Civil Liability for Continuous Disclosure Violations

Our next two articles examine the new Ontario regime of statutory civil liability for misrepresentations in the disclosure record of reporting issuers. The regime went into effect on December 31, 2005.

Investors now have the right under the Securities Act (Ontario) (the Act) to sue a reporting issuer (and others) for a misrepresentation in the issuer’s disclosure record. The policy rationale is simple: while prospectus purchasers have long had the statutory right to sue an issuer, its directors and certain officers for a misrepresentation in the prospectus, purchasers in the secondary market (where, it has been estimated, approximately 94 per cent of trading takes place) previously had no similar statutory right to recover for misrepresentations in the issuer’s ongoing disclosure record. The changes to the Act rectify this inequity.

An Overview

Under the new civil liability regime, investors are able to sue for (i) misrepresentations in a reporting issuer’s disclosure documents, (ii) misrepresentations in public oral statements made by representatives of the issuer and (iii) a failure by the issuer to make timely disclosure of a material change as required under the Act. The right to sue is available to those who bought or sold an issuer’s securities during a disclosure violation period, being the period starting when a disclosure violation occurs and ending when the disclosure violation is corrected.

Investors are able to sue the issuer, directors of the issuer, officers of the issuer that authorize, permit or acquiesce with respect to a disclosure violation and, in the case of a public oral statement, the person who makes the public oral statement on behalf of the issuer. Investors may also be able to sue experts, and significant securityholders of the issuer (and their directors and officers), in certain circumstances.

In this article, we focus only on the issuer and its directors and officers.

The Burden of Proof

The Act distinguishes between core documents and non-core documents. Core documents for an issuer and its officers are prospectuses, takeover bid circulars, issuer bid circulars, rights offering circulars, directors’ circulars, information circulars, MD&A, AIFs, annual financials, interim financials and material change reports. For directors, material change reports are not core documents.

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If a document is not a core document, the plaintiff must prove that the defendant knew of the misrepresentation, deliberately avoided acquiring knowledge of the misrepresentation or was guilty of gross misconduct in connection with its release. This same standard applies to public oral statements and for directors (but not for the issuer or its officers) in respect of a failure to make timely disclosure of a material change. The corollary is that for core documents, defendants have liability whether or not they had knowledge of the misrepresentation. This is also true for the issuer and its
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Deemed Reliance and Damages

Under the Act, a claimant is deemed to have relied on a misrepresentation or failure to make timely disclosure. In addition, damages do not have to be proved; rather the quantum of damages a claimant is entitled to is specifically set out in the Act. The damages calculation is based on the change in the issuer’s stock price in the period after the disclosure violation is corrected as compared to what it was when the claimant bought or sold the security. These elements of the statutory regime remove two of the major obstacles (proving reliance and damages) that have plagued the ability of plaintiffs to bring a common law action for a disclosure violation. These elements also make it easier to get a class action certified, as plaintiffs will have uniformity in these key aspects of their cases.

Leave of the Court to Bring an Action

In order to bring an action, leave of a court must first be obtained. A court can only grant leave if it is satisfied that the action is being brought in good faith and that there is a reasonable possibility that a trial will be resolved in favour of the plaintiff. Affidavit evidence is required to be filed by both plaintiff and defendant setting forth the material facts on which each intends to rely. The hearing to seek leave is therefore likely to be a serious merit-based review and we expect that courts will not grant leave lightly. The requirement for leave is intended to act as a check on the bringing of frivolous lawsuits, a common occurrence in the US. A court must also approve any settlements, again acting as a check on actions by plaintiffs’ counsel.

Limitations on Liability

There are limits on the damages for which an issuer and its directors and officers are liable in connection with a particular disclosure violation. In the case of the issuer, that amount is 5 per cent of the issuer’s market capitalization (based on capitalization calculated prior to the disclosure violation). For directors and officers, the limit is the greater of $25,000 and 50 per cent of their last 12 months’ compensation from the issuer. In addition, liability is assessed proportionately (rather than jointly and severally) in accordance with a particular defendant’s responsibility for the damages suffered by the plaintiff. However, in each case, these limitations are not available for someone (other than the issuer) who had knowledge of the disclosure violation.

Defences

There are a number of defences available under the Act. The key defences are set out here.

A person is not liable for a disclosure violation if the person proves that the plaintiff acquired or disposed of the issuer’s securities with knowledge of the violation.

A person (other than the issuer) is also not liable if the disclosure violation occurred without the knowledge or consent of the person and, if after the person became aware of the disclosure violation: (i) the person promptly notified the board of directors; and (ii) where the issuer took no corrective action with respect to the disclosure violation within two business days of that notification, the person promptly notified the OSC in writing. This latter requirement is subject to any law or professional confidentiality rule prohibiting disclosure to the OSC, an important factor for in-house counsel. This requirement may also create tension internally in situations where there is a disagreement as to whether there has been a disclosure violation as some officers and directors may feel compelled to go to the OSC to avoid liability.

The use by an issuer of a confidential material change report is also a defence under the Act to a failure to make timely disclosure of a material change. However, the issuer must have a reasonable basis for making the disclosure on a confidential basis and the disclosure must be made public as soon as that basis ends. Caution must be taken in using this approach (that has been available, but little used to date) as an issuer, by filing a confidential material change report, may find it difficult to argue (subsequently) that the change was not material.

There is also a defence for misrepresentations in forward looking information where reasonable and proximate cautionary language is included with that information, including a discussion of material assumptions. To rely on this defence, it is not enough to include boilerplate language or to cross-reference a litany of risk factors. Thoughtful and tailored cautionary language is required. Reliance on the
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report or opinion of an expert also protects an issuer, director or officer from a claim provided the expert has consented in writing to the use of the report or opinion.

Finally, and most importantly, a person is also not liable if the person can prove that before the disclosure violation occurred, the person conducted a reasonable investigation and, at the time of the disclosure violation, the person had no reasonable grounds for believing that a disclosure violation would occur (the so called “due diligence defence”). Unlike the prospectus context, this defence is also available to the issuer, in addition to directors and officers. Among the factors that a court will take into account in determining whether a defendant can get the benefit of the due diligence defence are the nature of the issuer, the knowledge, experience and function of the defendant, the office held (if the defendant was an officer), the nature of any system designed to ensure that the issuer meets its continuous disclosure obligations and the reasonableness of a person’s reliance on the issuer’s disclosure system.

We believe that the adoption and use of a suitable disclosure policy and the establishment of an effective disclosure committee are important factors in satisfying the due diligence defence. We will explore these topics in more depth in our next article.

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