



The IMAX Case: Superior Court certifies first-ever Ontario shareholder class action for misrepresentations on the secondary market

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In a pair of decisions released the same day, Justice Katherine van Rensburg of the Ontario Superior Court of Justice became the first judge to consider the statutory remedy created under section 138.3 of the Ontario *Securities Act* (the "Act") for shareholders of public companies who suffer damages from public company misrepresentations on the secondary securities market in documents such as annual financial statements and other public documents. In these decisions, Justice van Rensburg granted leave for Marvin Silver and Cliff Cohen to bring a claim under section 138.3 of the Act against the IMAX Corporation and several of its current and former officers and directors,¹ and also certified their section 138.3 claim as a class action.² These decisions are noteworthy because they represent the first time the courts have considered section 138.3's requirement that a plaintiff obtain leave of the court to proceed with such an action, and the first time an action brought under section 138.3 has been certified as a class action.

The plaintiffs in IMAX allege that several of the company's continuous disclosure filings contained misrepresentations because they prematurely recognized revenue associated with the installation of certain IMAX theatres. The plaintiffs further allege that these misrepresentations under the Act were only corrected by a subsequent restating of IMAX's financial statements and they seek damages caused by the drop in the value of their shares that occurred when IMAX's misstated financial results were corrected. In other words, the plaintiffs claim

they bought their IMAX shares at an inflated price based upon an inaccurate picture of the company's revenue at the time of their purchase.

The Cause of Action

Section 138.3 of the Act provides a civil cause of action to any shareholders who buy or sell the securities of a public company on the secondary market (i.e. a stock market) where misrepresentations existed in the marketplace at the time of the purchase or sale of their shares. This right of action exists against the company itself, and against a multitude of persons and entities related to the company.³

Securities actions arising from corporate misrepresentations are usually only economical if brought as class actions, as it is rare for an individual shareholder to suffer losses on a single stock of a magnitude to warrant the cost of prosecuting such complex litigation. However, it has traditionally been difficult for plaintiffs' counsel to have such claims certified as class actions – as there was typically no common issue relating to shareholders' reliance upon a particular misrepresentation in buying their shares. Further, it was hard to prove precisely the damages caused by a particular misrepresentation – as opposed to other market forces. In creating a statutory cause of action for public company misrepresentations, s.138.3 of the *Securities Act* eliminates or at least

lessens these two historical hurdles to the certification of class actions. Regarding the first hurdle, the Act provides that a shareholder has a right of action for damages whether or not they actually relied on the misrepresentation in question.⁴ On the damages issue, the Act provides a formula for the calculation of damages for claims brought under section 138.3 based upon the difference between a shareholder's purchase price and the share price after the misrepresentation has been corrected.⁵

The Leave Requirement

In addition to potentially facilitating shareholder class actions, section 138.3 also seeks to put a brake on the type of unmeritorious shareholder class actions (often referred to as "strike suits") that have historically plagued public companies in the U.S. Under section 138.3, shareholders are required to obtain prior leave of the court in order to be permitted to proceed with an action against a public company under section 138.3. In order to obtain leave, plaintiffs must satisfy the court that: (1) the action is brought in good faith; and (2) there is a reasonable possibility that the action be resolved at trial in favour of the plaintiff.⁶

In IMAX, Justice van Rensburg was the first to interpret the dual requirements of good faith and a reasonable possibility of success at trial, the latter of which is a statutory test that exists nowhere else in Canadian legislation.

Good Faith

Justice van Rensburg interpreted "good faith" to mean the plaintiffs must establish they are bringing their action "in the honest belief that they have an arguable claim, and for reasons that are consistent with the purpose of the statutory cause of action and not for an oblique or collateral purpose."⁷

On their leave application, the plaintiffs had adduced affidavit evidence stating they had a personal financial interest in the action on account of shares purchased during the relevant time

period, and stating that they wanted to hold IMAX, as a public company, responsible for its misrepresentations. There was no evidence to suggest any ulterior purpose. Accordingly, Justice van Rensburg found that the good faith requirement was met.

Reasonable Possibility of Success at Trial

Justice van Rensburg interpreted the "reasonable possibility of success at trial" requirement as imposing a relatively low threshold on the plaintiffs.⁸ She held that this step of the leave test is "designed to prevent an abuse of the court's process through the commencement of actions that have no real foundation; actions that are based on speculation or suspicion rather than evidence."⁹ The low threshold is warranted because of the limited amount and quality of evidence available to the court at the leave stage (i.e., no documentary or oral discoveries, evidence not tested in open court).¹⁰

In applying the above principles based on the evidence before her, Justice van Rensburg concluded that the fact that IMAX had restated its financials, and in its restatement admitted that its original financials did not comply with GAAP, meant that the plaintiffs would have a reasonable possibility of success at trial in establishing a misrepresentation.¹¹

Justice van Rensburg granted leave to proceed against both IMAX and several individuals who were associated with the company and involved in its financial disclosures. Based on their level of involvement in preparing and reviewing the financial statements, Justice van Rensburg found that the plaintiffs had a reasonable probability of success against the two co-CEO's of IMAX, the CFO, the VP of Finance and Comptroller, the directors of the company that were members of the audit committee, one director that frequently attended meetings of the audit committee (although not actually a member of the audit committee at the material times).

