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Re: Consultation Process in Connection with the Class Action Project

These comments are submitted on behalf of KPMG LLP, Deloitte LLP, Ernst & Young LLP, PricewaterhouseCoopers LLP, BDO Canada LLP and MNP LLP (the "Accounting Firms") in response to the invitation to comment on the recently released Consultation Paper of the Law Commission of Ontario ("LCO") with respect to its review of Ontario's *Class Proceedings Act* ("CPA").

1. Overview

The Accounting Firms audit businesses in every sector of the Canadian economy, including business services, consumer and retail, energy and natural resources, financial services, industrial markets, infrastructure and government, real estate and technology. They audit public companies, private businesses of all types and governments.

The Accounting Firms perform the vast majority of public company audits in Canada: they audit more than 98% of all Canadian reporting issuers by market capitalization. The Accounting Firms also audit 91% of the companies listed on the Toronto Stock Exchange and, in 2017, conducted in aggregate over 15,000 audits of private businesses in Canada.

We are pleased to take this opportunity to comment on the Consultation Paper and to present the perspective of the Accounting Firms regarding CPA reform. We believe that the accounting profession, which is increasingly targeted in class actions, and in particular, securities class actions,[1] is in a unique position to raise the policy concerns that arise when a class action regime facilitates a pursuit of perceived "deep pockets" without adequate safeguards against unmeritorious claims. Unlike defendant issuers who are unlikely to face multiple claims, Canadian accounting firms have become "serial defendants" to these cases. We believe that our experience with the class action regimes of Ontario and other Canadian provinces and jurisdictions illustrates the shortcomings of the current system and has provided insight that informs our suggested reforms.

Part XXIII.1 creates a statutory cause of action for secondary market misrepresentation that eliminates the common law requirement that individual plaintiffs prove reliance, making it much easier for plaintiffs to prove misrepresentation claims on a class-wide basis. While the legislature facilitated the certification of class actions involving

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[1] NERA publishes a Canadian class action trends report annually; these are available at www.nera.com. Since the introduction of Part XXIII.1 in late 2005 and parallel legislation in other provinces, auditors have been named as defendants in 14 statutory secondary market liability cases, seeking more than 10 billion CAD in damages. One statutory secondary market claim was commenced against an accounting firm in 2007 (*CV Technologies Inc,*) and one in 2010 (*Redline Communications Group Inc*.) Two such claims were commenced in each of 2011 (*Sino-Forest Corporation*; Zungui Haixi Corporation) and 2012 (*Baja Mining Corp.*; *Poseidon Concepts Corp.*). There were no claims commenced against accounting firms in 2013, but in 2014 there were three such claims (*South Gobi Resources*; *Asia Packaging Group*; *GreenStar Agricultural Corporation*). Three claims were then commenced in 2015 (*MDC Partners, Inc*.; *North American Palladium*; *Valeant Pharmaceuticals*) and two claims were commenced in 2016 (*Nobilis Health Corp*; *Concordia International Corp)*. Notably, these figures do not include the class actions premised on misrepresentation or *negligence simpliciter* commenced against auditors under common law alone (for example, *Lavender v Miller Bernstein*, 2017 ONSC 3958). With thanks to Brad Heys and Robert Patton of NERA for providing updated case data from NERA's Canadian securities class action database.

secondary market misrepresentations with its enactment of Part XXIII.1, it also provided a number of important safeguards to defendants. In particular, Part XXIII.1 sets out a leave requirement that allows the court to screen out clearly unmeritorious claims before they are commenced.[2]

In short the Accounting Firms are of the view that all class actions, and not only those that are brought pursuant to Part XXIII.1 of the Ontario *Securities Act* ("Part XXIII.1" and the "OSA"), should be subjected to a preliminary merits test.

This and other complementary reforms are discussed within the framework of the "Consultation Questions" identified by the LCO in its Consultation Paper below. However, we would first like to raise some initial concerns with the scope of the Consultation Questions and offer background regarding the substantive law relating to auditors' liability. This will provide necessary context for our recommendations.

2. Concerns With the Scope of Consultation

The LCO states in the Consultation Paper that it does not anticipate recommending substantive amendments to other provincial legislation.[3] For this reason, we have confined our comments, to the extent possible, to proposed reforms to the CPA. However, given the combined impact of the CPA and Part XXIII.1 of the Ontario *Securities Act* on the liability exposure of the accounting profession, we will necessarily be raising points of intersection with the Part XXIII.1 regime. Indeed, many of our concerns arise from common law misrepresentation or negligence claims which plaintiffs pursue against auditors *precisely to avoid* the carefully calibrated protections afforded to experts and other defendants under Part XXIII.1.

Given that statutory secondary market liability has now been in effect for over thirteen years and securities class actions currently account for over 27 billion dollars in stated

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[2] *Securities Act*, RSO 1990, c S5, s. 138.8 ("OSA").
[3] At page 2.

claims in Canada,[4] we are surprised that this particular category of class action has not been identified as an area for focus in the Consultation Paper. Indeed, securities class actions are not represented amongst the categories of class actions listed in Appendix "C" to the Consultation Paper. In our view, this is an oversight which will prevent a full appreciation of the class action landscape in Ontario, including the broader policy implications of causing auditors, insurers and other "secondary" or peripheral defendants to underwrite the costs of corporate malfeasance.

Further, it is hard to understand how one can adequately answer the question of whether courts should consider "the merits of a proposed class action at certification," an inquiry raised as part of Consultation Question 5, without reviewing the experience of securities class action litigants with the leave test under section 138.8 of the OSA. We strongly encourage the LCO to expand the scope of the current project to expressly include securities class actions or to conduct a review of Part XXIII.1 as a further, related phase.

Additionally, in light of the "independent, evidence-based and comprehensive" scope of the Class Action Project, we trust that the LCO, intended, in seeking to elicit a description of "class members' and representative plaintiffs' experience of class actions," under Consultation Question 7, to include consideration of the experiences of class action *defendants*. The experiences and perspectives of defendants are critical to an informed and balanced review of the CPA and may well transcend narrow interest-based advocacy. One should not assume that all forms of behaviour modification triggered by class actions are necessarily positive. The capacity of defendants to redistribute the costs of class action litigation to clients, customers, insurers, or society at large should be taken into account in any analysis as to whether the regime is effective in achieving its stated goals.

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[4] Bradley A. Heys and Robert Patton, NERA Economic Consulting, "Trends in Canadian Securities Class Actions: 2017 Update" 20, February, 2018, www.nera.com at 2. The vast majority of such claims are filed in Ontario. Heys and Patton's analysis, at page 7, shows that 79 per cent of securities class actions filed between 2006 and 2017 were commenced in Ontario. Sixteen per cent of these cases included a parallel filing in Quebec.

Again, the experience of the accounting profession is illustrative of the potential for class actions to simply transfer losses from some pockets to others, without any meaningful deterrent effect. Auditors are rarely if ever themselves the generators or "but for" cause of negligent or fraudulent accounting statements. Their alleged wrongdoing is a second-level failure to detect the fraud or negligence of others. This is not to suggest that auditors should not have to answer for their own negligence—there are effective civil and regulatory routes by which accountants are held to account for such misconduct.[5] Rather, the question becomes one of whether auditors should effectively become "insurers" against losses arising from corporate malfeasance when the wrongdoers themselves cannot be made to pay and whether our class action regime should distort established policy and tort law principles to achieve this.

While we speak for the Accounting Firms, the potential effects of unchecked class action exposure for auditors on the thousands of companies that are legislatively required to use audit services in Ontario should also be taken into account. The costs of doing business in the Province will inevitably increase if auditors are required to insure against indeterminate liability exposure. Further, these costs may be visited disproportionately on categories of business that are integral to the economic health of the Province. Companies with heightened risk profiles, such as start-ups, small businesses and those which focus on new technologies may find it difficult or impossible to procure audit services.[6] These policy concerns were identified by the Supreme Court of Canada over twenty years ago in the seminal decision on auditor's liability, *Hercules Managements Ltd. v Ernst & Young*,[7] and they remain pertinent today.

