SECURITIES CLASS ACTIONS

Moving Towards Clarity on the Viability of Fraud-on-the-Market in Quebec

Sarah Woods
Woods LLP

Introduction

The American fraud-on-the-market theory allows plaintiffs in a class action to establish the necessary element of reliance through common proof.

If the market is efficient, the theory goes, market prices will incorporate all publicly available information, including material misrepresentations, so that an investor who buys or sells stock in reliance on the integrity of the market price is in fact buying or selling stock in reliance on the material misrepresentations.[1]

Below, we set out why Canadian courts, and more specifically courts in Quebec, have rightfully been reluctant to embrace this theory in its American format.

Quebec, with its civil law backdrop, has managed to navigate these troubled waters and has moved towards greater clarity over the last few years, effectively distancing itself from the American doctrine of fraud-on-the-market, towards a distinctive civil law solution.

State of the Case Law on the "Fraud-on-the-Market" Theory in Quebec

(a) The Origins of the American Doctrine

The fraud-on-the-market theory stems from Rule 10b-5 of the *General Rules and Regulations Promulgated under the Securities Exchange Act of 1934*,[2] which states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

The United States Supreme Court addressed the validity of the fraud-on-the-market theory in *Basic, Inc. v. Levinson*.[3] Specifically, it examined whether reliance is a requisite element to be proven in order to successfully assert a private cause of action under Rule 10b-5. As a reminder, in cases involving publicly traded securities, the action's basic elements must include:[4]

- a material misrepresentation (or omission);
- scienter, i.e., a wrongful state of mind;
- a connection with the purchase or sale of a security;
- reliance, often referred to in cases involving public securities markets (fraud-on-the-market cases) as "transaction causation;"
- economic loss; and
- "loss causation," i.e., a causal connection between the material misrepresentation and the loss.

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[1] *In Re New Motor Vehicles Canadian Export v. American Honda*, 522 F.3d 6; 2008 U.S. App. LEXIS 6483, at 25.

[2] *General Rules and Regulations Promulgated under the Securities Exchange Act of 1934*, (U.S.) 17 C.F.R. §240 (the "*Rules*").

[3] *Basic Inc. v. Levinson*, 485 U.S. 224, 99 L. Ed. 2d 194, 108 S. Ct. 978 (1988) ("*Basic*").

[4] *Dura Pharmaceuticals, Inc. v. Broudo, Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 161 L. Ed. 2d 577,125 S. Ct. 1627 (2005) ("*Dura*"), at 1631.

The fraud-on-the-market theory assumes that the investing public relies on the integrity of the securities market to establish market prices that are equal to the value of the securities being traded:[5]

> We turn to the question of reliance and the fraud-on-the-market theory. Succinctly put:
>
> > The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business ... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements .... The causal connection between the defendants' fraud and the plaintiff's purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

In short, *Basic* stands for the principle that "[r]eliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury," and gives plaintiffs in a class action the benefit of a presumption that it indirectly relied on the alleged misrepresentation by relying on the integrity of the stock price established by the market, as long as all other requirements of Rule 10b-5 are met.[6]

As a result, the rationale of the fraud-on-the-market theory is that investors in securities of a company will be defrauded by any public and material misstatement or material omission regarding that company, including those investors who do not directly rely upon the misstatement or omission.

The State of the Fraud-on-the-Market Theory in Quebec

Reliance is an essential ingredient in any claim for negligent misrepresentation, whether in the field of securities or otherwise.

Generally, in Canada, excluding Quebec, a plaintiff must specifically plead the following in order to establish a claim for negligent misrepresentation:[7]

- the existence of a duty of care based on a "special relationship" between the representor and the representee;
- that the representation in question was untrue, inaccurate or misleading;
- the representor must have acted negligently in making the said misrepresentation;
- the representee must have relied, in a reasonable manner, on the said negligent misrepresentation; and
- the reliance must have been detrimental to the representee in the sense that damages resulted.

