SECONDARY MARKET LIABILITY SECURITIES CLAIMS: EVIDENCE NEEDED FOR LEAVE

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Statutory provisions for secondary market liability do not require claimants to prove that they relied upon alleged misrepresentations or omissions. This differs from available Canadian common law claims about misrepresentations. In turn, they permit more straightforward use of class actions in relation to securities matters. The *quid pro quo* is that before commencing such a claim, a claimant must first obtain leave from the court.[1]

Few decisions are made about leave to commence secondary market misrepresentations each year. A recent British Columbia Supreme Court decision considers this important, but infrequently adjudicated, statutory test for granting leave for secondary market liability. The decision in *Tietz v. Cryptobloc Technologies Corp.*[2] is notable for its careful review of evidence to determine whether leave should be granted.

The court ultimately granted leave to the petitioners to proceed against four out of six issuers. It reserved judgment with respect to one. It denied leave as against one. McMillan LLP acted for the issuer that successfully defended the petitioners' claim. This bulletin examines the court's reasoning about when there is a reasonable chance of success for secondary market liability claims.

Background

The petitioners applied for leave pursuant to s. 140.8 of the British Columbia *Securities Act* (the "**Act**") to bring secondary markets claims against six securities issuers[3], and some of their directors and officers within a proposed class action.[4]

The petitioners' claims concern alleged misrepresentations in documents released by the issuers in connection with private placements that occurred between January and August 2018.[5] The common allegation as between each issuer was that consultants associated with the private placements were paid consulting fees by the issuers around the time of the private placement.

In November 2018, the British Columbia Securities Commission (the "**Commission**") issued a news release and a temporary order prohibiting a group of consultants from buying or selling securities of eleven companies,

which included the six issuers at issue in *Tietz*.[6] The temporary order stated that the Commission was concerned about the connection between the private placements and the consulting agreements.[7] Following a hearing, the Commission extended the temporary order against some of the issuers and not others.[8] The Commission concluded that there was not enough *prima facie* evidence of misconduct to justify extending the temporary order against two issuers, Kootenay and Affinor.[9]

The petitioners commenced their claim in the British Columbia Supreme Court in February 2020. They alleged three sets of misrepresentation. The first alleged misrepresentation concerned the issuers' statements in their news releases and Form 9s regarding the price and proceeds of each private placement. The petitioners alleged these were untrue statements of material fact on the basis that the consulting fees could not be included as proceeds.[10]

The petitioners alleged in the second set of misrepresentations that the issuers erred by not disclosing that the issuers had entered into or agreed to enter into consulting agreements and by not including the particulars of those agreements.[11] The petitioners claimed that these material facts were necessary for an investor to properly understand the private placement transaction and to prevent their statements from being misleading.[12]

Finally, the petitioners claimed in the third set of misrepresentations that news releases issued by some issuers contained misrepresentations because the issuers knew the consultant subscribers had acquired free trading shares at an effective price much lower than the price disclosed to the market and the increase in trading volume was likely a result of the consultant subscribers selling their shares.[13]

Misrepresentation under s. 140.3 of the *Act*

The form of secondary market liability alleged in *Tietz* was founded under s. 140.3 of the *Act*. This statutory cause of action requires a misrepresentation of an untrue statement of material fact or an omission to state a material fact that is required to be stated or necessary to prevent a statement from being misleading.[14] A material fact is one that would reasonably be expected to have a significant effect on the market price or value of the security.[15]

In order to bring a claim for misrepresentation under s. 140.3 of the *Act*, the court must first grant leave pursuant to s. 140.8 of the *Act*. The court can only grant leave where there is proof:

a. the action is being brought in good faith, and
b. there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff.[16]

The good faith requirement is a very low bar and very few applications for leave fail to meet this stage of the test for leave.[17]

To meet the second part of the test, the plaintiff must be able to offer a plausible analysis of the legislative provisions and credible evidence in support of the claim.[18] In *Tietz*, the petitioners had to demonstrate that there is a reasonable possibility that their claim of misrepresentation under s. 140.3 of the *Act* would be resolved in their favour at trial.

