The Reliance Element in U.S. and Canadian Securities Class Actions | Securities Litigation

By James K. Goldfarb, Sumon Mazumdar, Usman M. Sheikh, and Sarah Woods – September 9, 2015

The United States and Canada both provide an aggrieved investor with redress for securities violations. In the United States, an investor may attempt to recover money damages under section 10(b) of the Securities Exchange Act of 1934, the general antifraud provision of the federal securities laws. In Canada, until recently, an investor's main recourse was tort law, principally common-law negligent misrepresentation and fraud causes of action. Statutory causes of action for securities misrepresentations have only recently been enacted and are still evolving. Despite those differences in the evolution and form of securities remedies in the United States and Canada, the challenge of proving reliance, the element connecting an investor's decision to buy or sell a security to a defendant's misstatement or omission, is common to both countries' securities class action regimes. What an investor must show to prove reliance, how it may show it, and whether it must be shown at all are answered differently in each jurisdiction. Understanding those differences might prove particularly useful as the plaintiffs' securities bar seeks greener pastures north of the border, while the Canadian courts adapt to recent developments arguably designed to mimic the U.S.-securities-based presumption of reliance in securities class actions.

The Element of Reliance in the United States

Section 10(b), together with U.S. Securities and Exchange Commission Rule 10b-5, prohibits a person from making a material misstatement or omission in connection with the purchase or sale of a security. To prevail on a section 10(b) claim and recover money damages, an investor must prove, at least, that he or she bought or sold a security because of a defendant's materially false or misleading statement or omission. As noted, the element connecting the investment decision to the statement or omission is called "reliance" or "transaction causation."

Investors commonly attempt to pursue section 10(b) claims collectively, under Rule 23(b)(3) of the Federal Rules of Civil Procedure, which governs class actions. To qualify for class treatment under that rule, a plaintiff must prove, among other things, that common questions of law or fact predominate over individual questions, thereby meriting class-wide treatment. But until 1988, tension among the reliance element of section 10(b), the predominance element of Rule 23(b)(3), and the realities of the securities markets confounded the federal courts. Specifically, the common-law conception of "reliance" as a personal exchange of information between a buyer and seller seemed ill-suited to the reality of the nature of transactions in the impersonal, modern securities markets. Moreover, if each putative class member had to prove that he or she personally read or heard a material misstatement on which he or she relied to invest in a given security, individualized, not common, questions of fact would predominate, likely making securities fraud class actions extremely difficult to proceed.

Addressing those tensions in 1988, the U.S. Supreme Court held that, rather than having to prove direct reliance, a plaintiff could invoke a rebuttable presumption of reliance. *See* [Basic Inc. v. Levinson](), 485 U.S. 224 (1988) (*Basic*'s rebuttable presumption of reliance applies to affirmative misrepresentations. The Supreme Court fashioned a different presumption of reliance for omissions. *See* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153–54 (1972)). The Court based the presumption on the "fraud-on-the-market" theory. That theory, itself drawn from the efficient market hypothesis developed by economists in the late 1960s and early 1970s, posits that in an efficient market, the price of a security rapidly reflects all material public information, including material misrepresentations. In other words, a public, material misrepresentation is baked into the market price at which an investor transacts—i.e., the fraud is "on the market." In application, reliance is presumed if a plaintiff can show that the misstatement was publicly made and material, the security was traded in an efficient market, and the plaintiff transacted in the security between the time the misrepresentation was made and the truth was revealed to the market.

The fraud-on-the-market theory can play out at two different stages of a securities class action. At the merits stage, the parties may dispute whether the misrepresentation was material—materiality being an element of a section 10(b) claim, as well as an essential predicate of the fraud-on-the-market theory. In contrast, market efficiency, as well as publicity and trade timing, may be, and commonly are, adjudicated earlier, at the class certification stage, when the lead plaintiff (and hopeful class representative) attempts to prove by a preponderance of the evidence that the putative class satisfies the Rule 23 requirements.

Typically, a plaintiff attempts to show market efficiency through the existence of a number of the following factors: (1) the average weekly trading volume expressed as a percentage of total outstanding shares; (2) the number of securities analysts following and reporting on the stock; (3) the extent to which market makers and arbitrageurs trade in the stock; (4) the company's eligibility to file SEC registration Form S-3 (as opposed to Form S-1 or S-2); (5) the existence of empirical facts "showing a cause-and-effect relationship between unexpected corporate events or financial releases and an immediate response in the stock price; (6) the company's market capitalization; (7) the bid-ask spread for stock sales; and (8) float, the stock's trading volume without counting insider-owned stock. The first five factors were identified in *Cammer v. Bloom*, 711 F. Supp. 1264, 1286–87 (D.N.J. 1989); the final three in *Krogman v. Sterritt*, 202 F.R.D. 467 (N.D. Tex. 2001). No federal appeals court has definitively approved those factors and, aside from the fifth factor (cause and effect), most financial economists question whether the factors are probative of market efficiency. Still, the factors have gained general acceptance in the federal district courts.

