

New Canadian Securities Law = Potential for Greater Personal Liability

On December 31, 2005, liability for Canadian public companies and their executives changed significantly with the introduction of new securities disclosure laws in Ontario. Previously, security holders could only sue based on misrepresentations made in an offering prospectus made during the initial public offering (IPO) stage. The new Bill 198 changes the *Securities Act (Ontario)* to impose liability when there has been a misrepresentation in a company's public disclosure, or when a company has failed to report a material change to its business in a timely manner, in the secondary market. The "secondary" market includes securities exchanges and over-the-counter trading where securities are bought and sold after they were brought public (in the "primary" market).

The new law has teeth as it expands the enforcement powers of the Ontario Securities Commission. Specifically, it establishes new offenses and increased penalties for violations by any company listed on the Toronto Stock Exchange or which has a strong connection to Ontario (so on the face of it, it is not limited to Canadian domiciled or listed companies). Other Canadian jurisdictions have indicated that they will be enacting similar legislation on a provincial basis, opening the door to a *de facto* national regime – something entirely new for Canada in the securities area.

Critical Features

The new liabilities are very similar to US Rule 10b-5 actions, with some notable differences. Significant provisions of the new law include:

- 1. Deemed Reliance:** Perhaps the most important provision is the removal of the requirement to establish actual reliance on a misrepresentation (effectively adopting the US "fraud on the market" theory). Liability can now be found even if an individual investor in the class did not rely on, or was not even aware of, the company's inaccurate disclosure.
- 2. "Intent" Not Necessary:** Under the new law, plaintiffs do not need to prove that the defendants intended to deceive, manipulate or defraud, or that they acted recklessly. This lower pleading standard may signal a more plaintiff-friendly environment than the US.
- 3. Damage Caps:**
 - a. Corporate liability caps** – the greater of 5% of market cap or \$1 million.
 - b. Personal liability caps** - the greater of \$25,000 or 50% of their remuneration as directors

NOTE: The individual caps do *not* apply if there has been "knowing violation of the disclosure rules." Plaintiffs will no doubt allege "knowing violation" to avoid the liability caps.
- 4. Judicial Leave:** Court approval is required to commence an action, and leave will be granted on the basis that the action is brought in good faith and has a reasonable possibility of success.



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While this may seem to protect defendants against frivolous US-style strike suits, *conversely*, it may give rise to early discovery, before class certification and before summary judgment. This may fuel cross-border litigation and cooperation between firms as US plaintiff firms seek to get early discovery in Canadian actions and try to use that information in parallel US litigation.

5. Rebuttable “Loss Causation”: Price changes of securities after the disclosure violation is revealed are now automatically deemed to have been caused by the violation, with the onus on the defendant to prove the changes are due to other factors. This goes further than the US and takes a step back from the defense protection afforded by the recent *Dura Pharmaceuticals* decision by the US Supreme Court. [For a discussion of *Dura*, see the *ER Alert* on The Top 10 Court Awards and Settlements of 2005].

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Potential Impact on Directors and Officers (D&O) Liability Insurance

As of the date of this newsletter, there has been no litigation under this new legislation, but legal observers and insurance carriers alike are anticipating greater exposure with the potential for more frequent and severe litigation. Areas that may be affected include:

- **Rates** – The threat of US plaintiff firms’ collaboration in Canadian suits may put upward pressure on pricing.
- **Underwriting** – Insurers will likely focus on disclosure control policies, internal controls, procedures for releasing public statements, record retention policies and forward-looking statements.
- **Defense Costs** – Likely to increase in size and to be incurred earlier in the process, with the need for preliminary motions for court approval to commence actions.
- **Insured Persons** – Bill 198 extends liability to “influential persons” and “experts”, which expands the category of potential defendants beyond directors and officers. Care must be taken to ensure D&O insurance is broad enough, but not too broad to dilute limits originally intended for directors and officers.

- **Personal Conduct Exclusions** – Those requiring “deliberate fraud” and “final adjudication” may be the best given the likelihood that plaintiffs will plead “knowing violations” of the law.
- **Insured v Insured** –The proportionate liability provisions of Bill 198 may increase claims between insured defendants who seek to exercise a right of contribution between each other, and create conflicts of interest. (Severability provisions which prevent imputation of warranties and conduct from one insured to another will be important).

Conclusion

Public companies in Canada may want to review the amount of D&O insurance they buy. With increased exposure for both companies and the executives who run them, it might also be appropriate to examine possible alternate program structures, including whether the company and the executives should share coverage and/or whether dedicated A-Side coverage might be suitable. Finally, independent directors may be more concerned about their dedicated insurance protection given their increased exposure for what may be day-to-day operational decisions.

The Law of Unintended Consequences

In *Merrill Lynch v Dabit*, the US Supreme Court recently addressed two interesting issues: 1) the intersection of state versus federal securities litigation and 2) the right that holders of securities have to sue to recoup paper losses. Most securities suits that we are familiar with are brought by those who *sold* stock after a stock drop rather than those who continued to own or hold the stock. In federal court, they usually allege violations of §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

Section 10(b) makes it unlawful for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange, any manipulative or deceptive device or contrivance.