The *Act* distinguishes between claims based on core and non-core documents. To bring claims concerning non-core documents, a plaintiff must prove an additional level of knowledge or wrongdoing on the part of the defendant. A defendant must also know about the misrepresentation, deliberately avoid acquiring knowledge of the misrepresentation, or be guilty of gross misconduct through their actions or failure to act in connection with the release of the documents.[19]

Public Correction

In addition to demonstrating that a misrepresentation occurred, a plaintiff must also show that the misrepresentation was publicly corrected.[20] The court in *Tietz* stated that on an application for leave, the question asked is "whether the alleged public correction is reasonably capable of being understood in the secondary market as correcting what was misleading in the impugned statement."[21]

The Court's Findings

The court held that each of the petitioners advancing claims were acting in good faith. The court's decision on granting leave primarily concerned whether there is a reasonable possibility of success; namely whether the petitioners had met the evidentiary "speedbump" they needed to get over to be permitted to advance their class proceeding. As noted above, the court found a reasonable possibility of success against only four of the six issuers.

For the issuers against whom leave was granted, the petitioners showed that there was a reasonable possibility of success that the consultant subscribers participated in the private placement on the condition that they would receive consulting fees from the subscription proceeds.[22] To come to this conclusion the court relied on:

- evidence from issuers' directors and officers in affidavits and on cross-examination indicating that this was the agreement;[23]
- evidence that the amount paid as consulting fees equaled the amount the consultant subscribers paid for their shares in the private placement;[24]
- the contemporaneity of the private placements and the consulting payments, as indicated by other public disclosure documents;[25] and
- the fact that without the proceeds of the private placement, the issuers would not have had enough cash

to pay the consulting fees.[26]

The court found that there is a reasonable possibility that the petitioners could prove at trial that the consulting agreements were material at the time of disclosure within the private placement news releases[27], Form 9s[28] and, in some instances, audited financial statements.[29] The petitioners were able to show that for each issuer, the consulting fee obligations were a significant portion of their cash position or cash outflows,[30] or exceeded their available cash.[31] The court also relied upon evidence of disclosure of the consulting agreements and fees incurred under them in subsequent public disclosure documents to conclude that the issuers regarded these fees as material for reporting purposes.[32]

For issuers that issued a trading news release, the petitioners were able to show that there is a reasonable possibility that they will be able to prove at trial that the issuers knew that the real reason for the trading increases was because of the consulting agreements.[33] There was evidence showing that the issuers agreed to return some of the private placement proceeds to consultant subscribers, creating a clear risk that the consultant subscribers would seek to make a profit by selling the shares at a price higher than they effectively paid, but lower than the market price.[34]

The court was willing to grant leave respecting non-core documents on the basis that certain directors and officers were aware of the consulting agreements[35] or, if the directors and officers were not aware of the consulting agreements, this ignorance was willful blindness or gross misconduct given the significance of the consulting fees.[36]

When granting leave, the court found that there was a reasonable possibility that the petitioners would be successful at trial in showing that news release and temporary order issued by the Commission on November 26, 2018 had a statistical impact on the share prices of the issuers and therefore constituted public corrections of the misrepresentations.[37].

A key difference between the issuer who was successful in opposing leave and the four unsuccessful issuers against whom leave was granted was the totality of evidence tendered against that issuer.[38] The only evidence available regarding the successful issuer was the petitioner's own testimony, the issuer's private placement news releases and trading news release, Form 9, the issuer's financial statements for the year ending May 31, 2018, and the Commission's news release and temporary order.[39]

The petitioners asked the court to draw inferences about this issuer's relationship with its consultants based on its financial statements and the Commission's news release and temporary order.[40] The court summarized that the issuer disclosed:

- information about the value of the private placements;

- how the proceeds would be used;
- that some or all of the investors were a new strategic shareholder group who would assist with bringing in additional investors;
- that the investors were purchasing their shares pursuant to an exemption that relates to employees, executive officers, directors and consultants; and
- that commissions that might have been paid to certain finders were not.

The petitioners responded in two ways. First, the petitioners sought to analogize the circumstances of this specific issuer to those of other issuers responding to the leave application. The petitioners also wanted the court to draw conclusions based on evidence of the same consultants regarding the other respondent issuers and based on evidence from other parties.[41] It refused to do so.

