiff class — faced with the traditional “co-ordination problem” — were unlikely to litigate the issues individually. In earlier cases, such as *Chadha v. Bayer* and *Pearson v. Inco Ltd.*, the courts had clearly indicated that aggregate damages awards required an antecedent demonstration of actual losses by all members of the class who were to share in the award.²⁴ In *Markson*, however, the Court of Appeal held that, at least in the circumstances of that case, aggregate damages could be awarded class-wide, even though it was impossible, from a practical point of view, to establish actual losses across the class. The court’s rationale was primarily that to decide otherwise would be to “immunize from suit” a large institution that was “allegedly receiving large amounts of illegal profits from millions of small transactions” — an “unconscionable result”.²⁵ Were the plaintiffs to succeed at trial, this certification ruling had the potential to permit many MBNA cardholders who (having suffered no harm) could not have sued the company successfully in their own right, to be transformed by the operation of the CPA into successful plaintiffs who are owed damages for losses they never suffered. As has been argued with respect to the similarly broad application of U.S. Federal Rule 23:

The consequences of this approach are troubling and far-reaching. ... [P]laintiffs will be emboldened to propose increasingly creative methods of generalized proof in order to assemble ever larger classes that should be ineligible for certification. Such

*class certifications exert enormous hydraulic pressure on defendants to settle cases that lack merit.*²⁶

These words, we would argue, could be applied without alteration or amendment north of the border.

Weaknesses of the Regulatory Model

Questionable Value to Plaintiffs

In addition to showing how a procedural statute, interpreted liberally and purposively by the courts, can create substantive legal rights, *Markson* is further testament to the increasingly strong regulatory focus of the class action system. The court in that case clearly endorsed the view that it was justifiable to overlook the imperfection of the proposed compensation scheme if, by doing so, it could be ensured that the corporate defendant did not escape the disciplinary force of the *CPA*. In many cases, settlements appear to result in little benefit to the plaintiff class — either the payout, on a per-person basis, is very small or it comes in a form (e.g. coupons) that is not of much practical value to many plaintiff class members. In other cases, as already noted, the entire settlement is distributed on a *cy près* basis, with at best an indirect benefit to the class members. It is worth quoting again an observation of Ian Binnie that we referred to in Part I:

*While on occasion [the Representative Plaintiff] is the legitimate spokesperson for the substantially damaged members of the Rusty Ford Owner's class, she is also the outraged defender of six million purchasers of pan-baked bread who suffered a cumulative overcharge of 9 dollars each in Hackett v. General Host, 455 F.2d 618 (1972).*²⁷

Over the two decades since the future Justice Binnie made that observation, the supply of “Rusty Ford” product defect cases has largely run dry, leaving the *CPA* to focus, not on the egregious *Naken*-like situations that preoccupied the legislators of 1990-92, but on *Hackett*-like situations in which the payment to the plaintiff class individually is minimal (or even on *Markson*-like cases in which the potential payment would not only be minimal but, for many recipients, quite clearly undeserved). This growing regulatory emphasis departs quite markedly from the consumer-compensation focus of those who debated and passed the *CPA* 20 years ago.

Structural Weaknesses of Regulation through the Court System

If the chief difference between class proceedings as conceived in the period prior to the enactment of the *CPA* and class proceedings as we know them today is indeed this shift toward a regulatory function, a full evaluation of the *CPA* would require an evaluation of its regulatory efficiency and fairness. While that would require economic and other analyses well beyond the scope of a brief review article, there is reason to doubt the fitness of the *CPA* for this purpose. No matter what form a system of regulation takes, there will almost certainly be more accusations and more investigations than there are findings of regulatory breach. Traditional forms of governmental regulation, for example, will frequently involve the investigation of a company with respect to a possible violation of safety standards. Often, the regulator will quickly determine that there is in fact no problem, and discontinue its investigation. While the company may have had to answer some queries or submit to an on-site inspection, it will usually be only modestly inconvenienced by this type of exercise of regulatory authority — as it should be, having *ex hypothesi* done nothing wrong. Where the same “regulation” is carried out by means of a class action, however, the situation changes. Here again, one would expect that instances of such litigation will exceed, by a considerable margin, the instances of actual violations. Such overbreadth is perfectly consistent with a healthy regulatory system and need not, in itself, be attributed to plaintiff “greed” or to any nefarious motives on the part of plaintiffs’ counsel (although as we noted in Part I, where the class action gets out of control, as in the case of U.S. securities law “strike suits”, there can be circumstances where virtually every company in a certain sector ends up being sued).²⁸ But where regulation takes this form, the cost to the innocent company under “investigation” via the litigation process is potentially much higher than in the traditional situation of bureaucratic regulation. There may be publicity issues, for example, and there are considerable up-front legal costs, including the cost of defending oneself at a certification hearing. While a defendant might hope to recover some of these costs after a successful trial, the time, expense and