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[5] The discipline committee of CPA Ontario has broad powers to sanction members and accounting firms found guilty of professional misconduct: *Chartered Professional Accountants of Ontario Act*, 2017, SO 2017, c 8, Sched 3, s 35(4). Case law imposes liability on auditors for negligent misrepresentation claims brought within privity of contract: *Deloitte & Touche v Livent Inc. (Receiver of)*, 2017 SCC 63. Also, as discussed above, Part XXIII.1 creates a statutory right of action in damages against experts for secondary market misrepresentations.

[6] These companies are an increasingly important part of Ontario's economy: G. Lamb and M. Seddon, "The State of Canada's Tech Sector, 2016", *The Brookfield Institute* (July 2016) online <http://brookfieldinstitute.ca/wp-content/uploads/2016/07/The-State-of-Canadas-Tech-Sector-2016-V2.pdf>.

[7] [1997] 2 SCR 165 ("*Hercules Managements*").

Further, as stated below, the increasing exposure of Canadian audit firms comes at a time when the US class action regime is progressively limiting the circumstances in which auditors and other professional advisors to a defendant corporation may be pursued by investors. It is undesirable to incentivize plaintiffs who might otherwise bring lawsuits in the US to bring lawsuits in Canada as a result of a more favourable regime and to subject the accounting profession to a significantly higher level of liability exposure in Canada than it faces in the US.

The Accounting Firms fully appreciate that class actions are part of doing business in Ontario and can serve important societal goals, including the promotion of access to justice. These submissions are not intended as an attack on class actions or Part XXIII.1, but seek to promote constructive and reasonable adjustments to the CPA that will help to refocus the legislation on its original objectives, while decreasing the potential for class actions to have unintended, distortive effects on the substantive law and economy of the Province. In fact, the Accounting Firms now have considerable experience with class actions brought pursuant to statutory secondary market liability regimes in Ontario and other provinces and believe that this legislation is generally functioning as intended. When used and applied as intended, it is striking an appropriate balance between the interests of plaintiffs and defendants. The Accounting Firms believe that the solution is to incorporate aspects of the Part XXIII.1, in particular the leave test, into *all* class proceedings.

3. Background: Auditors' Class Action Exposure

Hercules Managements and Limits on the Auditor's Duty of Care

In *Hercules Managements*, a unanimous panel of the Supreme Court of Canada recognized the various policy concerns associated with exposing auditors to liability when shareholders seek to rely on audit opinions for personal investment decisions.[8] In particular, the Supreme Court was concerned that the indeterminate liability exposure

[8] *Ibid*.

that would result if auditors owed duties to the investing public at large would have negative effects on the supply of accounting services.[9] The Supreme Court recognized that the increased time that would inevitably be expended in the performance of accounting services would have a negative impact on the timeliness of the financial information generated.[10]

Justice La Forest explained:

> …I would agree that deterrence of negligent conduct is an important policy consideration with respect to auditors' liability. Nevertheless, I am of the view that, in the final analysis, it is outweighed by the socially undesirable consequences to which the imposition of indeterminate liability on auditors might lead. Indeed, while indeterminate liability is problematic in and of itself inasmuch as it would mean that successful negligence actions against auditors could, at least potentially, be limitless, it is also problematic in light of certain related problems to which it might give rise.[11]

Justice La Forest went on to cite a range of undesirable consequences of expanding the class of persons to whom auditors owe duties, including "substantial costs" resulting from rising insurance premiums and increased opportunity costs as auditors must spend more time defending lawsuits, more reliance on exclusion clauses, the aforementioned reduction in the supply in accounting services and the result that increased costs will be passed on to accounting clients.[12]

Hercules Managements remains the leading case on the scope of auditors' duties in Canada and was recently affirmed by the Supreme Court in *Deloitte & Touche v Livent Inc (Receiver of)* (*"Livent"*).[13] However, a review of class action proceedings against auditors reveals a concerted effort by plaintiff investors to circumvent the common law restrictions on the auditor's duty by asserting imaginative claims in negligence

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[9] *Ibid* at para 34.
[10] *Ibid* at para 34.
[11] *Ibid* at paras 31-34.
[12] *Ibid* at para 34.
[13] 2017 SCC 63 at paras 16-22.

simpliciter (as opposed to negligent misrepresentation). As discussed below, this also results in a circumvention of Part XXIII.1 itself, which facilitates class actions based on misrepresentation claims against auditors but imposes certain safeguards.

To date Canadian courts have shown a certain willingness to certify negligence claims brought by investors against auditors notwithstanding *Hercules Managements*.[14] When this occurs, it is because the test under 5(1)(a) is based on the pleadings alone.[15] The applicable test, based on the Supreme Court decision in *Hunt v Carey*, does not permit a Court to foreclose creative or novel causes of action.[16] Common law negligent misrepresentation claims are very difficult to certify because the requirement that individual plaintiffs establish detrimental reliance on the alleged misrepresentation raises complex individual issues.[17] Indeed, this is the reason why Part XXIII.1 of the OSA (which provides for deemed reliance) was enacted.[18] However, claims based on negligence *simpliciter* focus on the conduct of the defendant and arguably do not involve questions of reliance.[19]

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[14] *Excalibur Special Opportunities LP v Schwartz Levitsky Feldman LLP*, 2014 ONSC 4118, aff'd (on this point) 2016 ONCA 916*; Lavender v Miller Bernstein*, 2017 ONSC 3958; *Catucci v Valeant Pharmaceuticals International Inc.*, 2017 QCCS 3870.

[15] The question of whether parties who are not within privity of contract with the auditor may sue in negligence is currently on reserve with the Court of Appeal for Ontario in *Lavender v Bernstein*, which arises from a summary judgment motion brought post-certification in a case in which clients of an investment brokerage allege they were owed a duty of care by the brokerage's auditors. The motions judge concluded that they did. The case raises the question of whether allowing the certification judge to consider some evidence of the merits prior to or during certification would have been more efficient and beneficial for both sides.

[16] [1990] 2 SCR 959 at para 36 ("*Hunt v Carey*").

[17] *Queen v Cognos Inc.*, [1993] 1 SCR 87; *Musicians' Pension Fund of Canada (Trustee of) v Kinross Gold Corp*., 2014 ONCA 901 at paras 128-129; *McKenna v Gammon Gold Inc.*, 2010 ONSC 1591 at para 160, rev'd in part on other grounds, 2010 ONSC 4068 at para 32 (Div Ct).

[18] Part 138.3 of the OSA provides that liability will be determined "without regard to whether the person or company relied on the misrepresentation" thus eliminating the reliance hurdle that the common law presented to investors seeking to sue for secondary market misrepresentation claims and facilitating certification of such cases.

[19] This question of whether negligence *simpliciter* claims could turn on questions of reliance is not free from doubt. *Yorkshire Trust Co. v. Empire Acceptance Corp. Ltd.*, 24 DLR (4th) 140, 1985 CanLII 334 at para 18 (in an action for simple negligence, the Court noted an investment never would have been marketed to investors without the necessary appraisal, stating that "it might be argued that this is a form of reliance"); *Lipson v. Cassels Brock & Blackwell LLP*, 2013 ONCA 165 at para 96, (reliance may be required in a claim for simple negligence because the allegedly negligent opinion in that case was a

The advantages to investors (or similarly situated non-parties to the audit retainer, which we will refer to as "third parties") of pursing class actions against auditors based on negligence are obvious. However, condoning the tactic disregards *Hercules Managements* and may also permit such plaintiffs to do an "end run" around contractual limitations or exclusions of liability which may govern an auditor's retainer agreement with the company, which may make the auditor's liability to third parties more extensive than the auditor's liability *to its own client*.

One might argue that certifying a claim brought by investors or other third parties against an auditor is simply a preliminary, pleadings-based decision that the claim should not be foreclosed at a preliminary stage. It is not a determination on the merits or a precedent suggesting that such claims are inherently viable. However, the practical reality is that the vast majority of class actions are unlikely to ever reach a determination on the merits because the costs, risk and demand on internal resources that such cases present once certified will almost always weigh in favour of reaching a settlement, irrespective of the merit of the case. If the issue does not get revisited, the certification decision *does* becomes a precedent and stands for the proposition that other third party claims against auditors premised in negligence cannot be dismissed prior to certification. This, in turn, forces more early settlements.