Turning now to Quebec, secondary market claims alleging misrepresentation can also be based on extra-contractual obligations, as was held in *Comité syndical national de retraite Bâtirente inc v. Société financière Manuvie*.[8] The courts have confirmed that as is the case for any extra-contractual civil liability matter, the Petitioner, to be successful on the merits, must prove (1) fault, (2) damages, and (3) causation between the fault and the damages[9] according to article 1457 of the *Civil Code of Quebec* ("CCQ"):

> 1457. Every person has a duty to abide by the rules of conduct which lie upon him, according to the circumstances, usage or law, so as not to cause injury to another.
>
> Where he is endowed with reason and fails in this duty, he is responsible for any injury he causes to another person by such fault and is liable to reparation for the injury, whether it be bodily, moral or material in nature.
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> He is also liable, in certain cases, to reparation for injury caused to another by the act or fault of another person or by the act of things in his custody.

[5] *Basic*, supra note 3 at 988-989.

[6] Ibid. at 989; see *Thompson v. Relationserve Media Inc.*, 2010 U.S. App. LEXIS 13371 (2010), at 121; also, see *Dura*, supra note 4 at 1631.

[7] *Queen v. Cognos Inc.*, [1993] 1 S.C.R. 87.

[8] *Comité syndical national de retraite Bâtirenteinc v. Société financière Manuvie*, 2011 QCCS 3446 ("*Manulife*").

[9] *Manulife*, ibid., generally; also, see *Theratechnologies inc. v. 121851 Canada inc.*, 2015 SCC 18 ("*Theratechnologies*"), at paragraph 28.

In misrepresentation claims and in claims where the damages are related to the loss in value of securities, a plaintiff, in addition to proving there exists a causal link between the fault and the damages allegedly suffered, must also prove that the damages are an immediate and direct consequence of the alleged misrepresentation, as per article 1607 of the CCQ:

> 1607. The creditor is entitled to damages for bodily, moral or material injury which is an immediate and direct consequence of the debtor's default.

The civil law regime does not *per se* require proof of common law proximity for an action in tort to succeed, but article 1607 of the CCQ does ensure that the damages are an immediate and direct consequence of the fault.

Reframed in terms of a civil action based on misrepresentation, a plaintiff must show that it suffered damages due to declarations that a prudent and cautious defendant would not have made, and that the plaintiff's damages are a direct result of the impugned declarations. There is no doubt that in a civil liability context, the plaintiff's biggest obstacle in a misrepresentation claim is the causation elements required as per article 1457 and 1607 of the CCQ: the plaintiff must prove on a balance of probabilities that the alleged damages were caused by the defendant's false declarations or omissions.

More recently, in the *Manulife* securities class action, the Respondent Manulife argued that failure by the Petitioners to successfully plead causation in its proceedings was fatal to the recourse as the criterion set out at article 1003 of the *Code of Civil Procedure* would not be satisfied:[10]

> 1003. The court authorizes the bringing of the class action and ascribes the status of representative to the member it designates if of opinion that:
>
> [...]
>
> (b) the facts alleged seem to justify the conclusions sought;

The Respondents in *Manulife* argued that the Petitioners, to be successful, would have to prove causation on the following two points:[11]

- each investor relied, at the time of the purchase of the security, on Manulife's alleged misrepresentations; and
- that the misrepresentation on which he or she relied effectively had a (negative) impact on Manulife's security price.

With respect to (b) above, the Court decided that a hearing on authorization was not the proper forum to determine whether the Petitioners' argument that invoking fraud-on-the-market was sufficient to satisfy this requirement.[12] The Court further elaborated that in certain circumstances, such as in *Morin v. Blais*,[13] a statutory violation could serve to establish a presumption of causation in civil law and subsequently, could "justify the conclusions sought." This, however, was once again deemed to be a question for the judge on the merits.[14]

With respect to (a) above, the Court again turned to possible causation presumptions on which a judge on the merits could base its findings, as per article 2849 of the CCQ, to conclude that the misrepresentation had a (negative) impact on the security's price:[15]

> 2849. Presumptions which are not established by law are left to the discretion of the court which shall take only serious, precise and concordant presumptions into consideration.

Thus, the Court in *Manulife* heavily favoured sourcing the grounds for causation in available civil law remedies, rather than attempting to adopt the American fraud-on-the-market doctrine (albeit leaving the door open to doing so in the context of a hearing on the merits).

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[10] *Manulife*, supra note 8 at paragraph 87.

[11] Ibid. at paragraphs 88 and 89.

[12] Ibid. at paragraph 94.

