

## Credibility Issues and Lack of Clear Record Lead to Rejection of Reasonable Investigation Defence as a Bar to Leave in Secondary Market Securities Class Action

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*Ontario Court of Appeal clarifies the approach to leave in statutory secondary market misrepresentation proceedings under Part XXIII.1 of the Ontario Securities Act where the reasonable investigation defence is raised.*

### Key Takeaways

- **Court of Appeal confirms criteria for leave when reasonable investigation defence is advanced.** At the leave stage, once the plaintiff has established a *prima facie* misrepresentation claim, the motion judge must decide whether there is a reasonable possibility that the defendant will not be able to establish one or more branches of the reasonable investigation defence at trial.
- **Motion for leave is not a mini-trial.** Where the record is limited and there are contentious issues of credibility, the proper course for the motion judge is to grant leave. The lack of a clear record makes evident that leave must be granted because there is no certainty that the reasonable investigation defence will succeed.
- **Integrity of the capital markets is an important consideration.** Where a motion judge denies leave, that decision must be consistent with the fundamental public policy underlying securities regulation, including continuous disclosure. Inconsistencies between a company's position in litigation and its public filings should attract significant scrutiny.

### Summary and Background

The Ontario Court of Appeal has clarified in *Rahimi v. SouthGobi Resources Ltd.*<sup>1</sup> the test for leave to proceed with a secondary market misrepresentation claim under section 138.8(1) and the defence of reasonable investigation under section 138.4(6)(a) of the *Securities Act*.<sup>2</sup> This putative secondary market securities class action against a corporate defendant, its auditor, and certain former executives and directors involved allegations of misrepresentations in the corporate defendant's financial statements between 2010 and 2012.

The corporate defendant, a coal mining company listed for trading in Toronto and Hong Kong, changed its revenue recognition policy effective January 2013, to be implemented on a go-forward basis. It concluded

that there was no need to restate its earlier financials. However, in November 2013, the corporate defendant nevertheless issued a formal restatement of its prior financial statements and announced in two press releases that its previous financial statements issued between 2010 and 2012 “are no longer accurate and should not be relied upon” and that there was a “material weakness” in determining appropriate financial accounting in respect of previous recognition policies. Following these announcements, the share price plummeted.

A putative class proceeding was commenced for all purchasers of shares of the corporate defendant between March 30, 2011 and November 30, 2013. The parties agreed that the question of certification should await the determination of leave under the *Securities Act*.

On the motion for leave, the defendants (other than the auditor) sought to rely on the defence of reasonable investigative efforts afforded to them by s. 138.4(6)(a) of the *Securities Act*. Contrary to the two press releases issued in November 2013, they submitted that the financial statements during the class period did not need to be restated and that there were in fact no material weaknesses in any internal financial reporting controls. Instead, they submitted, the restatement had been undertaken for other reasons and, as such, there was no misrepresentation in the corporate defendant’s financials during the class period – rather, the only potential misrepresentations were in the restatement itself or the press releases.

The motion judge permitted the proposed representative plaintiff to proceed against the corporate defendant (due to changes in management which called into question the defence of reasonable investigation) but not against the individual defendants on the basis that there was no reasonable possibility that the individual defendants would not be able to succeed on a defence of reasonable investigation at trial.

The proposed representative plaintiff appealed the motion judge’s decision to deny leave to proceed against the individual defendants. The corporate defendant cross-appealed the motion judge’s decision to grant leave as against it to proceed.

## **The Appeal**

The Court of Appeal allowed the appeal and dismissed the cross-appeal, holding that leave ought to have been granted to proceed as against the individual defendants. In its reasons, the Court of Appeal restated the principles applicable to leave motions under the *Securities Act* and clarified the approach to be taken when a reasonable investigation defence is raised. The Court of Appeal highlighted that leave motions are not to be treated as mini-trials, that both the evidence before the court and the evidence not before the court must be considered, and that the court’s analysis and decision should be animated by the fundamental public policy principles underlying the regulation of the capital markets, and in particular disclosure.

### **(a) The Leave Threshold**

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According to section 138.8(1) of the *Securities Act*, the court shall grant leave only where it is satisfied that (a) the action is being brought in good faith, and (b) there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.