Although the auditor is rarely the primary target of a class action, the auditor often remains to defend the claim after the defendant company has been rendered insolvent by a fraud. It is particularly vulnerable to unmeritorious third party negligence claims that are advanced to leverage settlements. Auditors are being required to defend (which usually means settle) cases that can expose them to liability that greatly exceeds the level of risk they assume under their retainer agreements.

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necessary precondition for marketing the investment opportunity)); *Robinson v. Rochester et al*., 2010 ONSC 463 at para 25, leave to appeal ref'd 2010 ONSC 1899 (Div Ct) (class members, in deciding whether or not to participate in a gift program, relied on the fact that there was a tax opinion supporting the legitimacy of the gift program).

We further discuss the negative effects of this cycle on the development of case law in the Province and the harm it ultimately does to all litigants below. At this stage, we wish to point out that this scenario demonstrates how the tactic of "pleading around" hurdles presented by established legal principles is condoned by the current test for certification and is used by plaintiffs to create leverage.

Limits on the Liability of Experts for Negligent Misrepresentation Under Part XXIII.1

The tendency of plaintiffs to plead common law misrepresentation claims against auditors in tandem with statutory secondary market misrepresentation claims under Part XXIII.1 has a similar effect. It circumvents carefully calibrated protections offered to experts and other securities class action defendants under the OSA.

Claims brought pursuant to Part XXIII.1 may only be pursued against the issuer, directors and officers of the issuer, influential persons and "experts" who have issued a "report, statement or opinion" containing a misrepresentation.[20] When auditors are named as defendants to Part XXIII.1 claims, they are being named as "experts".

Recognizing the same potential for indeterminate liability that informed the decision of the Supreme Court in *Hercules Managements,* Part XXIII.1 limits an expert's damages exposure to the greater of $1 million or the revenue the expert and its affiliates earned from the defendant issuer and its affiliates during the twelve month preceding the alleged misrepresentation, unless an expert makes a statement with knowledge that it constitutes a misrepresentation.[21]

Defendants to Part XXIII.1 also benefit from other safeguards that are not available to defendants at common law. Important among these is the leave test under section 138.8, which requires the plaintiff to demonstrate, before the action is commenced, that the action is brought in good faith and that "there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff." The legislative drafters imposed

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[20] OSA, ss 138.3(1)(e) and 138.3(2)(e).
[21] OSA, s 138.1 (definition of "liability limit") and s 138.7(2).

the leave requirement to guard against the possibility that Part XXIII.1 would be used coercively by opportunistic plaintiffs seeking to extract settlements.[22] However, this concern arises in *all* class action contexts. It is certainly no less relevant when plaintiffs plead common law misrepresentation or negligence claims precisely to avoid the leave test and liability limits imposed by Part XXIII.1.

The Supreme Court of Canada determined in *Theratechnologies Inc. v 121851 Canada Inc.* that the threshold for obtaining leave to proceed with such class actions should be more than a "speed bump" and that courts must undertake a reasoned consideration of the evidence to ensure the action has some merit. The SCC noted that "[w]hat is required is sufficient evidence to persuade the court that there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff."[23]

Section 138.16 of the OSA provides that a defendant shall be liable for only that proportion of damages that corresponds to that defendant's responsibility. This contrasts with joint and several liability under the *Negligence Act* which would apply to the common law torts.[24] The protection against joint and several liability is critical for auditors. When left to defend the case when the issuer and individual officers and directors are insolvent or impecunious, an auditor who may bear responsibility for some fraction of investor losses, could otherwise be responsible for the entire loss.

Notably, section 138.11 of the OSA provides that, notwithstanding the *Courts of Justice Act* and the CPA, the prevailing party is entitled to costs determined in accordance with the applicable rules of civil procedure. This excludes the application of section 31(1) of the CPA which allows the court, in exercising its discretion with respect to costs, to consider whether a class proceeding was a test case, raised a novel point of law, or

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[22] Canadian Securities Administrators Notice 53-302, Report of the Canadian Securities Administrators – *Proposal for a Statutory Civil Remedy for Investors in the Secondary Market and Response to the Proposed Change to the Definitions of "Material Fact" and "Material Change"*, (2000) 23 OSCB 7383 at 7383, 7390 and 7423.
[23] 2015 SCC 18 at paras 38 and 39.
[24] *Negligence Act*, RSO 1990 c N1, s 1.

involved a matter of public interest. This prevents plaintiffs from avoiding or minimizing adverse cost awards.[25]

The case law provides little comfort to auditors and other defendants that they will be able to confine their exposure through resort to the statutory protections that Part XXIII.1 was intended to offer them, including the leave test, liability limits and proportionate liability. Courts' willingness to certify common law misrepresentation claims to be pursued in tandem with Part XXIII.1 claims is allowing plaintiffs to "have their cake and eat it too". Common law claims that, but for Part XXIII.1 would not have been certified, are now being allowed to advance to common issues trials without the restrictions imposed on statutory misrepresentation claims including liability limits. Again, the implication is enhanced leverage for plaintiffs to achieve settlements.[26]

Comparing Regimes: Auditors' Class Action Exposure in the US

Successive US Supreme Court decisions have made it increasingly difficult for plaintiffs to pursue auditors in "10b-5" claims.[27] To help explain the US liability landscape for auditors, attached as Schedule "A" is a memorandum that has been prepared by Paul Weiss, Rifkind, Wharton and Garrison LLP. This memorandum summarizes developments in US case law that have progressively narrowed the scope of liability of advisors to public issuers such as auditors and lawyers (often referred to as "secondary liability" in recognition of the fact that advisors are rarely the originators of misrepresentations at issue) for securities misrepresentation to scenarios in which plaintiffs can demonstrate that the advisor had "ultimate authority" for the contents and dissemination of a fraudulent statement.

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[25] *Metzler Investment GMBH v Gildan Activewear Inc.*, 2009 CanLII 41540 at paras 64 and 65 (ONSC).

[26] Following *CIBC*, some but not all common issues in common law misrepresentation class actions may be certified along with the common issues relating to statutory claims under Part XXIII.1. In particular, issues of reliance and damages tend to raise complex individual issues, making them unsuitable for determination on a common basis. For a more complete analysis of the state of the law in this area, see A. Laing and H. Richards, "Common Law Securities Misrepresentation Claims – Still with us in the Post-*Green* Era?" (2016) 11:2 Can Class Action Rev 373 ("Laing and Richards").

[27] These are a rough equivalent to Part XXIII.1 claims. Rule 10b-5 is a rule promulgated under section 10(b) of the US *Exchange Act of 1934* and is the statutory basis for federal secondary market securities class actions.

As "*scienter*"—an intention to defraud or extreme recklessness as to the veracity of public statements—must be pleaded with particularity and proven in order to pursue a federal securities class action, mere allegations that an auditor was negligent or made negligent misrepresentations cannot suffice. Further, the Supreme Court has rejected the broad theory of "scheme liability" that US plaintiffs have advanced in an attempt to link accountants to primary violations with vague allegations of conspiracy.[28] As a result, there is little room left for advisors to be held liable under 10b-5 claims for misrepresentations that are not specifically attributable to the advisors themselves. Generalized statements in audit opinions (generally the alleged source of misrepresentations in Canadian class action claims against auditors) are insufficient to ground liability.

As capital markets become more and more interdependent, auditors operate in an increasingly global environment. The Accounting Firms support CPA reforms that would have the effect of minimizing the extent to which disproportionate liability exposure and settlement pressure can be visited on auditors in Ontario, relative to the exposure they would face for performing substantially similar tasks in neighboring jurisdictions--in particular the US. The reforms suggested below would help to narrow the gap that currently exists between auditors' class action exposure in the US and Canada.

Implications for CPA Reform

Having watched the dynamic discussed above play out in numerous cases, the Accounting Firms have concluded that it is time to abandon the fiction that certification motions are merely "procedural" and do not affect the substantive rights of the parties. This ignores the coercive effect of certification on defendants. We urge the LCO to recommend reforms to the CPA that would add an important protection afforded by Part XXIII.1 to the CPA--a merits-based leave requirement.