If the plaintiff carries its burden to show reliance (through the fraud-on-the-market theory), the defendant may rebut the presumption of reliance by, among other things, "[a]ny showing that severs the link between the alleged misrepresentation and . . . the price received (or paid) by the plaintiff." *Basic*, 485 U.S. at 248. For years, the lower courts disagreed about when and how a defendant could avail itself of the *Basic* rebuttal. The Supreme Court resolved the disagreement last year. *Halliburton Co. v. Erica P.*

John Fund, Inc., 134 S. Ct. 2398 (2014). The Court held that a defendant may rebut the presumption of reliance at the class-certification stage by showing a lack of price impact; that is, by showing that the alleged misrepresentations did not affect the security's price. Absent price impact, the "basis for finding that the fraud had been transmitted through market price would be gone," and individual questions of reliance would overwhelm common questions. Accordingly, the Court concluded that considering price impact at the class-certification stage was appropriate. Exactly how price impact will play out in different factual scenarios remains to be seen.

Reliance in Canada

Securities law in Canada has developed differently than in the United States. Investors proceeding under Canadian law only recently gained a statutory cause of action for securities misrepresentations. Up to that point, in Canada's common-law jurisdictions, an investor's principal remedy was to assert common-law causes of action and, in Québec, claims based on the Civil Code of Québec. (The province of Québec is the only jurisdiction in Canada that retains a civil law system and is governed by a civil code. All other Canadian provinces and territories are governed by the common law.) In each case, reliance posed a substantial obstacle for investor classes. For example, to prove the tort of negligent misrepresentation in common-law jurisdictions, a putative class of investors had to prove that each investor reasonably relied to his or her detriment on the impugned misstatement or omission (*see* *Queen v. Cognos Inc.*, [1993] 1 S.C.R. 87,110 (S.C.C.)), a difficult task. A class of investors suing under the Québec's Civil Code had a similarly heavy burden, also having to prove that each investor had relied on the misinformation in making his or her respective trades (*see* Civil Code of Québec arts. 1457 & 1607).

The fraud-on-the-market theory, as applied in the United States, has received an unkind reception in Canada. Despite several invitations to do so, Canadian courts have repeatedly resisted its application (*see, e.g.*, *Carom v. Bre-X Minerals Ltd.*, (1998) 40 O.R. 3d 780 (Can. Ont. Gen. Div.)). Courts in several Canadian provinces have yet to expressly decide the matter. In one recent case in Québec, for example, the issue was deferred to a later stage. *See Comité syndical national de retraite Bâtirente inc v. Société financière Manuvie*, 2011 QCCS 3446 (*Manulife*). Several reasons explain the resistance. First, courts have reasoned that the theory would improperly require the redefinition of the well-established common-law torts of negligent and fraudulent misrepresentation, which have long required proof of actual reliance as an essential component (*see Bre-X* ¶ 40 (noting that "to import such a presumption would amount to a redefinition of the torts themselves")). Second, courts have perceived that the theory was developed in the United States in response to a unique statutory context involving claims under Rule 10b-5 and to have been "almost unanimously rejected" in the United States when advanced in the context of common-law claims, such as those at issue in Canada (*see Bre-X* ¶ 36). As a result of those rulings and other perceived impediments for investors seeking redress, secondary market class actions in Canada languished.

Despite the resistance to American-style claims, and partly because of it, that tide has now somewhat

