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Living in a Material World: Materiality Drives Dismissal of Motion for Leave to Commence Statutory Misrepresentation Claims Under the *Ontario Securities Act*

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The Ontario Superior Court of Justice recently refused to grant leave to commence a statutory secondary market misrepresentation claim in a proposed class action pursuant to Part XXIII.1 of the *Securities Act*. The Court in *Paniccia v. MDC Partners Inc.* agreed with the defendants' submissions that the plaintiff had failed to demonstrate any reasonable possibility that the putative class would be successful at trial and reaffirmed the important gatekeeper role of the court in securities class actions. A link to the decision is here.

Key Takeaways

- **Absence of restatement of financial statements is a powerful fact for defendants**. In the context of a motion for leave to pursue a statutory cause of action, the plaintiff can rely on the fact of a restatement as an admission that the company has made a material misrepresentation. In the absence of a restatement, however, the plaintiff must adduce some evidence to show there is a reasonable prospect of demonstrating at trial that the company misled the market by publishing an untrue statement of material fact or by failing to disclose a material change in a timely manner.
- **The opinion of an accounting expert may not be useful in determining whether a fact or change is material**. While an accounting expert can opine on materiality from an accounting or auditing perspective, the determination of a material fact or material change is a legal test under the securities regulatory regime and ultimately up to the court to decide.
- **The commencement of a regulatory investigation, without more, does not trigger a disclosure obligation**. A reasonable investor would not expect a company to disclose a subpoena or a regulatory investigation (and in Canada, regulatory investigations are usually confidential). Instead, a reasonable investor would expect the company to respond to the subpoena, cooperate with the investigator, conduct an internal investigation and determine whether there is a material fact to correct or a material change to report.

Summary and Background

MDC Partners Inc. (MDC or the Company) is a dual-listed issuer, with its head office and investor relations group in New York. MDC is a leading global provider of marketing and communications services through subsidiaries referred to as "agency partners" or "partner firms." Over a thirty-year period, MDC acquired a network of fifty-one "agency partners," and grew into one of the largest and most successful marketing and communications firms in the world. MDC's shares trade on the NASDAQ and also traded on the TSX until November 11, 2015, when MDC voluntarily delisted due to the extremely low Canadian trading volume. An unknown number of shareholders reside in Canada and they hold between 0.8% and 2.6% of MDC shares.

In 2015, the proposed representative plaintiff commenced a global class action in Ontario, advancing both common law negligent misrepresentation claims and statutory misrepresentation claims under Part XXIII.1 of the *Securities Act* on behalf of all purchasers on the TSX and the NASDAQ. The plaintiff then amended the claim in 2017 to abandon the global class and limit the class to Canadian-resident purchasers on the TSX and the NASDAQ. The proposed class action sought damages from the Company and certain of its current and former officers on the basis of alleged misrepresentations of material facts and failure to disclose material changes in its financial and other disclosure filed between October 29, 2014 and March 2, 2015 that were allegedly corrected (or partially correctly) on April 27, 2015.

The plaintiff argued that the defendants had materially misrepresented certain facts with respect to: (1) the existence of an SEC subpoena and the commencement of an SEC investigation; (2) the commencement of an internal investigation related to the SEC subpoena; (3) the Company’s non-GAAP earnings disclosure (EBITDA); (4) the CEO’s compensation; and (5) MDC’s decision with respect to how it grouped its partner firms into financial reporting units. The defendants collectively argued that none of the disclosures contained any misrepresentations and, even if they were any, none of them were material.

The United States District Court for the Southern District of New York dismissed a parallel class action in the U.S. with prejudice on September 30, 2016.

The Decision

Under the *Securities Act* leave test for statutory misrepresentation, the plaintiff must satisfy the court that there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff. The leave test requires more than a superficial examination of the evidence. It is intended as a robust deterrent screening mechanism requiring a reasoned consideration of the evidence. Moreover, leave must be granted in respect of *each* misrepresentation alleged by the plaintiff. Evidence of materiality is key to satisfying the court that a statutory cause of action under Part XXIII.1 of the *Securities Act* should proceed.

Justice Perell analyzed each of the five alleged misrepresentations referred to above, with primary focus on the fact that the financial statements were not required to be recalled or restated either by the SEC or by the Company’s independent auditors. He ultimately found that none of the alleged misrepresentations were material.