reputational damage required to achieve a successful resolution through the court system can drive a company toward settlement, particularly given the lack of clarity in Canada with respect to such fundamental issues as waiver of tort, *cy près*, and aggregate damages.

In other words, by front-loading costs in the form of a complicated certification process, the CPA, when used as a form of regulation, places a substantial and unfair burden on innocent companies who, in a better-designed regulatory system, would be subjected only to relatively minor inconvenience and little if any publicity. If class litigation must be used as a form of regulation, it might be worth looking at other models, such as are used in some European countries, under which they are less of a free-for-all, with the “private Attorney-General” role played only by recognized consumer groups²⁹ — or, as in the case of Finland, by a special “Consumer Ombudsman”.³⁰ No matter what procedural form is eventually settled on, however, it remains that “behavioural modification” that is not bound closely to compensation for real losses is the job of regulators, not the courts. As Justice Baudouin of the Quebec Court of Appeal wrote in *Harmegnies v. Toyota Canada Inc.*, a “class action is not the way to punish someone who breaks the law, but rather only a way to compensate a group of persons for losses actually suffered in common.”³¹

Unsettling the Plaintiff-Defendant Equilibrium

On the plaintiffs’ side, the prospect of extracting substantial settlement or damages payments in more than one’s “fair share” of such cases may explain why class actions have become such a lucrative business, with rival groups of counsel battling for the right to represent the plaintiff class. While class actions may always have “behaviour modification” as part of their purpose, the equilibrium between plaintiff and defendant that is at the heart of our adversarial judicial system can co-exist with this in a fair way only if the courts settle the ground rules beforehand in a manner consistent with traditional conceptions of fault, and only if front-loaded legal costs and excessive demands at the certification stage do not incentivize faultless defendants to agree to costly settlements. Moreover, in expanding the “private Attorney-General” role beyond what was referred to above as mere “quarterbacking”, an expansive understanding of the CPA could give plaintiff

class counsel a considerable amount of influence over what many would regard as questions of public regulatory policy, such as decisions about which industries ought to be “targeted” with investigations. This issue has arisen recently with respect to the increasing number of class actions against franchisors, about which one defence counsel interviewed in *The Globe and Mail* mused (in the words of the reporter) that the “increase in cases has more to do with the efforts of class-action lawyers to recruit plaintiffs than with alleged transgressions by big franchisors.”³² However this may be, the basic principle remains that where defendants pay, it should be because justice is on the side of the plaintiffs — not because it is cheaper to do so than it would be to establish that justice is with them. If only for the sake of public respect for the court system, this principle should not be departed from.

Conclusion

The political justifications offered in support of the CPA in the years prior to its adoption do not entirely match the reality of the class actions regime as we have come to know it over its first 20 years. Enacted primarily for the purpose of rectifying real injustices resulting from Ontario’s weak joinder rules, as reflected in the ineffectiveness of *Naken* and similar lawsuits, the CPA has expanded — in accordance with U.S. experience — into a quasi-regulatory system. If Canada has not quite reached the point of being a “Shangri-La of class action litigation” — as the U.S. Supreme Court recently described the situation in that country³³ — the extraction of settlements and damages from manufacturers (typically “deep pocketed” multinationals) is nevertheless in danger of becoming an end in itself, rather than a means to providing appropriate compensation to those who have suffered harm. All of this is the predictable result of an attempt to fit the square peg of regulatory goals into the round hole of an adversarial and fault-based civil justice system. In coming years, it is to be hoped that the courts will ensure that the court system continues to focus on what it has always done best, by providing certainty about the applicable ground rules while ensuring that the financial incentives applying to plaintiffs and defendants are not thrown out of balance to the extent that the early settlement of weak cases becomes the “default” result and justice is neither done nor seen to be done.

