The preliminary merits test for secondary market claims is not just a “speed bump” to certification: The Supreme Court of Canada clarifies the test with its decision in *Theratechnologies Inc. v. 121851 Canada Inc.*

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Following amendments made in the last decade to various provincial Securities Acts to include statutory causes of action in the secondary market against public issuers for misrepresentation and/or failure to make timely disclosure to investors there has been ongoing debate about the appropriate threshold test for obtaining the requisite leave to commence a secondary market class action. Courts in British Columbia, Ontario and Quebec have each considered this issue: all seeking to find a balance between preventing cases without a realistic prospect of success but encouraging those with a likelihood of success.

On April 17, 2015, the Supreme Court of Canada released its decision in *Theratechnologies Inc. v. 121851 Canada Inc.* providing guidance on the preliminary merits test and settling the debate. In so doing, the court held that the statutory preliminary merits test in the Quebec legislation requires that there be “a reasonable possibility that the action will be resolved in the claimants favour” which necessitates “the claimant to offer both a plausible analysis of the applicable legislative provisions, and some credible evidence in support of the claim.”

The decision will have a significant impact on second market securities class actions in Canada.

Background

As Madam Justice Abella noted in *Theratechnologies*:

During the 1990s, following a series of high profile misrepresentations and incidents of questionable disclosure practices among publicly traded companies in Canada, the Toronto Stock Exchange created the Allen Committee to re-examine the regime governing disclosure in the secondary market. The Allen Committee concluded that the "current sanctions and funding available to regulators... are inadequate" and "the remedies available to investors in secondary trading markets who are injured by misleading disclosure are so difficult to pursue that they are, as a practical matter, largely hypothetical": Committee on Corporate Disclosure, Final Report - Responsible Corporate Disclosure: A Search for Balance (Toronto Stock Exchange, 1997), at p. 5. It
recommended the creation of a statutory civil liability regime that would help investors sue issuers, directors, and officers who violated their statutory disclosure obligations.  

Subsequently, the Canadian Securities Administrators adopted most of the Allen Committee's recommendations and began developing proposals to implement them across Canada. It also recommended that a screening mechanism be mandated as part of the statutory regime to ensure that only claims with a reasonable chance of success would be brought.

Secondary market civil liability arrived in Canada on December 31, 2005 when the Ontario Securities Act was amended to include a statutory cause of action against public issuers for misrepresentation and/or failure to make timely disclosure to investors. Other provinces followed suit shortly thereafter. For example, Alberta enacted its secondary market liability regime on December 31, 2006 followed by Manitoba on January 1, 2007, Quebec on November 9, 2007, Saskatchewan on January 1, 2008 and British Columbia on July 4, 2008.

These statutory causes of action for misrepresentation in the secondary market reduced the burden of proof on investors by removing the requirement to prove reliance on the misrepresentation. Prior to these legislative changes, investors in the common law provinces were compelled to consider bringing claims in tort for negligent or fraudulent misrepresentation. Proof of reliance, a key element in such causes of action, was often a barrier to the ability of an individual to bring a successful claim and was a major impediment to the certification of a class action as it made it difficult for a proposed representative plaintiff to demonstrate the requisite commonality and preferrability elements necessary for certification.

As discussed in detail by Abella, J. in Theratechnologies, the secondary market civil liability regimes, in addition to lowering the burden of proof for investors, include a “screening mechanism” to discourage unmeritorious litigation and strike-suits which are commonly seen in the United States. This gatekeeping function was achieved by adding a leave requirement (which is not present in the corresponding U.S. legislation) thereby foreclosing plaintiffs from commencing an action for breach of the statutory disclosure obligations under the applicable Securities Act without obtaining prior approval of the court. Court approval may be granted if the plaintiff can establish:

1. the action is being brought in good faith; and
2. there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.

This requirement is similar across the secondary market civil liability statutory regimes in most Canadian provinces.

It was generally anticipated that Canadians would see an influx in secondary market class actions as a result of this statutory reform. Although we have certainly seen an increase in such actions, it might be argued that we have seen less of an increase than initially anticipated. There has nonetheless been a steady upward growth year over year.

The Debate

In British Columbia, Ontario and Quebec debate and commentary arose in respect to the standard required to meet the threshold test on an application for leave.