changed. Specifically, Canada has seen two recent developments that have assisted investor classes in overcoming the requirement to prove individualized, actual reliance. First, as of 2005, provincial and territorial legislatures began enacting statutory causes of action for secondary market liability to facilitate investor recovery. The legislation featured provisions designed to relieve investors from having to prove actual reliance (*see, e.g.*, Ontario Securities Act § 138.3; Quebec Securities Actart. 225.12). But the statutes also included safeguards to ensure Canadian courts would not be flooded with the "strike suits" that plague U.S. courts. ("Strike suits" are a plaintiffs' bar practice of filing a section 10(b) action immediately upon any material share price drop—a sort of "shoot first, ask questions later" strategy. The U.S. Congress passed the Private Securities Litigation Reform Act of 1995 in part in an effort to curb strike suits.) Thus, investors attempting to rely on those statutes are subject to strict damages caps, special limitation periods, and a "leave" requirement. Under the "leave" requirement, in order to commence a claim, a claimant must satisfy a court that its proposed action is brought in good faith and that the reasonable possibility exists that the action will be resolved at trial in favor of the claimant. As the Supreme Court of Canada made clear this year, the "leave" requirement serves as a "robust deterrent screening mechanism" that requires claimants to offer "some credible evidence in support of [their] claim" in order to proceed (*see Theratechnologies Inc. v. 121851 Canada Inc.*, 2015 SCC 18 (Can.)).

Second, in an effort to withstand motions to strike and overcome the hurdles posed by the certification test for common-law negligent misrepresentation claims, secondary market claimants have taken an alternate route to establishing reliance for common-law claims. They have asserted that reliance can be inferred from the specific facts and circumstances of the case, one of the central circumstances being that the security in question traded on an efficient market (*see, e.g.*, *CC&L Dedicated Enter. Fund (Tr. of) v. Fisherman*, [2001] O.J. No. 4620, 18 BLR 3d 260 (S.C.J.)). As Justice Cumming explained in *Fisherman*,

> [h]ad the plaintiffs simply pleaded the 'fraud on the market theory' I would have foreclosed that consideration. Given, however, that the case law recognizes that a person's reliance upon a representation may be inferred from all the circumstances, in my view it would be premature to foreclose the consideration of this issue in the case at hand beyond the pleading stage.

Fisherman, para. 69.

A similar approach was taken at the securities class action authorization ("certification") in *Comité syndical national de retraite Bâtirente inc v. Société financière Manuvie*, 2011 QCCS 3446 (Can.), in which Justice Soldevila of the Superior Court of Québec stated that, in certain circumstances, a presumption of reliance could be inferred by the trial judge, if the requisite conditions are demonstrated (per article 2849 of Québec's Civil Code, for example).

The inferred reliance theory has had mixed success when challenged on motions to strike and on certification/authorization motions. However, the theory has yet to be tested at trial and, therefore, it

remains to be determined whether the court will be prepared to draw an inference of reliance, whether an inference of reliance will fulfill the plaintiff's burden of proof, and how the individual issues associated with rebutting the inference will be addressed.

Conclusion

While there have clearly been significant developments on both sides of the border in recent years on the issue of reliance in securities cases, it is still too early to assess their impact. In the United States, all eyes will be watching the treatment by the courts of the rebuttable presumption at the certification stage following the recent *Halliburton* decision. Will the courts be receptive to defense challenges at certification on the basis of a lack of price impact, making the United States less favorable to investor claims?

In Canada, for its part, while recent developments have suggested a more welcoming environment to investors seeking redress for securities law violations, several substantial challenges appear to remain. More specifically, the statutory safeguards and limitations imposed by provincial and territorial legislatures, the recent dicta from *Theratechnologies*, and the lack of general acceptance of the inferred reliance argument leave no doubt that neither common-law nor statutory claims will be a “walk in the park” for the investor-plaintiff in Canada.

One thing seems certain: This is an area to watch, as parties and courts on both sides of the border continue to develop the contours of the fraud-on-the-market and inferred reliance theories as well as the statutory causes of action to assist aggrieved investors with their claims.

Keywords: litigation, securities, investor reliance, negligent misrepresentation, fraud

James K. Goldfarb is a securities litigation partner at Murphy & McGonigle in New York City, New York. Sumon Mazumdar, a financial economist, is the lead director of the Securities & Finance Practice at Navigant Consulting in Oakland, California. Usman M. Sheikh is a securities litigation partner at Gowlings LLP in Toronto, Ontario. Sarah Woods is a partner at the litigation boutique firm Woods LLP in Montreal, Québec.

> Navigant Consulting is the Litigation Advisory Services Sponsor of the ABA Section of Litigation. This article should be not construed as an endorsement by the ABA or ABA Entities.

Copyright © 2016, American Bar Association. All rights reserved. This information or any portion thereof may not be copied or disseminated in any form or by any means or downloaded or stored in an electronic database or retrieval system without the express written consent of the American Bar Association. The views expressed in this article are those of the author(s) and do not necessarily reflect the positions or policies of the American Bar Association, the Section of Litigation, this committee, or the employer(s) of the author(s).

More Information