In connection with the sale of any security, Rule 10b-5 makes it unlawful for any person, directly or indirectly, to (a) employ any device, scheme or artifice to defraud, (b) make any untrue statement of a material fact or omit to state a material fact necessary to make the statements actually made appear 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

When Congress passed the Private Securities Litigation Reform Act of 1995 (SRA) it intended to end frivolous litigation by tightening the standards for federal securities class actions. In some ways, it was so *successful* that an unintended consequence was to shift securities suits away from federal court to state court, where the pleading standards were lower. The unfortunate result for many defendants was that rather than reducing litigation, they then faced suits not only in federal court, but in a number of parallel state court actions as well – all arising out of the same events.

To close this loophole, three years after passing the SRA, Congress passed the Securities Litigation Uniform Standards Act (SLUSA). With some exceptions¹, under SLUSA, any state case where there are more than 50 plaintiffs alleging misrepresentations or omissions regarding the purchase or sale of securities can be removed to federal court. While SLUSA pushed many securities actions into federal court, due to ever creative plaintiff firms, it was not completely successful in ending all efforts to avoid federal jurisdiction. One evasive attempt may have been an increase in filings of state-court derivative suits. Due to their traditional role and well-established place in state court, derivative actions had been carved out of SLUSA.

Know When to Hold 'Em, Know When to Fold 'Em

Another attempt was the state law "holding" claim, like *Dabit*. Turning our classic securities claim on its head, in these suits, the plaintiffs allege not that fraud induced them to buy or sell a security but that the fraud (the lie) convinced them to continue to *hold* a security they would otherwise have sold. Note that because these claims, ostensibly, do not plead a purchase or sale of securities, on the face of it, they do not fall under the federal reach of §10(b) or Rule 10b-5.

The Feds to the Rescue

Until last month, federal courts had to grapple with whether or not holder cases are exempt from SLUSA. With a split in the courts on this issue, the US Supreme Court agreed to decide the matter, which it did emphatically in its unanimous 8-0 decision in *Dabit*. In ruling against holders, the Supreme Court held that when examining potential preemption under SLUSA, the distinction between holders and purchasers or sellers was irrelevant. The phrase "in connection with the purchase or sale of securities" as used in prior related legislation should be broadly construed to require only that the fraud coincide with a securities transaction. Further, the broad construction of SLUSA was consistent with congressional intent to curb vexatious class action litigation alleging securities fraud.

The Future's Not Hard to See

For the plaintiffs in *Dabit*, the fact that their suit will be removed to federal court is likely to be a bad thing. Under a 30-year-old decision, the Supreme Court has already held (in *Blue Chip Stamps v. Manor Drug Stores*) that private rights of action under Rule 10b-5 should be limited to plaintiffs who were actual purchasers or sellers, based on the premise that suits by non-purchasers and non-sellers present a special risk of vexatious litigation that could "frustrate or delay normal business activity." This makes it seem a fairly safe bet that the *Dabit* plaintiffs will not fare well in federal court with their holder case. In fact, removal to federal court may well prove fatal to their cause.

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Conclusion

Dabit is no doubt a valuable win for potential defendants facing the specter of securities litigation under 50 different state securities laws, in up to 50 different state jurisdictions. But, in spite of both the Supreme Court's decision in this case and SLUSA, state law actions will continue to be a potential problem. Institutional plaintiffs, as an example, are realizing that if they choose not to join a federal class action, they can file actions in state court and avoid both SLUSA's removal and the SRA's heightened pleading standard. These opt-out state court actions can create real difficulties for defendants, with no discovery stays or pretrial coordination with the federal securities class action. So, the fight, in both state and federal court may continue on a different basis.



¹Exceptions to SLUSA include class actions based on the law of the state where the public company is incorporated, actions brought by a state agency or state pension plan, actions under contracts between issuers and indenture trustees, and derivative actions brought by shareholders on behalf of a corporation.

Corporate Governance for ERISA Fiduciaries – Differentiating Your Risk

Most of us have become accustomed to how we demonstrate good corporate governance from a Directors and Officers (D&O) liability perspective, but have continued to be challenged when it came to demonstrating superior governance when considering the unique responsibilities imposed by the Employee Retirement Income Security Act of 1974 (ERISA). Two recent factors exacerbated this problem.

The first is the continued hard market conditions for Fiduciary Liability insurance. This can be seen in the fact that there can be few insurance carriers willing and able to insure the primary layers for large or challenging risks and that higher premiums are often still the rule upon renewal. Additionally, some companies have found it difficult to purchase higher limits of coverage for their larger exposures. In this marketplace, it can be critical for fiduciaries to be able to distinguish themselves from the rest of the “pack.”

The second factor is today’s increased scrutiny of pension plans and their fiduciaries. In the US, this can be seen in the recent and ongoing investigation of pension assumptions by the Securities and Exchange Commission (SEC), the Department of Labor’s (DOL) continued enforcement initiatives, the Internal Revenue Service’s (IRS) announced increase in enforcement audits, and most recently, the announced two-year investigation by New York’s State Attorney General of pension plans and their relationship with investment advisors. Taken together with the growth of an active plaintiffs’ bar, these factors indicate that today’s ERISA fiduciaries are under the spotlight and their actions (or inactions) are likely to be questioned.

A countervailing trend – which could serve to both differentiate one’s risk and have a prophylactic impact on the actual exposure facing the plan, the plan fiduciaries and the plan sponsor – is an ERISA compliance audit. To date, at least one insurance company writing Fiduciary Liability insurance is actively advocating fiduciary audits and providing incentives in the form of enhanced insurance coverage for those who receive passing grades. From a risk management perspective, merely to review the audit questionnaire could provide a real benefit as it may allow one to benchmark the plan’s compliance against the external standards that will be applied by the DOL and IRS.

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