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[28] *Stoneridge Investment Partners, LLC v Scientific-Atlanta, Inc*., 552 US 148 (2008); *Janus Capital Group, Inc. v First Deriv. Traders*, 131 S Ct 2296 (2011).

Certification is a "watershed moment"[29] in a class action with significant ramifications for plaintiffs and defendants; it should not hinge on plaintiffs' ability to plead novel and creative causes of action to meet the minimal requirements of section 5(1)(a). If all cases, including those premised on common law causes of action, were subject to a leave requirement similar to that found in section 138.8(1) of the OSA, the threshold for refusing certification of the case based on a claim's lack of viability would change from the *Hunt v Carey* standard of "*plain and obvious* that the claim does not disclose a reasonable cause of action"[30] to "*no reasonable possibility* that the claim will be resolved in favour of the plaintiff."

A requirement that a plaintiff lead some evidence at the certification stage would provide a factual context for the case and allow certification judges to assess whether it is spurious. A merits-based test at the leave stage would also empower judges to deny certification to claims that are merely creative attempts to "plead around" established precedents, like *Hercules Managements*. It would not foreclose meritorious claims or hold plaintiffs to an unreasonable evidentiary burden. In the securities class action context, subjecting all claims to a leave test would also discourage attempts by plaintiffs to certify common law claims that have been "engineered" to avoid the Part XXIII.1 regime.

This reform would not exclusively benefit defendants. Subjecting cases to a higher level of scrutiny at or before certification would help to maintain the legitimacy of the CPA regime by providing an avenue for the early dismissal of the types of overreaching claims which are perceived to bring class actions into disrepute.

It would also lead to more developed case law that considers the appropriateness of a case for certification in a broader evidentiary context, similar to the body of case law that has developed under section 138.8 of the OSA. Notably there are scant trial decisions in class action cases and, as discussed, the 5(1)(a) analysis does not permit

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[29] *McGee v London Life Insurance Company Limited*, 2008 CanLII 68155 at para 5 (ON SC).
[30] [1990] 2 SCR 959 at para 36.

judges to engage in a thorough analysis of the viability of a claim. This results in a series of copycat claims being given the "green light" every time a novel cause of action passes the 5(1)(a) test.[31] A more nuanced body of case law would enable plaintiffs and defendants to make better informed decisions about whether to commence, defend or settle class actions in light of the risks of success or failure presented by actual factual circumstances.

The Accounting Firms' additional proposed amendments to the CPA support the important objective of permitting increased judicial scrutiny of cases at an earlier stage. They are set out below, organized in the context of the Consultation Questions. We do not address all questions.

Consultation Question 3:

What changes, if any, should be made to the costs rule in the CPA?

- **Should Ontario retain the two-way costs rule?**

The Accounting Firms encourage the LCO to maintain the two-way costs rule. We believe it leads to better informed choices and encourages counsel to reflect on the strength of a case, or a contemplated procedural motion before moving forward. Put another way, it provides important discipline and discourages frivolous claims and motions.

This being said, the Accounting Firms believe that greater transparency regarding a representative plaintiff's indemnification against adverse costs would benefit both sides. While defendants do obtain notification that funding will be supplied by the Class Proceeding Fund, and case law now establishes a defendant's right to certain details about third-party funding arrangements,[32] the extent to which a plaintiff is

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[31] Less than two weeks after certification of the common issues in *Lavender*, a Statement of Claim was issued in *Anthony Whitehouse v BDO Canada LLP* (July 20, 2017), CV-17-579357-00CP. It alleges, among other things, that investors in an open-ended mutual fund trust were owed a duty of care by the trust's auditor in negligence *simpliciter*, essentially copying the investors' approach in *Lavender*.

[32] *Musicians' Pension Fund of Canada (Trustee of) v Kinross Gold Corp*, 2013 ONSC 4974 at para 41.

being indemnified against adverse costs by class counsel is not always apparent. A provision in the CPA which would permit defendants to ask for and obtain details regarding a plaintiff's indemnification before being required to take steps in the action would encourage class counsel to discuss adverse costs with a representative plaintiff at the earliest juncture and alert defendants to scenarios where they may be unable to recover costs against an impecunious plaintiff.

Further, The Accounting Firms are of the view that section 31(1) is one-sided and outdated and should be removed from the CPA. The provision permits a judge awarding costs to consider whether the class proceeding was a test case, raised a novel point of law, or involved a matter of public interest. As drafted, section 31(1) suggests that only plaintiffs may rely on it.[33] Greater balance would be brought to the analysis that goes into awarding costs, which is already a discretionary process, without section 31(1).

Consultation Question 5:

- ***Is the current approach to certification under s. 5 of the CPA appropriate?***
- ***Should Courts consider the merits of a proposed class action at certification?***

As is explained in detail above, the Accounting Firms are strongly of the view that the imposition of a merits-based leave requirement would be a positive reform that would reduce the exposure of defendants to extortive and opportunistic claims but continue to promote access to justice for plaintiffs with meritorious cases. The leave requirement which is provided for under section 138.8 of the OSA is functioning as intended and is bringing an appropriate level of preliminary judicial scrutiny to statutory secondary market securities class actions. We recommend that the same test be incorporated into the CPA.

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[33] The language focusses on the "bringing of a class action" which is an action taken by plaintiffs. See, for example, *Ruffolo v Sun Life Assurance Co of Canada*, 2009 ONCA 274 at para 36.

<u>Consultation Question 6:</u>

> ***Are class actions meeting the objective of behaviour modification? What factors (or kinds of cases) increase (or reduce) the likelihood of behaviour modification?***

While behaviour modification is a worthy goal, from the perspective of the Accounting Firms, it is questionable whether this objective is currently being met by the CPA. Behaviour modification is not achieved when class action remedies do not involve restitution from the central actors whose conduct has caused damage to the class. Class actions that only succeed in visiting disproportionate liability on auditors or other secondary targets do not effectively censure the original wrongdoers (such as those who have committed accounting fraud) or have a deterrent effect on other potential wrongdoers. Further, such proceedings ultimately result in loss shifting to other parties who had no involvement in the misconduct, including insurers, businesses who use accounting services, and ultimately society at large.

<u>Consultation Question 8:</u>

> ***In light of existing constitutional restrictions, what is the most effective way for courts to case manage multi-jurisdictional class actions in Canada?***
>
> - ***Is the 2018 CBA Protocol sufficient to address multi-jurisdictional class actions?***
> - ***Is statutory guidance desirable, or should this issue be left to the courts?***
> - ***Should legislative amendments like those in the Saskatchewan and Alberta statutes be considered?***

Overlapping and duplicative class actions in multiple Canadian jurisdictions create significant problems for all class action litigants and place unwarranted burdens on the justice system. These problems include the wasteful and duplicative costs associated with litigating in multiple jurisdictions and the risk and uncertainty associated with inconsistent verdicts.[34] Statutory guidance is necessary in light of these complex issues.

While the Accounting Firms recognize that there are limits on what any one province can do to address the issues raised by multijurisdictional class actions, it strongly supports greater judicial and legislative co-operation across provincial boundaries.

The CBA Protocol is a helpful tool. However, it does not go far enough. Express statutory guidance similar to that seen in Alberta and Saskatchewan, which permits judges to certify or stay a multi-jurisdictional class proceeding where it would be preferable in light of other overlapping class actions, should be enacted in Ontario.[35] Ontario cannot dictate to other provinces how they should manage multijurisdictional proceedings but it can seek to lead by example.

Consultation Question 9:

How should Ontario courts address the issue of carriage in class actions?