The Court of Appeal applied the test for leave set out by the Supreme Court in *Canadian Imperial Bank of Commerce v. Green*,<sup>3</sup> which was based upon the test applied by the Supreme Court to a nearly identical provision of the Quebec *Securities Act*<sup>4</sup> in *Theratechnologies Inc. v. 121851 Canada Inc.*<sup>5</sup> Applying this jurisprudence, the Court of Appeal held that:

for there to be a reasonable possibility that a misrepresentation action will be resolved at trial in favour of the plaintiff under s. 138.8(1)(b), ‘there must be a reasonable or realistic chance that it will succeed,’ and the plaintiff must ‘offer both a plausible analysis of the applicable legislative provisions, and some credible evidence in support of the claim’: *Green*, at para 121. The plaintiff must adduce ‘sufficient evidence to persuade the court that there is reasonable possibility that the action will be resolved in the [plaintiff’s] favour’: *Theratechnologies*, at para 39.

The Court of Appeal underscored that a reasoned consideration includes some weighing of the evidence before the court, but also an assessment of what evidence is not before the court. Since full production is not required at the leave stage and the defendant may have relevant evidence that has not been produced, the motion judge must ensure that evidentiary limitations do not operate to prejudice a plaintiff who has a potentially meritorious claim.

In this case, the motion judge found that the proposed representative plaintiff had made out a *prima facie* case and that the real issue was whether there was a reasonable possibility that the defendants would not be able to establish one or more of the branches of the reasonable investigation defence at trial. The Court of Appeal held that the motion judge erred in law in approaching the motion as if it were a mini-trial. There were significant issues of credibility and a limited record. The proper course was not for the motion judge to use best efforts to resolve the issue on the available but unclear record. Rather, the lack of a clear record ought to have made evident that leave must be granted because there could be no certainty that the reasonable investigation defence would ultimately succeed.

## **(b) Reasonable Investigation Defence**

Following its analysis of the leave requirements, the Court of Appeal turned to the reasonable investigation defence, available under section 138.4(6) of the *Securities Act*. Pursuant to that section, a person or company is not liable in an action under section 138.3 in relation to a misrepresentation if that person or

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company proves that (a) before the release of the misrepresentation, the person or company conducted or caused to be conducted a reasonable investigation, and (b) at that time the person or company had no reasonable grounds to believe that the document or public oral statement contained the misrepresentation.

In this case, the Court of Appeal held that the motion judge's error in treating the leave motion as if it were a mini-trial was compounded by conducting a review of the credibility issues which failed to properly consider (i) the gaps in the evidence and (ii) the conflicting evidence. In pointing to numerous problems, the Court of Appeal noted that this was not a case where there was truly uncontroverted evidence in support of a reasonable investigation defence. Instead, this was a case where there was conflicting evidence emanating from the corporate defendant on the key issue for determination.

In coming to unwarranted evidentiary conclusions regarding the credibility of the individual defendants as the leave motion were a mini-trial, the motion judge improperly foreclosed a misrepresentation claim that had a reasonable possibility of success. Given the credibility problems with the individual defendants' evidence, which could only be determined at trial, the Court of Appeal held that this was not a case in which the policy objective of the leave requirement of protecting defendants from unmeritorious claims would be advanced by denying leave to the proposed representative plaintiff on the basis of the reasonable investigation defence.

## **(c) Public Policy**

The Court of Appeal also noted that the decision to deny leave in respect of the claim against the individual defendants was inconsistent with public policy underlying securities regulation, and that the motion judge had ignored the importance of continuous disclosure. In this case, the defendants argued that they should be permitted to invoke the reasonable investigation defence where corporate disclosure documents tell one story and evidence submitted to the court tells another. This discrepancy leaves investors guessing as to the corporation's true state of affairs, a circumstance and result that the Court of Appeal found unacceptable.

## **Conclusion**

This decision strongly suggests that courts should not entertain a reasonable investigation defence at the leave stage where there are serious issues of credibility surrounding the defence. A motion for leave is not a mini-trial. Where the plaintiff is able to establish a *prima facie* case in the misrepresentation claim and there is conflicting evidence on key issues for determination, a plaintiff should be granted leave to proceed with the claim.

And even in clearer cases, where a motion judge denies leave, that decision should be consistent with the fundamental principles underlying capital market regulation, including continuous disclosure. According to the Court of Appeal, "[t]here is no room for prevarication or double-talk" when it comes to a company's

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position in litigation and its public filings.

The Court of Appeal's decision in *Rahimi v. SouthGobi Resources Ltd.* is available [here](#).

If you have any questions concerning this case or securities litigation generally, please contact Wendy Berman, John M. Picone, Danielle DiPardo, or any other member of the Cassels Securities Litigation Group.

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<sup>1</sup> 2017 ONCA 719.

<sup>2</sup> R.S.O. 1990, c. S. 5 (the "Securities Act").

<sup>3</sup> 2015 SCC 60.

<sup>4</sup> C.Q.L.R., c. V-1.1.

<sup>5</sup> 2015 SCC 18.

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