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¹ *General Motors of Canada Ltd. v. Naken*, [1983] S.C.J. No. 9, [1983] 1 S.C.R. 72. As discussed in Part I, this was a product liability case relating to problems with the "Firenza" automobile produced in the 1970s by General Motors.

² *Class Proceedings Act, 1992*, S.O. 1992, c. 6, s. 33(1).

³ Ian Binnie, Q.C., "The Class Proceedings Act: A Defendant's Perspective", in *Ontario's New Class Proceedings Act: Are You Prepared?* (Toronto: The Law Society of Upper Canada, 1992), at F-2.

⁴ Canadian courts have repeatedly identified the phenomenon of broadly distributed but individually small harms as a key rationale behind class actions. See, for example, *McLaine v. London Life Insurance Company*, [2007] O.J. No. 5035 (O.S.C.J. D.C.), para. 12 and *Western Canadian Shopping Centres Inc. v. Dutton*, [2000] S.C.J. No. 63, [2001] 2 S.C.R. 534, at para. 29.

⁵ Accepted in *Abdool v. Anaheim Management Ltd.*, [1995] O.J. No. 16, 21 O.R. (3d) 453 (Div. Ct.) and affirmed by the Supreme Court of Canada in *Hollick v. Toronto (City)*, [2001] S.C.J. No. 67, [2001] 3 S.C.R. 158, para. 27.

⁶ See for example the comments by the court in *Markson* cited at note 25 below.

⁷ H. Michael Rosenberg, "Waiving Goodbye: The Rise and Imminent Fall of Waiver of Tort in Class Proceedings", *The Canadian Class Action Review*, vol. 6, no. 1 (April 2010), 37-86 at 47.

⁸ *Serhan v. Johnson & Johnson*, [2004] O.J. No. 2904 (O. S.C.J.), paras. 34-35.

⁹ *Serhan v. Johnson & Johnson*, [2011] O.J. No. 27, 2011 ONSC 128 [*Serhan settlement*].

¹⁰ In her ruling approving the *Serhan settlement*, Horkins J. expresses what appears to be skepticism about waiver of tort as a standalone cause of action, adding that even if it were a cause of action, there could still be policy reasons for not applying it in consumer-product class action cases. See *Serhan settlement*, paras. 66-71.

¹¹ Such a decision might be made, for example, when it had proved impossible to locate or identify all of the class members, leaving some or all of the settlement undistributed. In some cases, the entire settlement is *cy près*. See for example the *Serhan settlement*.

¹² *Cassano v. The Toronto-Dominion Bank*, [2009] O.J. No. 2922 (O.S.C.J.).

¹³ *Cassano*, at para. 22 and notably in Cullity J.'s comment to the fourth point of the document included with the decision as an "Appendix".

¹⁴ *Cassano*, para. 25ff.

¹⁵ *Serhan settlement*, para. 55.

¹⁶ *Serhan settlement*, para. 51.

¹⁷ Other than the dissenter's criticism of the original plan to direct the *cy près* benefit to Canadian law schools, with which (as discussed above) Cullity J. agreed.

¹⁸ *Cassano*, para. 64.

¹⁹ While Cullity J. generally did not accept the substance of the written submission of the class member/shareholder advocate in *Cassano*, he clearly considered it and made a point of appending the submission to his written reasons.

²⁰ *Epstein v. First Marathon Inc.*, [2000] O.J. No. 452 (O.S.C.J.), para. 69.

²¹ *Serhan Estate v. Johnson & Johnson*, [2006] O.J. No. 2421, 85 O.R. (3d) 665 (Div. Ct.), at para. 252, citing *Ontario New Home Warranty Program v. Chevron Co.*, [1999] O.J. No. 2245, 46 O.R. (3d) 130 (S.C.J.), para. 50.

