SEPTEMBER 2003

Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

"The (new) draft legislation...aims specifically at situations where the conditions of companies have been misrepresented or there has been a failure to disclose material changes to their businesses in a timely way."

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Business Law Department, Steven Jeffery at 416.593.3939 or sjeffery@blaney.com.

NEW ONTARIO LAW PROMISES INVESTORS BROADER RECOURSE

Rodney L.K. Smith, Q.C.

The Ontario government is putting the finishing touches on new legislation that will give both retail and institutional investors who have lost money in stock and bond markets broader – but not unfettered – legal recourse to recover damages.

The draft legislation prompted by the beatings that unsuspecting investors took in such scandals as Enron, WorldCom and Bre-X, aims specifically at situations where the conditions of companies have been misrepresented or there has been a failure to disclose material changes to their businesses in a timely way.

Investors have had recourse to the courts in such circumstances for a generation. However, there has been an onus on them to show that they were aware of the misrepresentations in question, acted because of those misrepresentations, and suffered losses as a result of those actions.

A new part to Ontario's *Securities Act* removes that historic onus by accepting the theory that, in a secondary securities market, such as a stock exchange, prices are determined by available material information about a company and its business regardless of whether every individual buyer or seller is aware of the information.

The theory carries with it the notion that misleading statements made in annual reports, quarterly reports or in press releases, will have a direct impact on buyers or sellers of securities by influencing the price of those securities, even if the buyers or sellers are not aware of the misleading statements and do not directly rely on them.

This concept that misrepresentations will impact markets even if specific buyers are not directly aware of them finds its origins in the theory of "fraud on the market" developed by U.S. Courts.

The concept is carried into the new provisions of the Ontario *Securities Act* but is extended in a significant way.

In the United States, the doctrine of "fraud on the market" applies only to fraudulent misrepresentation, i.e. misrepresentations that were knowingly false when made. In Ontario, it is to apply whether the misrepresentations are fraudulent or merely made carelessly.

As well, the new Ontario legislation creates higher liability exposure, not only where a defendant's lack of care leads to a misrepre-

"The draft changes to the Ontario Securities Act address a number of critical issues and represents a Made in Canada approach that will hopefully lead to greater confidence in public markets."

Rodney L. K. Smith, Q.C. leads Blaneys' Commercial and General Litigation group. He has a wide-ranging practice in corporate, commercial, insurance and municipal litigation.

Rodney can be reached at 416.593.3963 or rsmith@blaney.com.

sentation but also where the defendant deliberately avoided acquiring knowledge of the misrepresentation (i.e. was wilfully blind).

The draft legislation also extends to a new category of defendant, styled the "influential person." This is a person who can influence the public company directly or indirectly, and includes not only individuals or corporations who materially affect control, but also promoters and insiders.

This reach to recover damages from persons or companies beyond the responsible issuer is a significant advance. Where a judgment or settlement is paid by a responsible issuer to the plaintiff shareholders, it is the continuing shareholders in the responsible issuer who indirectly pay the judgment or settlement. There is a basic inequity in having long-term shareholders foot the bills when all shareholders have suffered at the hands of actions by influential persons. While the liability limit for individuals is quite restrictive under the new legislation, in the case of an influential person that is a corporation, the liability limit is the greater of $1,000,000 or 5 per cent of the market capitalization of the influential person.

I particularly like the feature of the new legislation dealing with onus of proof. The burden varies depending on the type of violation and the type of defendant. The legislation distinguishes between "core" documents, such as annual reports, and "non-core" documents, such as news releases.

Once the plaintiff establishes that a misrepresentation or a failure to make timely disclosure has occurred in a core document, it is for the defendant to prove that he, she or it exercised due diligence to assure that such a misrepresentation or failure would not occur. The legislation gives considerable guidance to a Court on the factors to be considered in assessing a due diligence defence.

Also of interest in the new legislation are provisions dealing with a safe harbour for forward-looking statements, reliance on experts, proportionate liability, derivative information and taking corrective action.

While the new legislation seeks to strengthen the capacity of wronged investors to win compensation, it takes particular care to balance their interests with those of other investment industry stakeholders who have feared that extending civil liability to Canadian investors would lead to the kind of litigation that has bedevilled the securities industry in the United States.

It achieves this directly by imposing a dollar limit on the liability of various categories of defendants, thus eliminating any prospect of "limitless liability."

The draft changes to the Ontario *Securities Act* address a number of critical issues and represents a Made in Canada approach that will hopefully lead to greater confidence in public markets.

At the same time, it promises to protect responsible public companies and the investment industry against the most opportunistic and inappropriate aspects of securities litigation that has been undertaken in the United States. ■

BLANEYS ON BUSINESS

“Saying a business should operate in good faith is one thing. But defining the duty is something else. What is good faith? What does it mean?”

H. Todd Greenbloom, a Partner in Blaney McMurtry's Corporate/Commercial law group, has an active business law practice that includes all aspects of franchising and licensing. His clients are involved in a wide range of industries including restaurants, food service, hospitality, recreation, trade shows, retailing, manufacturing and advertising. He is a member of the Canadian Bar Association and the Canadian Tax Foundation and is an Affiliate member of the Canadian Franchise Association.