The petitioners also sought to rely on certain statements of "very limited" evidentiary value from the Commission.[42] A "concern" expressed by a regulator is not a finding of fact by that regulator, and the nature of the Commission's public comments about one issuer did not meet the credible evidence standard establishing a reasonable possibility of finding the facts which are the foundation of the petitioners' misrepresentation claims.[43]

Based on the case the petitioners presented, the court held that there is no reasonable possibility of the petitioners proving their misrepresentation claim at trial against this one specific issuer.[44] The court held that "engaging the same consultants around the same time as other respondent issuers against whom there is evidence of the quid pro quo agreements does not, in my opinion, overcome the credible evidence standard to support a finding that there is a reasonable possibility of finding the facts which are the foundation of the petitioner's misrepresentation claims."[45]

Conclusion

In an attempt to oppose leave being granted and frame issues in their favour, parties will often have the urge to deliver evidence responding to a claim. Sometimes, however, a petitioner will simply not have sufficient evidence to establish a misrepresentation and/or correction to a public disclosure. In these circumstances, would-be defendants should consider strategically the extent to which they risk improving an otherwise inadequate evidentiary record for a petitioner by tendering evidence in defence. In some cases, the risks may outweigh the rewards, especially when the record is light.

Parties who are the subject of secondary market misrepresentation claims that involve regulatory proceedings have an additional consideration: What is the stage of that proceeding and what findings of facts have been made? Speculation by enforcement staff is unlikely to support a secondary market liability claim on its own. Meanwhile, the court also upheld that a settlement related to *other parties* will not form the basis for granting

leave against a different party. Parties will not be bound by the compromises struck by others.

[1] For further information about secondary market securities class actions, see our publication, Bears v. Bulls: Secondary Market Securities Class Actions in Ontario.
[2] *Tietz v. Cryptobloc Technologies Corp.*, 2021 BCSC 2275 [*Tietz*].
[3] PreveCeutical Medical Inc. ("PreveCeutical"), Kootenay Zinc Corp. ("Kootenay"), Affinor Growers Inc. ("Affinor"), Global Estimate Capital Corp., formerly known as Cryptobloc Technologies Corp. ("Cryptobloc"), BLOK Technologies Inc. ("BLOK"), and Bam Bam Resources Corp., formerly known as KOPR Point Ventures Inc., formerly known as New Point Exploration Corp. ("New Point").
[4] *Tietz, supra* note 2 at para 1.
[5] *Ibid* at para 57.
[6] *Ibid* at para 78.
[7] *Ibid* at para 80.
[8] *Ibid* at para 83.
[9] *Ibid* at para 87.
[10] *Ibid* at paras 64, 67.
[11] *Ibid* at para 70.
[12] *Ibid* at para 71.
[13] *Ibid* at para 74.
[14] *Securities Act*, RSBC 1996, c 418, s 1(1) [*Act*].
[15] *Ibid*.
[16] *Act*, *supra* note 19 at s 140.8.
[17] *Tietz*, *supra* note 2 at para 49.
[18] *Ibid* at para 52, citing *Theratechnologies inc. v. 121851 Canada Inc.*, 2015 SCC 18 at para 39.
[19] *Ibid* at paras 145, 228, 296, 359.
[20] *Ibid* at para 40.
[21] *Ibid* at para 43.
[22] *Ibid* at paras 117, 217, 273-274, 338.
[23] *Ibid* at paras 210, 324.
[24] *Ibid* at para 333.
[25] *Ibid* at paras 207-208, 266, 270, 325.
[26] *Ibid* at para 112.
[27] *Ibid* at paras 143, 224, 290, 353.
[28] *Ibid* at paras 143, 290, 353.
[29] *Ibid* at paras 143, 290.

[30] *Ibid* at paras 135, 277.
[31] *Ibid* at paras 143, 223, 349.
[32] *Ibid* at paras 126, 343.
[33] *Ibid* at paras 123, 221.
[34] *Ibid* at paras 120, 227.
[35] *Ibid* at paras 229, 297, 360.
[36] *Ibid* at para 146.
[37] *Ibid* at paras 152, 305.
[38] *Ibid* at para 168.
[39] *Ibid* at para 172.
[40] *Ibid* at para 177.
[41] *Ibid*.
[42] *Ibid* at para 175.
[43] *Ibid* at para 178.
[44] *Ibid* at para 179.
[45] *Ibid* at para 178.

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A Cautionary Note