²² See, among other examples cited in Part I of this discussion, the remarks of Justice Montgomery, referred to at p. 20.

²³ *Markson v. MBNA Canada Bank*, [2007] O.J. No. 1684, 2007 ONCA 334.

²⁴ *Chadha v. Bayer Inc.*, [2003] O.J. No. 27 (Ont. C.A.), para. 49; *Pearson v. Inco Ltd.*, [2005] O.J. No. 4918 (Ont. C.A.), para. 77; see also *Kranjcec v. Ontario*, [2004] O.J. No. 19 (Ont. S.C.J.), paras. 63-64.

²⁵ *Markson*, at paras. 46 and 42, respectively.

²⁶ *In Re Wal-Mart Stores, Inc. v. Dukes et al.* (U.S.S.C. No. 10-277), *amicus curiae* brief of DRI—The Voice of the Defense Bar, January 27, 2011, at 3.

²⁷ *Supra* note 3.

²⁸ Janet Cooper Alexander, "Do The Merits Matter? A Study of Settlements in Securities Class Actions", *Stanford Law Review*, vol. 43, no. 3 (Feb. 1991), pp. 497-598, at 513ff.

²⁹ For example, in Spain and the Netherlands.

³⁰ See "Finnish Practices to Ensure that Consumers Can Obtain Redress", *Current Issues In Consumer Law* (Consumer Ombudsman of Finland), June 2007, available at <www.tinyurl.com/finombud> (accessed January 28, 2011).

³¹ *Harmegnies v. Toyota Canada Inc.*, [2008] J.Q. no 1446, 2008 QCCA 380, at para. 48 (translation). Leave to appeal was refused, [2008] S.C.C.A. No. 173 (S.C.C.).

³² Geoffrey Shaw, reported by Jeff Gray in "Revolt of the Franchisees", *The Globe and Mail*, January 18, 2011.

³³ *Morrison et al. v. National Australia Bank Ltd. et al.*, 561 U.S. ___ (2010), per Justice Scalia for the majority.

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WHEN DISCLOSURE MEANS LITIGATION

THE CONFLICT BETWEEN GOOD CORPORATE GOVERNANCE AND SECURITIES CLASS ACTIONS



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Half a decade after its enactment, and after a relatively slow start, a trend is emerging in actions brought under Part XXIII.1 of the *Ontario Securities Act* [OSA]¹ which provides a statutory cause of action for secondary market investors. Law firms specializing in plaintiff side securities class actions have ostensibly expanded their role to that of corporate watchdog by monitoring corporate disclosure documents and press releases for announcements of errors or the need for financial restatements, to subsequently issue a statement of claim instituting a class proceeding (sometimes even before the restatement itself is issued).

The purpose of the amendments was to promote greater accountability for issuers and improved investor confidence through improvement to the quality of continuous disclosure; as well, the amendments provide redress to secondary market investors for: (i) misrepresentations made by or on behalf of a responsible issuer in a publicly disclosed document or public oral statement; and (ii) a responsible issuer's failure to make timely disclosure of a material change. However, the committee which recommended the changes also stressed that the purpose of the provisions was to be deterrence, and not investor compensation. Since coming into force on December 31, 2005, 21 class actions² have to date been commenced under these provisions, eight of which have already settled. A review of the more recently filed actions indicates that, though laudable, the objective of promoting good governance through continuous disclosure now inevitably means a lawsuit for any oversight, regardless of the cause.

Issuers must now turn their minds not only toward practicing good governance in a way that will prevent errors in the first place, but also in a way that will minimize their liability should errors occur. This article will examine the actions under the secondary market liability provisions of the OSA to date and the kinds of disclosure that have led to securities class actions.

Background

In 1994 a committee, chaired by Thomas Allen (the "Allen Committee") was formed by the Toronto Stock Exchange to review corporate disclosure practices in Canada and to examine the rules to determine whether investors should be able to pursue private remedies if a company fails to comply with its disclosure obligations. The Allen Committee was formed, in large part, due to concerns with regard to issues in ongoing disclosure of public companies such as the timeliness of the release of information and the content of such releases.