- ***Should a modified "first to file" rule be considered in Ontario?***
- ***Should the CPA be amended to provide guidance on carriage issues? If so, what reforms would you recommend?***

The current approach of Ontario courts is to apply a test that weighs a variety of factors in order to identify the action most likely to advance the interests of the class.[36] This approach is preferable to a "first to file" rule that would only lead to the filing of weak, poorly developed or meritless claims as plaintiffs' counsel race to be

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[34] Ward K. Branch and Emily Unrau, "Whither Canada: Why Don't We Know Where to Litigate and Why Do We Take So Long?", Civil Litigation Conference 2014 at 7.1.1 to 7.1.7 <http://static1.1.sqspcdn.com/static/f/299713/24639955/1396021370360/Whither+Canada+Why+Don%27t+We+Know+Where+to+Litigate+and+Why+do+We+Take+So+Long.pdf?token=Rt9o9cA4MHU9Hp8%2BH42sRz%2FoLJ8%3D>.

[35] This language is also adopted in the Uniform Law Conference of Canada's "Uniform Class Proceedings Amendment Act", s 4(2).

[36] See, for example, *Wilson v LG Chem Ltd*, 2014 ONSC 1875 at paras 17-19 and *VitaPharm Canada Ltd v F Hoffmann-LaRoche Ltd*, [2000] OJ No 4594 at paras 48-49 (ONSC).

the first “past the post”. The Accounting Firms are in favour of a recommendation to incorporate the common law test as it currently stands into the CPA.

Additionally, the Accounting Firms believe that an express provision should be included in the CPA to ensure that the judge who hears the carriage motion should not hear the certification motion or assume case management responsibilities for the case after carriage is determined. The carriage test requires a judge to choose the case that best advances the interests of the class. It is unfair to defendants if that same judge then determines certification of the case that he or she has already decided is best suited to certification. Defendants are not active participants in carriage motions and do not make submissions at the carriage stage. This reform would help to balance the interests of defendants with those of the class and allow defendants to contest certification without concern that the judge may have already formed a view of the merits or the appropriateness of certification.

Consultation Question 10:

> ***What is the appropriate process for appealing class action certification decisions?***
>
> - ***Should appeals from successful certification decisions be taken directly to the Divisional Court, without the need to obtain leave?***
> - ***Should all appeals from certification decisions proceed directly to the Court of Appeal? Is the leave to appeal test appropriate?***

Asymmetrical appeal rights created by Section 30 of the CPA have made it difficult for defendants to obtain leave to appeal in order to address problematic or inconsistent decisions at the appellate level, increasing the uncertainty and expense associated with litigating class actions and preventing the development of the case law. Better developed case law benefits all litigants by allowing them to make better informed strategic decisions.

A good illustration of the distortive effect of Section 30 is provided by the manner in which the issue of common law claims has developed in securities class actions.[37] It was apparent by 2010 that there was significant disagreement amongst motion judges as to whether "parallel" common law misrepresentation claims should be certified. However, even while acknowledging that the "relationship between common law and statutory claims of misrepresentation is important, and merits appellate consideration" the Divisional Court in *Silver v IMAX* applied a stringent test and concluded that leave should not be granted.[38]

As a result, the question of whether common law claims should be certified was not decided by the Court of Appeal for Ontario until 2014, after plaintiffs in the *CIBC* case, who were denied certification, appealed the determination as of right, and the issue was ultimately addressed by the Supreme Court of Canada in late 2015.[39] But for the leave requirement, which is imposed exclusively on defendants, the issue would likely have been clarified much sooner, avoiding several unnecessary years of confusing precedents.

For this reason, the Accounting Firms believe that the appeal provisions of the CPA should be amended to give defendants equal rights to appeal the certification motion without leave and prevent further delays or distortions in the development of important legal principles.[40] Notably, this would bring Ontario in line with other provinces that have symmetrical appeal rights.[41]

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[37] For a more detailed discussion, see A. Laing and R. Carson, "Whither Common Law Claims for Secondary Market Misrepresentation?: An Analysis of Certification Decisions in *McCann* v. *CP Ships*, *Silver* v. *IMAX*, *McKenna* v. *Gammon Gold and Dobbie* v. *Artic Glacier*", The Canadian Class Action Review, Vol 7 No 1, October 2011.

[38] *Silver* v*. IMAX Corp,* 2011 ONSC 1035.

[39] *Canadian Imperial Bank of Commerce v Green*, 2015 SCC 60 [*CIBC*].

[40] Prior to the SCC's decision in *CIBC*, several lower court decisions produced conflicting decisions on whether common law misrepresentation claims could be certified in conjunction with Part XXIII.1 claims. For an overview of these conflicting decisions, see Laing and Richards, *supra* note 26 at 381-389.

[41] See Schedule B for a breakdown of provinces that have enacted symmetrical appeal rights. Notably, the vast majority of provinces provide for symmetrical appeal rights.

<u>Consultation Question 12:</u>

In addition to the issues listed in this paper, are there provisions in the CPA that need updating to more accurately reflect current jurisprudence and practice? If so what are your current recommendations?

As stated above, the Accounting Firms believe that CPA reform is incomplete without a consideration of Part XXIII.1. We believe that case law regarding the extent to which a plaintiff may certify common law misrepresentation claims that are duplicative of claims being advanced under Part XXIII.1 remains indeterminate[42] and that the matter should be addressed through amendment to the CPA, or the OSA, or both.[43]

As discussed above, Part XXIII.1 aims to facilitate secondary market misrepresentation class actions while, at the same time, providing protections against meritless claims and indeterminate liability for defendants. Given that parallel common law misrepresentation claims constitute an "end run" around the entire Part XXIII.1 regime, the Accounting Firms believe that the CPA should include a provision that requires plaintiffs to elect their recourse, either by pursuing claims under Part XXIII.1 with the accompanying protections for defendants, or by pursuing common law misrepresentation claims with the accompanying requirement to prove reliance.

If included in the CPA, the provision could state:

> Notwithstanding section 138.13 of the OSA, when a class proceeding advancing claims pursuant to Section 138.3 of the OSA is certified, it shall, subject to the right of a class member to opt out or an order decertifying the action, be the sole recourse for class members pursuing claims premised on the misrepresentation or failure to make timely disclosure alleged and all provisions of Part XXIII.1 of the OSA

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[42] *CIBC*.

[43] Section 138.13 of the OSA provides that the right of action and defences under Part XXIII.1 are "without derogation" from any other rights or defences the plaintiff may have in an action brought otherwise than under Part XXIII.1. This is relied on by plaintiffs to suggest that parallel common law claims brought within the same action as Part XXIII.1 claims may be certified. It is hard to see how the provision can justify the certification of a cause of action that was not certifiable prior to the enactment of Part XXIII.1 and would not be certifiable if brought as a stand-alone claim.

> shall apply, including, without limitation, any available burdens, defences, limitations of liability and limitation periods.

However, the most appropriate place for this amendment would be to add the following as subsection 138.13(2) of the OSA:

> (2) Notwithstanding subsection (1), when a class proceeding advancing claims pursuant to Section 138.3 is certified, it shall, subject to the right of a class member to opt out or an order decertifying the action, be the sole recourse for class members pursuing claims premised on the misrepresentation or failure to make timely disclosure alleged and all provisions of this Part shall apply including, without limitation, any available burdens, defences, limitations or exclusions of liability, and limitation periods .

The Accounting Firms greatly appreciate this opportunity to present its views on CPA reform. We also wish to thank Jeffrey Galway, Andrea Laing and Helen Richards of Blake, Cassels & Graydon LLP for their assistance in preparing this submission. We would be pleased to meet with researchers for the Project to further discuss our views.

Yours very truly,

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Schedule "A"

MEMORANDUM

May 22, 2018

To:	Blake, Cassels & Graydon LLP	Subject:	**Scope of Auditor Liability Under the U.S. Federal Securities Fraud Laws**
From:	Daniel J. Kramer, Audra J. Soloway		

Legislation and federal court decisions in the United States over the past two decades have dramatically altered the scope of private securities fraud liability under Section 10(b) of the Securities and Exchange Act of 1934 ("the '34 Act"), including for secondary actors like auditors. For years, federal courts struggled to locate the line between primary liability and secondary liability for statements that were reviewed, approved, or prepared by professionals on behalf of a client. In 1994, however, the United States Supreme Court eliminated secondary liability under an "aiding and abetting" theory in *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*,[1] a ruling that offered tremendous protection for auditors against securities class actions.

