



Liability for Secondary Market Disclosure

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On December 14, 2009, in *Silver v. IMAX Corporation*, the Ontario Superior Court granted leave for the plaintiffs to proceed with their class action under the secondary market liability provisions of the *Securities Act* (Ontario) (the "Act").¹ It is the first time leave has been granted for an action under those provisions. As such, the decision offers at least preliminary guidance as to how courts will interpret those rules.

Background

On February 17, 2006, IMAX issued a press release announcing that it had completed a record 14 theatre installations in the fourth quarter of 2005 and expected to meet or exceed its full year earnings guidance for 2005.

On March 9, 2006, IMAX filed its Form 10-K containing its 2005 annual financial statements and issued a press release reporting on its earnings and revenues. It also announced that day that its board had made a decision to explore strategic alternatives for the company, including a sale or merger.

On August 9, 2006, IMAX issued a press release stating that it was in the process of responding to an informal inquiry from the SEC regarding the timing of its revenue recognition (related to the manner in which IMAX recognized revenue as related to its process of installing theatre systems). The press release also disclosed that as of that time, no buyer had emerged offering a satisfactory price for the company. The next day, IMAX's share price dropped 40%.

In 2007, IMAX restated its financial statements for a number of previous years. The restatement acknowledged that IMAX had erred in the manner in which it had recognized revenue (revenue being recognized prematurely) and that its financial statements had not complied with GAAP.

Subsequently, a class action was commenced alleging that IMAX had misrepresented that (i) its

revenue for 2005 had met or exceeded the company's previous earnings guidance; (ii) its financial statements complied with GAAP; and (iii) it had completed a number of theatre installations in 2005. The misrepresentations were alleged to have been made in IMAX's Form 10-K and the February and March 2006 press releases. IMAX and certain of its officers and directors were named as defendants in the action.

The Secondary Market Liability Provisions

The Right of Action

At the end of December 2005, the Act was amended to give purchasers of securities in the secondary market a statutory right of action against issuers and their directors and officers for misleading, insufficient or untimely disclosure.²

Pursuant to the Act, a disclosure violation is triggered when a misrepresentation about the issuer is made in:

- Public documents released by an issuer or a person or company with authority to act on behalf of an issuer.
- Public oral statements made by a person with authority to speak on behalf of an issuer.

Or through:

- The failure by an issuer to make timely disclosure of a material change in its affairs.

An investor who acquires or disposes of an issuer's securities during the period where there is a continuous disclosure violation (the period of time between when the disclosure violation first occurred and when it was publicly corrected), has a statutory right of action for damages, irrespective of whether the person or company relied on the misrepresentation.

Defences

An issuer and/or its directors and officers will not be liable in an action under the secondary market liability provisions if they can prove that (i) before the release

¹ The court, in a separate ruling, also certified the action as a class action proceeding.

² New Part XXIII.1 – *Civil Liability for Secondary Market Disclosure*

of the document containing the misrepresentation, the issuer and/or its directors and officers conducted (or caused to be conducted) a reasonable investigation; and (ii) at the time of the release of the document, the issuer and/or its directors and officers had no reasonable grounds to believe that the document contained a misrepresentation (commonly referred to as the “due diligence defence”).

In determining whether the due diligence investigation was reasonable, the rules provide that the court will consider “all relevant circumstances”, including, among a list of specified factors, the existence, if any, and the nature, of any system designed to ensure that the issuer meets its continuous disclosure obligations.

Leave to Proceed

No action may be commenced under the secondary market liability provisions without the leave of the court. Pursuant to section 138.8 of the Act, the court will grant leave only if it is satisfied that the action is (i) being brought in good faith; and (ii) there is a reasonable possibility that the action will be resolved in favour of the plaintiff.

The Decision

Justice van Rensburg found that the plaintiffs had met the “good faith” requirement in that they had a personal interest in the action and had also asserted altruistic reasons for bringing the action (being to hold the defendants accountable for making misrepresentations to the public). With respect to the “reasonable possibility” requirement, the judge indicated that “there must be something more than a *de minimus* possibility of success at trial” and found that the fact IMAX had restated its previous financial statements in 2007 and had admitted that those statements did not comply with GAAP lent support to the plaintiffs’ claim of misrepresentation, and therefore the plaintiffs had a reasonable possibility of success at trial for establishing that a misrepresentation had been made.

The Due Diligence Defence

The defendants argued that the matters at issue arose from an accounting judgment made by IMAX in completing its financial statements for 2005, that the accounting issues were complex, that a reasonable investigation had been conducted and that the defendants reasonably relied on the advice of the company’s auditors, even if the judgment proved ultimately to be in error.

In considering the proper elements of the due diligence defence and whether the defendants had

established the factual basis for relying on that defence, the court determined that the “business judgment rule” of judicial deference to corporate decisions had no application, indicating:

“There is no compelling reason for a court to apply the business judgment rule when considering the [due diligence] defence in the context of a statutory remedy for secondary market misrepresentation. Statutory disclosure obligations exist to protect investors and the capital markets. There is a mandatory obligation to issue accurate financial statements, with strict liability for any material misrepresentation, subject to the prescribed defences. The onus of establishing the defences is on the defendants, and the terms of the defences are prescribed by the statute. Reading in a standard of deference to a director’s decisions would be both unnecessary and inconsistent with the scheme and purpose of the statutory remedy.”

With respect to IMAX and its officers, the court found that there was a reasonable possibility that they would not succeed in establishing a due diligence defence by reason of their own participation in IMAX’s accounting, an admitted lack of internal controls, their knowledge of the status of the theatre installations in question and their knowledge of IMAX’s past practices, policies and disclosures respecting revenue recognition.

With respect to certain of IMAX’s directors, the court noted that these individuals were aware of the potential issues with IMAX’s financial reporting and that the circumstances that existed at the time may well have called for closer scrutiny on the part of those directors (by reason of their positions, responsibilities and knowledge). The court stressed that its finding did not mean that the plaintiffs were likely to succeed against some or all of those individuals, but only that there was sufficient evidence to meet the threshold for including them as defendants. The court also noted that an important issue to be tried was the extent to which those individuals or any of them were entitled to rely upon the opinions and advice of the company’s auditors.

Justice van Rensburg refused leave with respect to two of IMAX’s directors, finding they had no knowledge of the matters involved in the misrepresentation.

Implications of the Decision

The defendants have sought leave to appeal the IMAX decision. If the decision is not overturned, the case would suggest that the requirement to obtain leave for an action under the secondary market liability provisions of the Act may not be overly

difficult to obtain. At a minimum, one of the implications of a restatement of an issuer's financial statements may have become clear.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.

If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.

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