One of the perceived gaps in the law was that statutory civil liability was available for purchasers of securities in the primary market but was not available in the secondary market, which represented 94 per cent of all trading.³ Due to a growing recognition that private rights of action were a necessary complement to the enforcement activities of securities regulators, the Allen Committee undertook to make recommendations for the institution of legislation which would improve the regulation and quality of corporate disclosure in Canada. In its report, "Responsible Corporate Disclosure: A Search for Balance",⁴ the Allen Committee sought to develop a framework that would balance the interests of the various market participants (the "Allen Report").

The Allen Report recommended statutory civil liability for secondary market disclosure so that meritorious actions would have a route to recovery and therefore serve as a deterrent to inaccuracies and untimeliness in corporate disclosure, concluding that "the combination of class actions with statutory civil liability for misrepresentation in continuous disclosure, properly designed would provide the benefits of better disclosure without unduly facilitating meritless litigation."⁵

The Canadian Securities Administrators then proposed draft legislation to amend the OSA and the proposed amendments subsequently came into force on December 31, 2005. Under these provisions an action

may only be commenced with leave of the court, and a plaintiff must first establish that: (i) the action is brought in good faith; and (ii) there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.⁶ As noted by one jurist, since its enactment, entrepreneurial class actions law firms have been very interested in pursuing actions under the new legislation.⁷

The leave requirement means that, in theory at least, a preliminary motion for leave ought to precede the motion for certification (although in practice that has not necessarily been the case, as plaintiffs seek to bring both motions at the same time).

The Evolution of Actions under Part 23 of the OSA

As noted, at date of writing, the authors are aware of 21 class actions in which statements of claim have been issued indicating an intention to seek leave to commence an action under the secondary market liability provisions of the OSA. Of these actions, eight have already settled.⁸ Interestingly, in the cases which have settled, the ratio of the settlement amount to the damages as estimated in the Statement of Claim has been relatively low, ranging from approximately 4 to 14 per cent.⁹ None of the proposed actions have yet gone to a trial on the merits of the claims.¹⁰

A review of the securities class actions which have been commenced to date demonstrate that the most common indicator that a securities class action lawsuit will be commenced is an announcement by the issuer indicating a potential issue with prior disclosure documents causing a drop in share price, and a subsequent announcement that the issuer's financial statements will require restatement.

The first action commenced under the amendments, *Silver v. IMAX Corporation et al. [IMAX]*, is the only case that has yet received leave of the court to commence an action and also been the subject of a contested certification hearing.¹¹ In *IMAX*, the disclosure documents and announcements that lead to a securities class action on behalf of plaintiff shareholders included a press release in February, 2006 in which the company announced 14 completed theatre installations in the fourth quarter of 2005 and that it expected to meet its full year earnings guidance for 2005; a press release in

August, 2006 in which the company stated that it had recognized revenue in the fourth quarter of 2005 on ten installations in theatres which did not open that quarter but that this was in accordance with generally accepted accounting principles ("GAAP"); and, a press release in 2007 where the company indicated that it had restated its 2005 financial statements and acknowledged that it erred in recognizing revenue for theatre systems that were not completely installed, and that it had not complied with GAAP.

Similarly, in *Ainslie v. CV Technologies (now Afexa Life Sciences)* the disclosures which resulted in the action were press releases announcing that financial statements required restatement due to revenue deferral issues.¹² In *Marcantonio v. TVI Pacific* the action resulted from a press release indicating that TVI would require restatement due to non-cash errors made in consolidating the accounts of its foreign affiliated companies.¹³ In that case the plaintiffs alleged that, among other accounting errors, TVI's stock options were manipulated and that TVI had incorrectly expensed its stock options to senior executives.¹⁴ In *O'Neil v. SunOpta, Inc.* the company announced significant write-downs in some areas of its operations that would impact its previously issued financial statements.¹⁵ In *Pysznyi v. Orsu Metals Corporation* the claim alleging that the company's financial statements were materially false and/or misleading and that its liabilities were understated and its earnings overstated was precipitated by a press release indicating that Orsu Metals would be delayed in completing its annual consolidated financial statements because it had to incorporate the financial implications of successful litigation in South Africa and was experiencing unexpected difficulties with one of its operations. The press release stated that the company anticipated that these issues would result in a restatement of its previously filed interim financial statements.¹⁶ All four of these actions have since settled.