In subsequent years, plaintiffs responded by recasting such fraud claims under new theories of primary liability. The Supreme Court has now curtailed these efforts, however, in three key decisions: the 2008 *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[2] case, which rejected the broad new theory of "scheme liability" employed by plaintiffs to sue auditors for primary violations with vague allegations of conspiracy; second, the 2011 *Janus Capital Group, Inc. v. First Derivative Traders*[3] decision, which clarified that the maker of a fraudulent statement must have "ultimate authority" over its contents and dissemination in order to incur primary liability; and third, the 2015 *Omnicare, Inc.* v. *Laborers District Council Construction Industry Pension Fund*[4] decision, which clarified the heightened standards applicable to

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1 511 U.S. 164 (1994).

2 552 U.S. 148 (2008).

3 131 S. Ct. 2296 (2011).

4 135 S. Ct. 1318 (2015).

statements of opinion and judgment like those often rendered by auditors. When these decisions are combined with the heightened pleading standards for alleging fraudulent intent under the ’34 Act, the U.S. jurisprudence has left little room for professionals such as auditors to be held liable under Section 10(b) for misstatements that are not specifically attributed to them.

This Memorandum describes the steady narrowing of the scope of liability for auditors since 1994 in the United States federal courts and legislature.

A. The Supreme Court Eliminates Aiding and Abetting Liability for Accountants under Section 10(b) in *Central Bank of Denver*

Prior to the Supreme Court’s decision in *Central Bank of Denver*, it was routine for plaintiffs to sue primary violators of the statute and name other professionals, such as accountants and lawyers, as defendant aiders, abettors, and co-conspirators for assisting in the preparation of a financial statement. The Court held, however, that there is no civil liability for aiding and abetting under Section 10(b), finding that the plain text of the statute only prohibits making misrepresentations; it does not prohibit giving aid to a person who makes such a misrepresentation.[5]

The Court also articulated a policy rationale for this holding, explaining that liability for aiders and abettors “exacts costs that may disserve the goals of fair dealing and efficiency in the securities markets.”[6] These costs derive from the creation of confusion among those who provide services to issuers, given the degree to which the rules for aiding and abetting liability remain unclear. Thus, extending the reach of civil liability under Section 10(b) might, in fact, harm investors, the intended beneficiaries of the statute.[7]

Yet, even while eliminating aiding and abetting and conspiracy as distinct causes of action, the *Central Bank of Denver* Court noted that “secondary actors” may be held liable under other theories—a proviso that would lead to a decade of debate among appellate courts over what types of conduct by a secondary actor could give rise to primary liability under Section 10(b).[8]

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5 *Id.* at 177.

6 *Id.*

7 *Id.* at 189 (“[T]he increased costs incurred by professionals because of the litigation and settlement costs under 10b-5 may be passed on to their client companies, and in turn incurred by the companies’ investors.”)

8 *Id.* at 191.

B. Plaintiffs Respond by Expanding Theories for Primary Liability of Auditors after *Central Bank of Denver*

Central Bank of Denver shifted the battlefield over the liability of secondary actors. In the wake of the decision, plaintiffs in complex fraud cases continued to charge many of the same parties once named aiders and abettors as primary violators of Section 10(b) or other sections of the securities laws. This led appellate courts to adopt various alternative – and sometimes overlapping – standards for determining whether conduct was sufficient to render a secondary party a primary violator under Section 10(b).

One line of cases applied different iterations of a "substantial participation" test, which subjected secondary actors to primary liability as long as they played a "significant role" in the creation of the false or misleading statements.[9] For example, in *McGann v. Ernst & Young,* the Ninth Circuit held that *Central Bank of Denver* did not preclude finding an accounting firm primarily liable for securities fraud where the accountants knew that an audit report containing allegedly false information would be filed with an issuer's annual 10-K report.[10] Likewise, in *In re Software Toolworks Inc. Sec. Litig.,* the Ninth Circuit determined that an accountant's participation in the drafting of two letters to the SEC, which related to an upcoming offering and contained misleading statements was "sufficient to sustain a primary cause of action under §10(b), and as a result, *Central Bank of Denver* did not absolve [the auditor] on these issues."[11]

In applying multiple versions of the "substantial participation" test – including the so-called "entanglement" and "endorsement" theories of liability[12] – the Ninth Circuit became its primary champion during the period following *Central Bank of Denver*, although several lower courts also applied versions of it.[13]

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9 *See, e.g. Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) (holding that accountants' "substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements").

10 *McGann v. Ernst &Young,* 102 F.3d 390, 396 (9th Cir. 1996).

11 *In re Software Toolworks,* 50 F.3d 615, 628 n.3 (9th Cir. 1994).

12 "Entanglement" involves participation by corporate insiders in the preparation of analysts' reports such that the analysts' statements may be imputed to the insiders of the company, *see, e.g. Cooper v. Pickett*, 137 F.3d 616, 624 (9th Cir. 1997); whereas the "endorsement" theory holds that defendants may be liable for the statements of others if they ratify or endorse them. *See, e.g. In re RasterOps Corp. Sec. Litig.,*1994 WL 618970 (N.D. Cal. Oct. 31, 1994).

13 *E.g. Cashman v. Coopers & Lybrand,* 877 F. Supp. 425 (N.D. Ill. 1995) (finding accountants to be primarily liable where they were "centrally involved" in the drafting and preparation of a prospectus and other promotional material).

A second line of cases – including decisions in the Second, Tenth, and Eleventh Circuits – rejected this "substantial participation" approach in favor of a bright-line test. These cases held that defendants may be primarily liable under Section 10(b) only for their own statements and not for the statements of others, no matter the degree or manner of their involvement.[14] As the Second Circuit explained in *Shapiro v. Cantor*, a class action alleging non-attributed participation by an accounting firm in financial statements , "[i]f *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)."[15]

The bright-line test was based on a reliance-based rationale. As the Second Circuit noted in *Wright v. Ernst & Young*, a case where an accounting firm was alleged to have merely reviewed and approved an alleged misstatement, to allow such claims "would circumvent the requirements of the Act, as reliance only on representations made by others cannot itself form the basis of liability."[16] The Tenth Circuit agreed that, following *Central Bank of Denver*, "[actors] must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[17]

Still another line of cases combined elements of both the "substantial participation" and "bright-line" approaches, requiring something less than clear attribution, but also demanding some degree of reliance by the investor on the auditor's identity and participation. The Fourth Circuit articulated this standard in *In re Mutual Funds Investment Litigation*, holding that a secondary actor who played a "substantial role in preparing or approving" the statement, such that "interested investors *would have known* that the defendant was responsible for the statement at the time it was made, even if the statement on its face is not directly attributed to the defendant," may be held accountable as a primary violator.[18]

Finally, plaintiffs also increasingly attempted to extend liability to secondary actors based on what became generally referred to as "scheme liability," a standard grounded in conspiracy-based theory that seemed to weigh the actor's state of mind and relationship with the main violator above all else.[19] Indeed, an accountant or

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[14] *See, e.g. Pacific Inv. Mgmt. Co LLC v. Mayer Brown LLP,* 603 F.3d 144 (2d Cir. 2010) ("[A] secondary actor can be held liable in a private damages action brought pursuant to Rule 10b-5(b) only for false statements attributed to the secondary actor-defendant at the time of dissemination.").

[15] 123 F.3d 717, 720-721 (2d Cir. 1997).

[16] *Wright v. Ernst & Young*, 152 F.3d 169, 175 (2d Cir. 1998).

[17] *Anixter v. Home-Stake Prod. Co.,* 77 F.3d 1215, 1226 (10th Cir. 1996).

[18] 566 F.3d 111 (4th Cir. 2009), *rev'd, Janus Capital Group, Inc. v. First Deriv. Traders,* 131 S. Ct. 2296 (2011).

