New damages regime

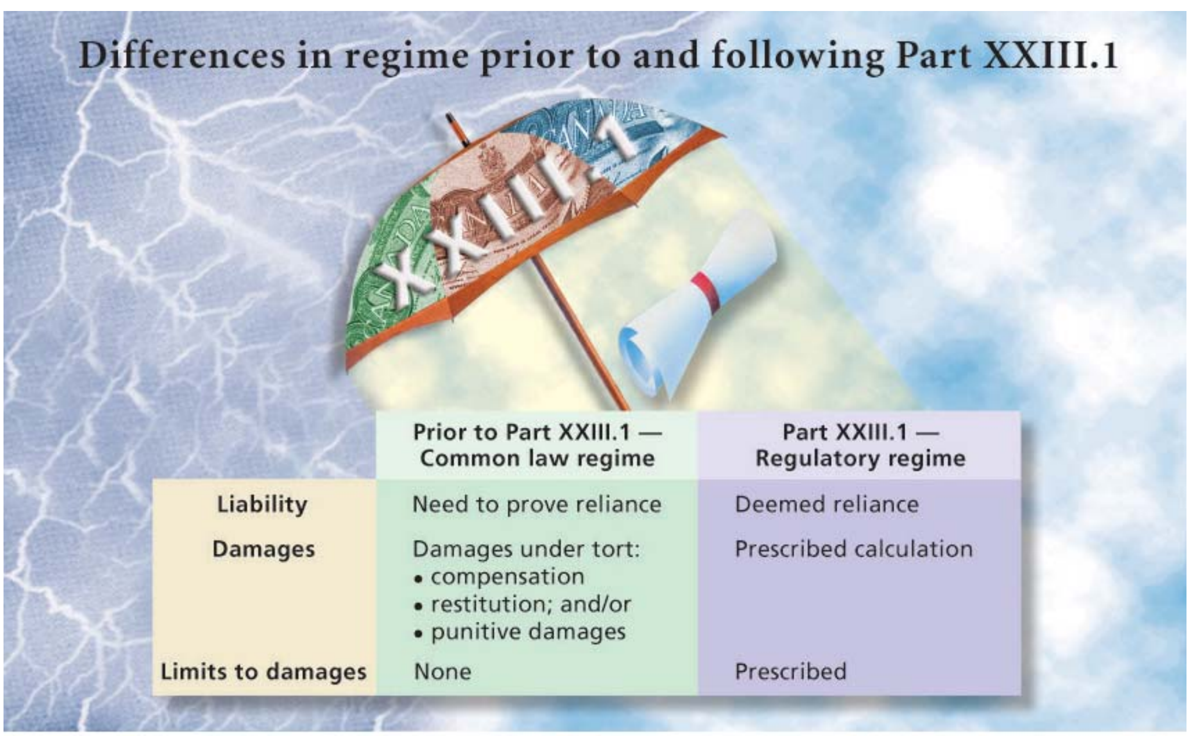
ALTERNATIVE WAYS TO SEEK REDRESS FOR PROBLEMS WITH SECURITIES TRADED IN THE SECONDARY MARKET

If proclaimed in force, Ontario Bill 198 will create Part XXIII.1 to Ontario Securities Act and a new regime for establishing liability and quantifying damages where parties buy and sell publicly traded securities in the secondary market (i.e., securities not traded under a prospectus). Part XXIII.1 focuses on civil liability for secondary market disclosure and prescribes the damages regime. Specifically, it addresses situations where a party has bought or sold securities and alleges it has sustained a loss caused by misrepresentations or failure to make timely disclosure on the part of the issuer or certain parties associated with the issuer. It does not replace the existing common law regime; it provides the aggrieved parties with an alternative avenue through which to seek redress.

Prior to the new Part XXIII.1, the plaintiff had to prove reliance, damages were quantified in accordance with common law and there were no limits on the quantum of the damages. The plaintiff could claim damages in tort, which include compensation, restitution and punitive damages.