Justice van Rensburg, however, refused to allow the action to proceed against two external directors of IMAX who were not members of the audit committee. Justice van Rensburg found that the directors not directly involved in the IMAX financial statements would be able to succeed in advancing the “reasonable investigation” defence¹² and should therefore not be included in the proposed action under s.138.3.

Noteworthy Aspects of the Decisions, and Unanswered Questions

In addition to the basic conclusions set out above, there are several other aspects of the decision of Justice van Rensburg that are notable:

- Justice van Rensburg held that it is not necessary to plead fraud in advancing a section 138.3 claim, as liability flows from the absence of due diligence, not fraud.¹³
- Justice van Rensburg held that the “reasonable possibility of success” stage of the leave test involves a consideration of not only of the viability of the cause of action in a given case (i.e., the existence of a misrepresentation), but also a consideration of any defences available to the proposed defendants.¹⁴
- Although Justice van Rensburg’s interpretation of the “reasonable possibility of success at trial” requirement may superficially appear to impose a low threshold for obtaining leave, this requirement may still amount to a substantial practical barrier to plaintiffs’ counsel – especially in situations where the evidence needed to prove the case is primarily in the possession of the defendant corporation, and not otherwise obtainable by plaintiffs’ counsel (unlike the case in IMAX, where the primary evidence of a misrepresentation was itself a public document). Because a plaintiff must meet this test before discoveries it can be very difficult, if not impossible, to compel a defendant to disclose information that may be key to establishing a reasonable chance of success.
- Justice van Rensburg found that she must conduct an individual determination for each defendant as to whether the plaintiff had a reasonable possibility of success against each defendant at trial, as opposed to a global consideration of the likelihood of success as against all defendants.¹⁵
- Justice van Rensburg held that the business judgment rule (i.e. deference to corporate management decisions that are made in good faith) should not be read into the “reasonable investigation” defence, because such an approach would be inconsistent with the purposes of the Act.¹⁶
- Justice van Rensburg held that the company, its inside officers/directors, and members of the audit committee were not certain to succeed on a defence of “reasonable investigation”, in spite of the fact that the financial statements in question were also approved by IMAX’s external auditor.¹⁷
- Unlike the other defendants, the external directors that were not involved in the audit committee were permitted to rely upon the report of the external auditors, and rely upon the opinion of the audit committee, in making out the defence of reasonable investigation.¹⁸
- Justice van Rensburg held that the defendants could not make out the “expert reliance” defence with respect to the external audit. She held that the expert reliance defence is not triggered by the fact that an expert was relied upon, but rather the defence is only triggered where the misrepresentation was contained within a document that “includes, summarizes or quotes from a report, statement of opinion made by the expert.”¹⁹ The misrepresentation in this case was contained in the financials prepared by IMAX.²⁰
- The main point of resistance on the 138.3 claim by counsel to IMAX was on the leave application, and not on the class action

certification motion.²¹ The class action was certified for a global class of IMAX investors, based largely on supplementary common law causes of action asserted by the plaintiffs. In essence, the 138.3 claim was subsumed into the global class on account of the common law claims advanced against the defendants. Accordingly, there was no fulsome consideration of the geographic constraints of section 138.3; a remedy granted by Ontario statute. Justice van Rensburg speculated that the defendants may advance an argument in their

statement of defence that section 138.3 does not apply to all class members, irrespective of where the class members reside, and on which stock exchange the class members purchased their shares.²²



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¹ *Silver v. IMAX Corp.*, [2009] O.J. No. 5573 (S.C.J.) [*IMAX Leave Decision*].

² *Silver v. IMAX Corp.*, [2009] O.J. No. 5585 (S.C.J.) [*IMAX Certification Decision*]. The certification decision also involved several common law claims including negligent misrepresentation, “reckless” misrepresentation, and conspiracy.

³ *Securities Act*, R.S.O. 1990, c. S.5, s. 138.1 [*Securities Act*].

⁴ *Ibid.*

⁵ *Ibid.*, s. 138.5.

⁶ *Ibid.*, s. 138.8

⁷ *IMAX Leave Decision*, *supra* note 1 at para. 308.

⁸ *Ibid.* at para. 25.

⁹ *Ibid.* at para. 330.

¹⁰ *Ibid.* at para. 326.

¹¹ *Ibid.* at para. 351.

¹² *Ibid.* at para. 426.

¹³ *Ibid.* at para. 345.

¹⁴ *Ibid.* at para. 333.

¹⁵ *Ibid.* at para. 336.

¹⁶ *Ibid.* at paras. 371-72.

¹⁷ *Ibid.* at paras. 387-99, 410-23

¹⁸ *Ibid.* at paras. 424-26.

¹⁹ *Securities Act*, *supra* note 3, s. 138.4(11).

²⁰ *Leave Decision*, *supra* note 1 at paras. 432-35.

²¹ *Certification Decision*, *supra* note 2 at paras. 12-13.

²² *Ibid.* at para.154.