[19] In addition to the appellate courts adopting "scheme liability," *see* note 23 and accompanying text, *infra*, the SEC seemed to endorse a version of this scienter-centric standard. *See, e.g. Enron Corp.*

other professional who participated in a fraudulent "scheme" violated Section 10(b) under this approach, even if such a party did not make a public misstatement or violate any duty to disclose.[20] Just as in the case of the other expanded theories, a circuit split quickly developed over the viability of "scheme liability." Whereas the Fifth and Eighth Circuits held it insufficient to plead that the defendant merely participated in a scheme to defraud, the Ninth Circuit and various other lower courts were amenable to the theory.[21]

C. The Supreme Court Narrows and Clarifies the Scope of Liability for Secondary Actors under Section 10(b) in *Stoneridge* and *Janus*

With its rulings in *Stoneridge* and *Janus*, the Supreme Court would define the parameters of liability for auditors and other secondary actors under Section 10(b), shutting down the new avenues plaintiffs were using to re-label "aiding and abetting" and "conspiracy" violations as new forms of primary liability.

In 2008, the Supreme Court addressed the "scheme liability" circuit split in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*,[22] which involved a class action suit against a cable operator, and multiple secondary entities which purportedly participated in a fraudulent scheme to inflate revenues. The *Stoneridge* Court rejected scheme liability as a concept on the grounds that plaintiffs do not allege reliance when they argue scheme liability. Put simply, plaintiffs do not plead reliance in scheme liability cases because the secondary entities' "deceptive acts, which are not disclosed to the investing public, are too remote to satisfy the requirement of reliance."[23]

Further, the Supreme Court noted that scheme liability is inconsistent with Congressional intent. Congress had responded in 1995 to *Central Bank of Denver* by passing Section 104 of the PSLRA, which authorizes the SEC – but not private parties – to bring aiding and abetting claims. Scheme liability "would revive in substance the implied cause of action against all aiders and abettors...[and] would undermine Congress' determination that this class of defendants should be pursued by the SEC and not private litigants."[24]

Securities and Deriv. Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002) (agreeing with the rule proposed by the SEC that "when a person, acting with others, creates a misrepresentation…the person can be liable as a primary violator … if … he acts with the requisite scienter," even if that party is not the principle initiator of the misstatement).

20 *See, e.g. Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006).

21 *See id; In re Global Crossing Ltd. Sec. Litig.* 322 F. Supp. 2d 319 (S.D.N.Y. 2004) (finding that an accountant "committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud").

22 552 U.S. 148 (2008).

23 *Id.* at 161.

24 *Id.* at 162-163.

With its 2011 decision in *Janus,* the Court further constricted the universe of possible primary violators of Section10(b), holding that a defendant only "makes" a statement under the provision if that defendant "is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it."[25] *Janus* concerned two closely related but separate legal companies –Janus Investment Fund (JIF) and its investment advisor, Janus Capital Management (JCM) – and addressed the question of whether misstatements in a prospectus filed by JIF were "made" by JCM, given its role as a closely related investment advisor. The Court ruled that, notwithstanding JCM's relationship to JIF, "[o]ne who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by – and only by – the party to whom it is attributed."[26]

An auditor's position as an outside versus in-house service provider is relevant under *Janus*, since "[t]he degree of separation between [the primary and secondary actors] naturally will inform the analysis of where ultimate authority lies."[27] Lower court decisions have found that the *Janus* "ultimate authority" rule is applicable to outside service providers, as well as (in some instances) insiders..[28]

Built upon the reasoning in *Stoneridge* and *Central Bank of Denver*, *Janus* represents another constriction in a steady narrowing of liability for professionals assisting with the preparation of alleged misstatements. Its "ultimate authority" test has made it very difficult for plaintiffs to meet the elements of § 10(b) in asserting a claim against auditors for a statement that is not directly attributed to them.

D. The Stringent Pleading Standards Also Curtail Claims Against Auditors

Not only must plaintiffs now plead "ultimate authority" over the alleged misstatement, but under the statutory reforms to the '34 Act implemented in 1995, a plaintiff alleging securities fraud must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."[29] In *Tellabs Inc. v. Major Issues & Rights, Ltd*,[30] the Supreme Court clarified that ""[t]o qualify as

[25] 131 S. Ct. at 2296.

[26] *Id.*

[27] *Haw. Ironworkers Annuity Trust Fund v. Cole*, 2011 U.S. Dist. LEXIS 98760, at *9 (N.D. Ohio Sept. 1, 2011) (acknowledging that *Janus* had found the legal separation of the parties to be persuasive evidence that the defendants did not have ultimate authority).

[28] *See, e.g.*, *Fulton Cty. Emps. Ret. Sys.* v. *MGIC Inv. Corp.*, 675 F.3d 1047, 1051 (7th Cir. 2012) (corporation did not have ultimate authority over statements made by executives of affiliated, but not controlled, entity that participated on investor call).

[29] 15 U.S.C. § 78u-4(b)(2) (1997 & Supp. 2008).

[30] 551 U.S. 308 (2007).

'strong' … an inference of scienter must be *at least as compelling* as any opposing inference of nonfraudulent intent."[31] With respect to auditors, plaintiffs thus must allege not only that they had ultimate authority over the alleged misstatements under *Janus*, but also sufficient facts from which to establish a strong inference that the auditor had motive and opportunity to deceive shareholders, or engaged in conduct so reckless as to constitute fraudulent intent.

In a regime where allegations of scienter will be dismissed provided that a plausible, nonculpable explanation for alleged misconduct "tips the scales ever so slightly" in a defendant's favor,[32] credibly charging auditors with fraudulent motives has become a significant hurdle. In particular, courts are reluctant to find that misconduct such as failure to adhere to GAAP accounting standards justifies a finding of scienter, absent strong evidence of fraudulent intent.[33] Even allegations of significant 'red flags' may not suffice to establish auditor liability. In one Second Circuit decision, for example, the Court affirmed the dismissal of a complaint against auditors who had certified the financial statements of a battery manufacturing company, notwithstanding allegations of numerous red flags, including allegations that the SEC filings contained dramatic discrepancies from other company filings in China, as well as inflated revenues, unusually high profit margins, and undisclosed related party transactions.[34] The Second Circuit held that such allegations demonstrated, at most, negligence by the auditors in failing to conduct sufficient diligence to uncover the alleged frauds, noting further that the auditors generally were under no duty to inquire about the inconsistent foreign filings.[35]

E. The Supreme Court Provides Broad Protections for Estimates, Projections, and Opinions

The U.S. Supreme Court has also clarified that statements of opinion and judgment are subject to additional pleading obstacles. This is significant for auditors because many accounting decisions are inherently subject to discretion, and subject to varying judgments. Such statements of opinion can be false only if the speaker did not honestly hold the expressed judgment.

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31 551 U.S. 308, 127 S. Ct. 2499, 2504-05 (2007).

32 *New Jersey v. Sprint Corp.*, 531 F. Supp. 2d 1273, 1281 (D. Kan. 2008).

33 *See, e.g. Ley v. Visteon Corp.,* 2008 U.S. App. LEXIS 20994, at *39–40 (6th Cir. Oct. 6, 2008) (noting GAAS violations alone are insufficient to raise a strong inference of scienter); *Ind. Elec. Workers' Pension Trust Fund IBEW v. Shaw Group, Inc*., 537 F.3d 527, 534 (5th Cir. 2008) (holding that mere publication of inaccurate accounting figures, or failure to follow GAAP, without more, does not establish scienter); *In re Corning, Inc. Sec. Litig*., 2005 U.S. App. LEXIS 5259, at *n.5 (2d Cir. 2005).

34 *In re Advanced Battery Tech, Inc.*, 781 F.3d 638, 641-46 (2d Cir. 2015).

35 *Id.* at *13; *see also Special Situations Fund III QP, L.P.* v. *Deloitte Touche Tohmatsu CPA, Ltd.*, 645 Fed. Appx. 72 (2d Cir. 2016) ("mere allegations of negligence or allegations that a better audit would have uncovered the fraud earlier will not suffice").