Representations or misrepresentations include a broad array of communications such as traditional announcements, financial statements, quarterly reports, fairness opinions, valuations, commentary of all kinds, as well as more current communication formats including e-mails and websites. A failure to communicate or make timely communication are also culpable.

Broadly stated, Part XXIII.1 says the plaintiff is deemed



	Prior to Part XXIII.1 — Common law regime	Part XXIII.1 — Regulatory regime
Liability	Need to prove reliance	Deemed reliance
Damages	Damages under tort: • compensation • restitution; and/or • punitive damages	Prescribed calculation
Limits to damages	None	Prescribed

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to have relied on the representation in question or the lack thereof; prescribes the damages calculation and limits on the quantum of damages payable by the defendants.

These differences are summarized in the table on page 37.

Part XXIII.1 requires two different calculations in order to determine the plaintiff's damages:

- actual loss calculation — the difference between the price at which the securities were acquired and the price at which the securities were disposed of; and
- objective loss calculation — the difference between the price at which the securities were acquired and the trading price in the 10 trading days immediately after the misrepresentation was corrected or the required disclosure was made.

For example, if securities were acquired for $100 during the period of the misrepresentation or failure to make timely disclosure on the part of the issuer or certain parties associated with the issuer (the misrepresentation) and the average trading price of the securities in the 10 days trading after the misrepresentation was disclosed was $70, then the objective loss is $30. If the securities were disposed of for $70 within the 10 trading days after the misrepresentation was disclosed, the damages would be $30 as well. If the securities were disposed of prior to resolution of the related litigation, the damages would be the lesser of the actual loss and the objective loss. If the securities were sold, for example, at $80, the damages would be $20. If the securities were sold for $65, while the actual loss was $35, the damages would be restricted to $30. If, however, the securities were not disposed of prior to resolution of the related litigation, the damages would be $30 or the objective loss.

Similar logic applies if securities were disposed of during a period of misrepresentation. Clearly, a seller is entitled to compensation when the sale was made under the cloud of actual misrepresentation, inadequate or untimely disclosure.

The calculation of damages prescribed in Part XXIII.1 is based on the Allen Report. The report of the March 1997 committee of corporate disclosure considered a number of approaches to quantifying damages. It recommended damages be calculated on an out-of-pocket basis. Draft regulations, released May 1998, included a methodology for quantifying damages based on the plaintiff's actual loss.

Prior to reaching its conclusion, the report considered those measures used by US courts under section 10(b) of the Securities Exchange Act of 1934, and rule 10(b)5 of the Securities and Exchange Commission, including:

An out-of-pocket measure — the difference between the contract price, or the price paid, and the real or actual value at the date of sale. Thus, if a plaintiff bought stock for $75 a share, and the stock was worth $50 a share at the time the misrepresentation was made, the out-of-pocket measure of damages is $25 a share.

A benefit-of-the-bargain measure — focuses on the plaintiff's potential gain. Specifically, the measure calculates the difference between the price paid or received, and what could have been paid or received if the misrepresentation was true. Thus, if a plaintiff was told that stock was worth $75 a share and was only able to sell the stock for $40 a share once the misrepresentation was disclosed, the benefit-of-the-bargain measure of damages is $35 a share. This is notwithstanding that the stock might have been worth $50 at the time of the misrepresentation.

A cover or conversion measure — allows the defrauded seller to recover the difference between the highest value a security achieves within a reasonable period after the plaintiff discovers, or should have discovered, the fraud and the value of the consideration at the time of the transaction. Thus, if the defrauded seller sold stock for $40 a share and the stock subsequently reached a value of $80 a share within a reasonable time period, the cover measure of damages is $40 a share. This measure is a variation on the benefit-of-the-bargain measure. The cover measure takes the concept of worth to be the highest value a security achieves within a reasonable period after the plaintiff discovers the fraud.