Round v. MacDonald, Dettwiler and Associates Ltd. was the first decision in British Columbia to address the threshold issue for commencing a secondary securities market action on the basis of misrepresentation of material facts and breach of disclosure obligations under the Securities Act. The chamber’s judge dismissed the plaintiff’s application for leave on the basis that the events giving rise to the action occurred before the secondary market statutory regime was in place in British Columbia. The judge also dismissed the argument that the plaintiff did not personally need to have a cause of action in order to advance the claim on behalf of others finding instead that this was a necessary requirement. The chamber’s judge made the following comments in that regard:

[72] Much of this argument neglects the plain wording of the statute. It will be recalled, first, that the test for leave involves the court being satisfied that there is "a reasonable possibility that the action will be resolved at trial in favour of the plaintiff": s. 140.8(2)(b). Additionally, section 140.8(3) states:
Upon an application under this section, the plaintiff and each defendant must serve and file with
the court one or more affidavits setting forth the material facts upon which each intends to rely.

[73] Taken together, several propositions emerge from these sections. First, the leave application involves a review of evidence. Each side is required to provide evidence of material facts upon which each intends to rely. Secondly, the analysis must involve a weighing and balancing of the evidence of each side. It is not sufficient for the court simply to rely on material filed by the plaintiff. Thirdly, the test involves an assessment of the merits of the proposed action on the evidence. The court must analyze the evidence to decide whether it is satisfied that the "reasonable possibility" test is satisfied. [Emphasis added]

In considering the “reasonable possibility” component of the test, the chamber’s judge further commented:

[76] Establishing a reasonable possibility of success at trial involves more than merely raising a triable issue or articulating a cause of action. Equally, it does not require a plaintiff to demonstrate that it is more likely than not that he or she will succeed trial. But it is clear, in my view, that the test is intended to do more than screen out clearly frivolous, scandalous or vexatious actions. An action may have some merit, and not be frivolous, scandalous or vexatious, without rising to the level of demonstrating that the plaintiff has a reasonable possibility of success. [Emphasis added.]

While the Court of Appeal upheld the chamber judge’s refusal to grant leave, it did not directly deal with whether the action had a reasonable prospect of success on the merits. The events giving rise to the action occurred before the statutory cause of action was in existence. The Court of Appeal therefore agreed with the chamber judge’s conclusion that there was no reasonable possibility that the plaintiff’s claim could succeed as the secondary market liability provisions did not apply retroactively and the plaintiff could not rely on parallel provisions in the Ontario legislation that had earlier come into force and effect.

The judge’s comments in *Round v. MacDonald* provided some general guidance on the “reasonable possibility” threshold in British Columbia suggesting that the courts gatekeeping function was to do more than simply screen out frivolous, scandalous or vexatious claims.

In Ontario, the courts appeared to adopt a less stringent threshold. In *Green v. CIBC*, Mr. Justice Strathy suggested that the leave requirement is a relatively low threshold:

[373] I respectfully agree with van Rensburg J. and Tausenfreund J. that the leave requirement is a relatively low threshold. It is meant to screen out cases that, even though possibly brought in good faith, are so weak that they cannot possibly succeed. This is consistent with the purpose of the legislation – to screen out strike suits that are plainly unmeritorious. It is not meant to deprive bona fide litigants, with a difficult but not impossible case, from having their day in court. This interpretation is also consistent with the philosophy of our legal system that contentious issues of fact and law are generally decided after a full hearing on the merits. [Emphasis added.]

In *Ironworkers v. Manulife Financial*, Mr. Justice Belobaba noted his reservation against such a low threshold. In his view, the threshold had become nothing more than a “speed bump” requiring plaintiffs to simply show a triable cause of action. His Honour preferred the approach taken by the British Columbia Supreme Court in *Round v. MacDonald* but felt that the matter was doomed given the Supreme Court of Canada’s decision in *R v. Imperial Tobacco Canada*.

The Supreme Court of Canada’s decision in *Theratechnologies* addressed this debate in the Quebec context.

The Decision in *Theratechnologies*

In *Theratechnologies*, the plaintiff, 121851 Canada Inc., sought leave to commence a class proceeding against Theratechnologies Inc. (“Thera”) for damages resulting from breach of its statutory disclosure obligations under the *Quebec Securities Act*. Thera, a pharmaceutical company, was in the process of applying to the FDA for approval of a new drug called Tesamorelin. As part of that process, Thera provided information and updates to its shareholders. It also provided a Briefing Package to an expert Advisory Committee convened by the FDA. The Briefing Package contained various information on Tesamorelin as well as results of clinical studies that Thera had previously disclosed to its shareholders. These trials studied the potential side effects of Tesamorelin including an
increased risk of diabetes. The results demonstrated that there were no major safety concerns and that any such effect was minor and could be clinically managed.

The FDA also delivered a briefing document including a Background Memorandum to the Advisory Committee. The Background Memorandum contained questions about Tesamorelin’s potential side effects. The Briefing Package and the material provided by the FDA to the Advisory Committee was published on the FDA website as per its policy.