In *Omnicare, Inc.* v. *Laborers District Council Construction Industry Pension Fund*,[36] the Supreme Court addressed a plaintiff's burden when alleging that a statement of opinion is materially misleading. The *Omnicare* Court held that, liability for a false statement of opinion may exist only if "the speaker did not hold the belief she professed"[37] or "the supporting fact she supplied were untrue."[38] In cases concerning omissions, a high burden is also imposed: "[t]he investor must identify particular (and material) facts going to the basis for the issuer's opinion—facts about the inquiry the issuer did or did not conduct or the knowledge it did or did not have—whose omission makes the opinion statement at issue misleading to a reasonable person reading the statement fairly and in context."[39]

Crucially, the *Omnicare* court held that a statement of opinion is not necessarily misleading just because the issuer knows, but fails to disclose, some fact cutting the other way.[40] "Reasonable investors understand that opinions sometimes rest on a weighing of competing facts," which is the very reason "why an issuer may frame a statement as an opinion, thus conveying uncertainty."[41]

The reach and contours of the *Omnicare* decision have been further clarified in the Courts of Appeals. As the Second Circuit has held in both *Tongue* v. *Sanofi*[42]and *Martin* v. *Quartermain*,[43] *Omnicare* provides broad protections for speakers with a good-faith basis underlying their estimates, projections, or opinions. The court observed that, under *Omnicare*, a statement of opinion—including estimates and predictions—can be misleading in one of only three ways: (1) if the speaker does not honestly hold the belief professed; (2) if the facts supplied in support of the belief are untrue; or (3) if the speaker's omission of information renders the statement misleading to a reasonable investor.[44] In those decisions, the Court of Appeals affirmed rulings dismissing fraud claims against companies who allegedly misrepresented their prospects for FDA approval (*Tongue*) and their estimates of the quality of gold in company-owned mines (*Martin*), even though plaintiffs pleaded that defendants had private information that conflicted with their publicly-expressed opinion. Such allegations, the Court held, do not suffice

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36 135 S. Ct. 1318 (2015).

37 *Id.* at 1327.

38 *Id.*

39 *Id.* at 1332.

40 *Id.* at 1329.

41 *Id.*

42 *Tongue* v. *Sanofi*, 816 F.3d 199 (2d Cir. 2016).

43 *Martin* v. *Quartermain*, 2018 WL 2024719 (2d Cir. May 1, 2018).

44 *Id.* at *2.

because the estimates at issue had to be viewed in context.[45] That context, the Court observed, included the volatility of the industry and its inherent risks, as well as statements by the company emphasizing the "preliminary nature" of its "estimates," the "subjective" nature of its "process" relying on "judgment," and its reliance on "inferences that may ultimately prove inaccurate."[46]

As these appellate decisions illustrate, meeting the *Omnicare* standard "is no small task for an investor."[47]

The *Omnicare* standard has already successfully been invoked by auditors to defend against claims stemming from statements of opinion. In *Querub* v. *Moore Stephens Hong Kong*, a summary order without precedential value, the Second Circuit found that that "[a]udit reports, labeled 'opinions' and involving considerable subjective judgment, are statements of opinion subject to the *Omnicare* standard."[48] In that case, the court affirmed a district court order granting summary judgment to an auditor because plaintiffs had not established that the auditor did not believe its clean audit opinions or "omitted material facts about the basis for its audit reports."[49]

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45 *Id.* at *3.

46 *Id.*

47 *Tongue*, 816 F.3d at 210 (quoting *Omnicare*, 135 S. Ct. at 1332).

48 *Querub* v. *Moore Stephens Hong Kong*, 649 Fed. Appx. 55, 58 (2d Cir. 2016).

49 *Id.*; *accord Special Situations Fund III QP, L.P.* v. *Deloitte Touche Tohmatsu CPA, Ltd.*, 645 Fed. Appx. 72, 76 (2d Cir. 2016) (under *Omnicare* standard, at pleading stage, plaintiffs failed adequately to allege that auditor "lacked a subjective belief in its opinions and that its opinions were materially misleading because [opinion] omitted key facts").

For these reasons, under well-established Supreme Court jurisprudence, liability for secondary actors such as auditors has now been substantially curtailed by the high pleading standards and the gradual tightening of both primary and secondary theories of liability. While the U.S. Congress briefly debated the creation of a new private cause of action for aiding and abetting securities law violations in 2010[50] – which would theoretically overturn *Central Bank of Denver* and its progeny – the idea was ultimately set aside for study without action,[51] and no legislation is pending or expected on the issue at this time.

D.J.K.
A.J.S.

[50] During debate over the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 §§ 929M, 929O, 124 Stat. 1376 (July 21, 2010), Rep. Maxine Waters, D-N.Y. proposed amending the Senate version of the bill to include a provision creating a private right of action for investors against anyone who aids or abets securities fraud.

[51] *See* Government Accountability Office, "Securities Fraud Liability of Secondary Actors," GAO-11-664 (July 21, 2011) (exploring the arguments for and against creating secondary liability for aiders and abettors, which center on whether it would enhance deterrence of securities fraud, promote equitable compensation of injured investors, and affect the U.S. economy and corporate governance).

Schedule “B”

Jurisdiction	Symmetrical Appeal Rights	Legislation	Appeal Rights Pinpoint	Provision
Ontario	No	*Class Proceedings Act*, S.O. 1992, c. 6	ss 30(1) and 30(2)	A party may appeal to the Divisional Court from an order refusing to certify a proceeding as a class proceeding and from an order decertifying a proceeding. A party may appeal to the Divisional Court from an order certifying a proceeding as a class proceeding, with leave of the Superior Court of Justice as provided in the rules of court.
Alberta	Yes	*Class Proceedings Act*, S.A. 2003, c. C-16.5	s 36(1)	Any party, without permission to appeal, may appeal to the Court of Appeal from any of the following: (a) an order certifying or refusing to certify a proceeding as a class proceeding; (b) an order decertifying a proceeding; (c) a judgment on common issues; (d) an order made under Division 2 of this Part, other than an order that determines individual claims made by class members or subclass members.
British Columbia	Yes	*Class Proceedings Act*, R.S.B.C. 1996, c. 50	s 36(1)	Any party may appeal to the Court of Appeal from (a) an order certifying or refusing to certify a

Jurisdiction	Symmetrical Appeal Rights	Legislation	Appeal Rights Pinpoint	Provision
				proceeding as a class proceeding, (b) an order decertifying a proceeding, (c) a judgment on common issues, and (d) an order under Division 2 of this Part, other than an order that determines individual claims made by class or subclass members.
Manitoba	Yes	*Class Proceedings Act*, C.C.S.M. c. C130	s 36(4)	With leave of a justice of The Court of Appeal, a representative plaintiff or defendant may appeal to The Court of Appeal from (a) an order certifying or refusing to certify a proceeding as a class proceeding; or (b) an order decertifying a proceeding.
New Brunswick	Yes	*Class Proceedings Act*, R.S.N.B., 2011, c. 125	s 38(3)	With leave of a judge of The Court of Appeal of New Brunswick, any party may appeal to that court from (a) a certification order or an order refusing to certify a proceeding as a class proceeding, or (b) a decertification order.
Newfoundland and Labrador	Yes	*Class Actions Act*, S.N.L. 2001, c. C-18.1	s 36(3)	A party may, with leave of a judge of the Court of Appeal, appeal to the Court of

Jurisdiction	Symmetrical Appeal Rights	Legislation	Appeal Rights Pinpoint	Provision
				Appeal from (a) an order certifying or refusing to certify an action as a class action; or (b) an order decertifying an action.
Nova Scotia	Yes	*Class Proceedings Act*, S.N.S. 2007, c. 28	s 39(3)	With leave of a judge of the Nova Scotia Court of Appeal, any party may appeal to that court from (a) a certification order or an order refusing to certify a proceeding as a class proceeding; or (b) a decertification order.
Quebec	No	*Code of Civil Procedure*, C.Q.L.R. c. C-25.01	s 578	A judgment authorizing a class action may be appealed only with leave of a judge of the Court of Appeal. A judgment denying authorization may be appealed as of right by the applicant or, with leave of a judge of the Court of Appeal, by a member of the class on whose behalf the application for authorization was filed.
Saskatchewan	Yes	*The Class Actions Act*, SS 2001, c C-12.01	s 39(3)	With leave of a justice of the Court of Appeal, any party may appeal to the Court of Appeal from: (a) an order certifying or refusing to certify an action as a class action; or

Jurisdiction	Symmetrical Appeal Rights	Legislation	Appeal Rights Pinpoint	Provision
				(b) an order decertifying an action.