The Chasins measure — allows the defrauded buyer to recover the difference between the lowest value a security achieves within a reasonable period after the plaintiff discovers, or should have discovered, the fraud and the value of the consideration at the time of the purchase. Thus, if the defrauded buyer bought stock for $50 a share, and the stock subsequently dropped to $18 a share within a reasonable time period, the Chasins measure of damages is $32 a share.

Consequential losses — in addition to the losses quantified above, the plaintiff may be entitled to recover other losses caused by the misrepresentation or failure to make timely disclosure. One example of a consequential loss might be a previously paid dividend.

Perfect storm conditions may be incubating in Canada if they haven't already arrived under the combined influence of SOX and related governance and securities enhancements

The damages payable under Part XXIII.1 are potentially limited through: the application of the principle of causality; the apportionment of the damages to each defendant and prescribed limits on the damages payable by each defendant.

The principle of causality requires the loss be caused by the misrepresentation or failure to make the required disclosure. "The assessed damages shall not include any amount that the defendant proves is attributable to a change in the market price of securities that is unrelated to the misrepresentation or the failure to make timely disclosure." The defendant may need to stratify the changes in the share price in light of economic and company factors influencing market price to ensure the loss was caused by a misrepresentation or failure to make timely disclosure on the part of the issuer.

The sophistication required of the expert will not be in the formulaic application of the prescribed damages, but rather in the stratification of the changes in the share price in light of factors both internal and external to the company influencing the market price to ensure damages are restricted to that portion of the loss caused by the misrepresentation or failure to make timely disclosure. In addition, expert opinion may also be required where there is no

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published market for the security or it is very thinly traded and the published market price is not the appropriate proxy. In the latter case, fundamental valuation principles will be essential to establishing the appropriate benchmark.

Section 138 requires the court to determine each defendant's portion of the aggregate damages assessed that corresponds to the defendant's responsibility for the damages. If the court determines that a defendant authorized, permitted or acquiesced in making the misrepresentation or the failure to make timely disclosure while knowing it to be a misrepresentation, or failure to make timely disclosure, the whole amount of the damages assessed may be recovered from that defendant.

Section 138 establishes liability limits depending upon the plaintiff's role (i.e., responsible issuer, director or consultant) and based on a formula using the issuer's market capitalization or the consultant's compensation. Damages otherwise payable under the liability limits are reduced for damages assessed in other actions in respect of the misrepresentation or failure to make timely disclosure, and amounts paid in settlement of any such actions. The liability limits do not apply "if the plaintiff proves that the person or company authorized, permitted or acquiesced in the making of the misrepresentation or the failure to make timely disclosure while knowing it to be a misrepresentation or failure to make timely disclosure."

Early in the dispute, counsel should consider preparing a number of what-if calculations of the amounts payable by the various defendants to the various plaintiffs, taking into account the formula for quantifying damages, possible apportioning of liability and limits on damages. This will assist in identifying the key factors that will increase or decrease the amounts payable and establishing the range of likely outcomes. If the dispute continues unresolved, counsel may require additional assistance to ensure damages have been correctly quantified.

The deemed reliance on the misrepresentation or failure to make timely disclosure will accelerate securities class actions and other securities litigations. Directors, officers, auditors and other experts will undoubtedly face greater risk. Further, the damage quantification regime is now formulaic but for the defendant's ability to reduce the computed amount for matters unrelated to the breach. The onus has clearly shifted to the defendant.

Perfect storm conditions may well be incubating in Canada if they have not already arrived under the combined influence of the Sarbanes-Oxley Act, related governance and securities regulations' enhancements and the new Part XXIII.1 to the Ontario Securities Act. In the long run, this is good news for investors, competent directors, professionals and class-action litigators and bad news for those not wanting to live in the increasingly transparent fishbowl of the public markets.

In October 2003, Stikeman Elliott LLP issued an informative analysis of the above and related changes to the Ontario Securities Act entitled Litigation Unleashed — perhaps this said it best.

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