[13] *Morin v. Blais*, [1977] S.C.R. 570.

[14] *Manulife*, supra note 8 at paragraphs 96 and 97.

[15] Ibid. at paragraph 99; the Court also refers to *Biondi v. Syndicat des cols bleus regroupés de Montréal (SCDP-301)*, 2010 QCCS 4073, at paragraphs 136 and 137.

A Quebec Statutory Remedy for Misrepresentation on the Secondary Market

During the 1990s, the Toronto Stock Exchange created the Allen Committee to re-examine the regime governing disclosure in the secondary market. The Allen Committee recommended the creation of a statutory civil liability regime that would help investors sue issuers, directors, and officers who violated their statutory disclosure obligations.[16] Quebec implemented the recommendations of the Canadian Securities Administrators through Bill 19, *An Act to amend the Securities Act and other legislative provisions*,[17] which received assent on November 9, 2007.[18]

Under this new statutory regime, investors were released from the heavy burden of demonstrating causation thanks to article 225.12 of the *Quebec Securities Act*,[19] which states:

> 225.12. The plaintiff is not required to prove that the plaintiff relied on the document or public oral statement containing a misrepresentation or on the issuer having complied with its timely disclosure obligations when the plaintiff acquired or disposed of the issuer's security.

The investor, by virtue of article 225.12 of the QSA, is thus relieved from proving:

- that the variation in the market price of the security was linked to the misinformation or omission; and
- that they personally relied on that information or omission in buying or transferring the security.[20]

This is in stark contrast with the civil law requirement of having to prove reliance on a misrepresentation that immediately and directly caused damages when the "truth" was revealed.[21]

[16] *Theratechnologies*, supra note 9 at paragraph 29.
[17] S.Q. 2007, c. 15,
[18] *Theratechnologies*, supra note 9 at paragraph 32.
[19] R.S.Q. c. V-1.1,("*Q.S.A.*").
[20] *Theratechnologies*, supra note 9 at paragraph 33.
[21] S. Rousseau, "Étude du recours statutaire en responsabilité civile pour le marché secondaires des valeurs mobilières au Québec" (2009) 43 *R.J.T.* 709, at 753.

It should be noted that article 225.12 of the QSA does not create a presumption of reliance equivalent to the fraud-on-the-market theory. Indeed, it merely stipulates that when a security is acquired or transferred at the time of a false declaration or omission of information that should have been disclosed, the fluctuation in the value of the security is presumed to be attributable to that fault.[22] It thus only creates a presumption, which is a fraction of the much broader American presumptions contained in the fraud-on-the-market theory.

We further note that this presumption is rebuttable, as per article 225.30 of the QSA, which states:

> 225.30. Assessed damages are not to 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.

Further, various substantive and procedural limitations were incorporated into the relevant articles of the QSA as a counterbalance for this very investor-friendly presumption, notably the presence of a damages cap.[23]

Conclusion

The Allen Committee's preoccupations with easing the plaintiff's difficult burden of proving causation in misrepresentation class action cases was certainly a reflection of the Canadian courts' discomfort associated with a blunt importation of the American doctrine of fraud-on-the-market into Canada.

Soldevila S.C.J.'s judgement in *Manulife* is cautionary for plaintiffs hoping to file a class action based on alleged misrepresentations all the while attempting to avoid the limits imposed by the QSA. Indeed, despite the civil avenues available to them in their pursuit of proving causation, which we might add at this stage have yet to be explored in a judgement on the merits, causation remains a real evidentiary hurdle. This is even more so in light of the lessons to be gleaned from the recent Supreme Court of Canada decision in *Theratechnologies*, whereby the obligations to

[22] *Theratechnologies*, supra note 9 at paragraph 33.
[23] C.f. article 225.33 of the Q.S.A.

prove all the elements of liability, i.e., fault, damages and causation in cases of misrepresentation were reaffirmed.[24]

We thus conclude that we are indeed closer than ever to gaining some clarity on the viability of the doctrine of fraud-on-the-market in Quebec. Our view is that Quebec courts are more likely than ever to favour a home-grown civil law solution to the question of reliance in non-statutory misrepresentation class actions, rather than searching for a solution across the border.

[24] *Theratechnologies*, supra note 9 at paragraph 28.