Following publication of the material, several stock quotation companies publically expressed concern about Tesamorelin’s potential side effects. Thera did not react as it was of the view that the material it had provided to the FDA provided a comprehensive response to these concerns.

Over the two days following these public commentaries, Thera’s stock fell by 58 percent. On the third day, the Advisory Committee voted in favour of approving the drug and Thera’s stock bounced back. The plaintiff had sold its shares in Thera during this period at a significant loss. It sought leave to commence a class proceeding claiming that the information of an increased risk of diabetes and the FDAs questions about those side effects amounted to a material change and that Thera had breached its statutory disclosure obligations under the Securities Act.

The issue at the heart of the case was the evidentiary threshold of the “reasonable possibility” requirement when seeking leave under the Securities Act to commence an action for compensation. Both the motion’s judge and the Court of Appeal concluded that the plaintiff had met the threshold and as such had granted the plaintiff’s application for leave. Thera appealed to the Supreme Court of Canada.

The Supreme Court of Canada allowed the appeal and unanimously concluded that the plaintiff had not met the requisite burden under the “reasonable possibility” threshold. In writing the court’s decision, Abella, J. confirmed that the test “sets out a different and higher standard than the general threshold for the authorization of a class action under art. 1003 of the C.P.P.” which is considered a “low threshold”. 12

The legislature intended to create a more “meaningful screening device” within the securities regime. The purpose of which is to strike a balance between avoiding unmeritorious claims and strike suites. The court is given an “important gatekeeping role” and is required to conduct a “preliminary examination” with a “reasoned consideration of the evidence” to ensure that the action has some merit on an application for leave under section 225.4 of the Quebec Securities Act.

Abella, J. agreed with Belobaba J.’s comments in Ironworkers v. Manulife Financial, stating that the test should be more than a mere “speed bump”. The test requires “that there be a “reasonable or realistic chance that the action will succeed.” While Abella, J. was cautious to point out that a leave application should not amount to a “mini-trial”, she further clarified that “sufficient evidence” is required to demonstrate that “there is a reasonable possibility that the action will be resolved in the claimants favour.” She stated the threshold as follows:

A case with a reasonable possibility of success requires the claimant to offer both a plausible analysis of the applicable legislative provisions, and some credible evidence in support of the claim.18

In applying this approach to the case at bar, Justice Abella found that the plaintiff had not provided any evidence of a material change in Thera’s operations, capital or business. The drop in shares was related to an external event. There was no evidence to suggest that the questions posed by the FDA or the Briefing Package departed from the regular and routine FDA process nor that it presented any “new” or “undisclosed” information.

Justice Abella went on to add some additional clarity to the meaning of the “material change” test. Abella, J. emphasized the distinction between “material facts” and “material change” clarifying that not all material events or information will necessarily result in a material change. To do otherwise would improperly expand the disclosure obligations under the Act.19 As a result:

Thera had a statutory duty to disclose material changes in its operations, capital or business in a timely manner, not to reassure its investors at every stage of the FDA approval process.20

[Emphasis added]

Conclusion
The decision in *Theratechnologies* has given some much needed clarification to the evidentiary threshold issue for the leave test for secondary market claims. Although concerned with the *Quebec Securities Act*, this decision will impact other provinces in Canada having a parallel regime. Its effect will be most pronounced in Ontario where the threshold was previously seen as a low one and will assist in reaffirming the more stringent approach taken in jurisdictions like British Columbia. While we will undoubtedly continue to see an increase in securities class actions in Canada, the Supreme Court of Canada’s decision in *Theratechnologies* is bound to decrease the need for strike applications by setting a higher hurdle for plaintiffs seeking to commence class proceedings in this area.

1. *Theratechnologies Inc. v 121851 Canada Inc.*, 2015 SCC 18
2. *Ibid* at para 29
4. For example, see *Securities Act*, RSBC 1996, c 418, s 140.8; *Securities Act*, RSA 2000, c S-4, s 211.08; *Securities Act*, RSO 1990, c S.5, s 138.8; *Securities Act*, CQLR, c V-1.1, s 225.4.
6. 2011 BCSC 1416 aff’d 2012 BCCA 456
7. 2012 BCCA 456 at para 57
8. 2012 ONSC 3637
9. Also known as *Dugal v. Manulife Financial*, 2013 ONSC 4083
11. 2011 SCC 42
12. *Supra* note 1 at para 35
13. *Supra* note 1 at para 36
14. *Ibid*
15. *Supra* note 1 at para 38
16. *Ibid*
17. *Supra* note 1 at para 39
18. *Ibid*
19. *Supra* note 1 at para 53
20. *Supra* note 1 at para 54

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