(i) SEC subpoena

The plaintiff argued that the receipt of a subpoena from the SEC in October of 2014 relating to an investigation of certain financial disclosures and accounting practices of the Company was a material fact that the Company was required to disclose and that by not disclosing it in a timely manner, the Company was falsely representing that it was not under investigation. The Company disclosed the SEC subpoena and the results of its internal investigation on April 27, 2015.

Justice Perell held that the mere service of a subpoena, or the mere existence of a regulatory investigation, without more, does not trigger a duty to disclose. In fact, premature disclosure of an investigation can adversely harm share values even where it later turns out that there was no wrongdoing. A reasonable investor would not expect a company to disclose a subpoena or a regulatory investigation (and in Canada, regulatory investigations are usually confidential). Instead, a reasonable investor would expect the company to respond to the subpoena, cooperate with the investigator, conduct an internal investigation and determine whether there is a material fact to correct or a material change to report to its investors. Justice Perell concluded that the defendants did just that. Finally, he noted that the SEC took no issue with the timing of the Company's disclosure regarding the SEC subpoena and internal investigation (described below).

(ii) Internal Investigation

Once MDC received the SEC subpoena, it set up a special committee and commenced an internal investigation. Following the findings of the internal investigation, MDC publicly disclosed that it was taking steps to strengthen and improve its internal controls over financial reporting (ICFR). The plaintiff argued that failing to disclose the fact of the internal investigation was a material misrepresentation and that the Company materially misrepresented the effectiveness of its ICFR (as evidenced by the admission that such controls required improvement and strengthening).

Justice Perell held that there was no misrepresentation. He noted that the Company's auditors had not withdrawn or restated their clean audit opinion and had not required the Company to restate its financial statements. Justice Perell further noted that the plaintiffs' expert acknowledged that external auditors will not provide a clean audit opinion with respect to the effectiveness of ICFR where they have identified any material weaknesses in ICFR. Further, he noted the SEC never required the Company to restate any of its financial disclosure, including its disclosure relating to the effectiveness of its ICFR. Moreover, neither the plaintiff nor its expert could identify any particular weaknesses in the company's ICFR.

(iii) EBITDA Disclosure

The plaintiff argued that the Company's disclosure contained misrepresentations because it did not make clear that the SEC requested that the Company use the term "adjusted EBITDA."

Justice Perell disagreed. First, EBITDA is a non-GAAP measure for which there is no standard formula and MDC accurately reported its formula for calculating EBITDA. Second, evidence demonstrated that MDC

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did publicly disclose its exchange of correspondence with the SEC in which the SEC requested that the Company use the term “adjusted EBITDA.” Moreover, this alleged misrepresentation and the correspondence between the Company and the SEC occurred *before* the statutory leave period so it could not properly form part of the plaintiff’s claims.

(iv) CEO Compensation

Justice Perell concluded that none of the public statements contained any false statements about the CEO’s compensation and the amounts were immaterial in any event. Moreover, the CEO repaid all of the amounts, which were improperly expensed (as determined by the Company’s internal investigation). The SEC did not require a restatement of any of the previously issued financial statements, and on April 27, 2015, MDC announced that it did not expect there would be any impact to its previously issued financial statements.

(v) Reporting Units

Justice Perell found that MDC’s decision to change its grouping of partner firms into four reportable segments instead of two reportable segments was not material. In any event, this decision was made after the statutory leave period and was prompted by communications with the SEC, which also occurred after the statutory leave period.

The Upshot

Motions for leave provide a real opportunity for defendants to knock out a proposed class action in appropriate circumstances. Courts take the gatekeeper function of the leave test seriously and closely analyze evidence of materiality before allowing a proposed claim to proceed. In cases involving alleged financial disclosure misrepresentation, the absence of any restatement requirement by a regulator and/or the company’s independent auditors or any other amended disclosure is a powerful fact in establishing that any alleged misrepresentations are not material.

Wendy Berman, Lara Jackson, and Stephanie Voudouris of the Cassels Securities Litigation Group represented one of the individual defendant officers, the Company’s Senior Vice President and Chief Accounting Officer, on the motion for leave.