Todd can be reached at 416.593.3931 or tgreenbloom@blaney.com.

DUTY OF GOOD FAITH EMERGING AS LARGER ONUS ON BUSINESS

H. Todd Greenbloom

Once business people have entered into an agreement in Ontario, can they rely on it, or will the law restrain them from enforcing their rights because they have failed to deal with the other side in good faith?

At the beginning of this decade, the odds that the courts would prevent business people from enforcing their contract rights because of a failure to act in good faith were relatively long because the remedy was not on many people’s radar screens.

Today, however, those odds stand perceptibly shorter and anyone entering into an agreement must now consider whether they may be subject to a duty of good faith and, if so, how that duty should affect their conduct.

Why? There has been a change in the statute law, and while it involves only one business field specifically – franchising – it has implications for all fields because it has sensitized the courts to the long-standing duty of good faith at common law that covers all business.

Saying a business should operate in good faith is one thing. But defining the duty is something else. What is good faith? What does it mean?

There is no precise definition. Some commentators take the position that bad faith is self evident. Others observe that there is a continuum in which it is necessary to be aware of how your conduct affects someone with whom you have a contract.

At one end of this continuum are fiduciary duties where the fiduciary is obliged to disregard its interests and treat the interests of the other as paramount.

At the other end are unconscionable transactions where one side is not required to have any regard for the interests of other so long as it does not abuse its position totally.

In the middle is good faith where one side needs to be concerned only with its own interests so long as it takes into account the rights of the other.

In the franchise context, the question of how good faith is defined is often expressed this way: Does the duty of good faith create rights for an aggrieved party (e.g. renewal rights, exclusivity rights) or does it only fill gaps in situations where the agreement is silent or unclear?

The duty of good faith can be an alarming concept. At one extreme, anyone entering into an agreement may not have any assurances that it will receive what it bargained for, especially if the courts choose to create new rights.

There has been at least one case in the United States, for example, where a franchisee was successful with respect to territorial encroachment and non renewal, even though it did not pay royalties and started a competing business in the trade area contrary to the terms of its agreements with the franchisor.

On the other hand, there have been Canadian cases that have recognized the rights of franchisors to enforce their remedies and made it clear that there is no obligation to renew. Even in some cases where the franchisee was successful, the success likely was based on the

"All businesses are well advised to make sure that the contracts into which they enter are understandable, comprehensive and unambiguous."

franchisor breaching its obligations (e.g. providing projections that had no basis in reality; not providing training; delivering a partially completed operation when a turn key with new equipment was promised).

A number of recent cases indicate how the concept of good faith may be applied in the future. In one instance a franchisor was considered to be in breach of its duty when it failed to protect the rights and interests of its franchisee with respect to a landlord whose changes to the configuration of a mall were detrimental to the franchisee.

In another case the franchisee was in a mall with a major department store as the anchor tenant and saw its sales drop dramatically when the department store went bankrupt and closed. The franchisee identified a new location across the road in a competing mall and brought this new opportunity to the franchisor. The franchisor, contrary to its normal policy, granted the rights in the new location to a third party and the new franchise overlapped the term of the exiting franchisee. The court found the franchisor's conduct to be in bad faith.

A recent Court of Appeal decision reversed a trial court's finding in a good-faith case. The trial court judge found that a franchisor breached its duty of good faith when it introduced a new business that offered the same service as a franchisee, but to different target market. The judge found that the franchisor was not acting in good faith because the new operation might take business away from the franchisee.

The Court of Appeal, on the other hand, concluded that there was no breach of good faith since the franchise agreement did not prohibit the franchisor from opening a new line of business and there was no indication that the new business had actually caused any loss of sales.

This recent Court of Appeal decision may provide insight on when the middle part of the spectrum (i.e. good faith) is the appropriate standard. The case might, in fact, confine access to good faith obligations to those circumstances in which one party has superior knowledge and controls the access of the other to that knowledge.

To sum up, a new body of law with respect to the duty of good faith is building and the chances that the duty could come into play more regularly across the whole spectrum of business have increased.

As a result, all businesses are well advised to make sure that the contracts into which they enter are understandable, comprehensive and unambiguous. If these contracts contain onerous terms, these terms must be spelled out clearly so that everybody agreeing knows what to expect and that they may suffer from 'unfair' provisions.

Businesses are also well advised to ensure that they operate in ways that are clearly in good faith and cannot be seen to be seeking to deprive somebody of benefits for which they have clearly bargained. ■

Blaneys on Business is a publication of the Business Law Department of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com.Legal questions should be addressed to the specified author.

EXPECT THE BEST

Blaney McMurtry
BARRISTERS & SOLICITORS LLP

20 Queen St. West, Suite 1400
Toronto, Canada M5H 2V3
416.593.1221 TEL
416.593.5437 FAX
www.blaney.com