Recent actions which have been filed as a result of errors leading to the restatement of financial statements include claims against Redline Communications Group Inc. and easyhome Ltd. The action against Redline Communications Group Inc. arose as a result of a press release indicating that a preliminary internal review had revealed that the company may not have been following proper revenue recognition accounting policies (and

therefore that certain of its financial statements may not have been prepared in accordance with GAAP) which may result in the company being required to restate financials.¹⁷ Another press release was issued approximately two-and-a-half months later announcing Redline's intention to restate certain of its financial statements.¹⁸

The class action against easyhome Ltd. arose from a press release announcing that the company had discovered an employee fraud in the amount of approximately \$3.4 million requiring the company to restate prior period financial statements.¹⁹ The employee fraud was detected by the company during a detailed review of its consumer loans receivable portfolio. An investigation indicated that the manager of an easyfinancial kiosk fraudulently withdrew company funds by processing fictitious loan applications. The payments for the fraudulent loans were made by other fraudulent loans. In this case, the company took immediate action to mitigate the financial damage of the fraud, terminated the employee and has taken steps to strengthen its internal control processes.²⁰ A class action was nevertheless immediately commenced.

Further examples of the types of disclosures that have resulted in securities class actions include press releases indicating net losses,²¹ the announcement of an investigation into anti-competitive conduct followed by suspension of distributions to unit holders,²² alleged misrepresentations with respect to forward looking information,²³ alleged misstatements with respect to risk management practices and policies,²⁴ and errors in exploration data.²⁵

Recently filed actions indicate that plaintiff class actions firms are becoming increasingly sophisticated in monitoring for potential actions and moving quickly when an opportunity arises. For example, the press release indicating that Redline Communications Group Inc. had restated its financials was issued on September 3, 2010. On September 7, 2010 a plaintiff class action law firm announced an investigation into the restatements and a notice of action was issued on September 10, 2010. Similarly, in the proposed action against easyhome Ltd. the press release was issued on October 14, 2010, the law firm announced its investigation on October 15, 2010 and a proposed securities class action was filed on October 25, 2010.

The same plaintiffs' firm has recently announced investigations into both Victoria Gold Corp. and Cathay Forest Products Corp. The investigations were commenced less than a month after Victoria Gold Corp.'s announcement that it had identified a mathematical error in the estimate of the gold resources on one of its projects and within a week of a press release indicating that the estimates should no longer be relied upon,²⁶ and less than two weeks after Cathay Forest Products Corp. issued a news release announcing the restatement of its financial statements.²⁷

Conclusion

The evolution of these actions to date indicates that issuers should take note that, not only must they practice good corporate governance through continuous and responsible disclosure, they should do so in a way that will minimize potential liability such as continuously monitoring internal controls, acting with due diligence, incorporating cautionary language into all disclosure documents and taking quick and effective corrective action upon realization of a problem. The speed at which these actions are being commenced upon disclosure of an issue and a subsequent drop in share price indicates that issuers should be prepared to take quick defensive action if and when a material issue occurs.

The clear tension between scrupulous corporate governance and early disclosure of possible issues may be at odds with an overly sensitive plaintiffs' bar, who awaits any announcement no matter the cause, and pounces with a significant securities class action. Indeed, the fact of a pending class action may do far more harm to the company's share value (and, therefore, its shareholders) than the original press release by the company or the underlying issues. It remains to be seen whether these types of class actions will actually make their way to a trial of issues, or whether (like most other class proceedings), they will be settled before any substantive determination of the merits. And while it remains "early days" in the progress of these types of actions, a skeptic might question whether the original goal of the Allen Committee of deterrence is indeed being met, or if, instead, the current shareholders are simply transferring value to former shareholders.

¹ *Securities Act*, R.S.O. 1990, c. S.5, ss. 138.1-138.14.

² *Silver v. Imax Corporation*; *Ainslie v. Afexa Life Sciences*; *Stastrny v. Southwestern Resources Corp.*; *Xing v. Celestica Inc.*; *Marcan-*

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