DIRECTORS' NEGLIGENT MIS-STATEMENT LIABILITY IN A SCHEME OF SECURITIES REGULATION

*Ralph L. Simmonds**

I. INTRODUCTION

At both the federal and provincial levels in Canada, express statutory rules of liability in damages, designed to enforce desired norms of business behaviour, have been a feature of recent statutory reform.[1] This article focuses on the rules in respect of disclosure documents, required under a scheme of securities regulation, which contain errors or omissions resulting from directors' negligence.

One of the earliest express statutory rules of civil liability in this field was the Directors Liability Act, 1890 in the United Kingdom.[2] A relatively simple provision of the Act made directors liable in damages to those who had invested in new issues of securities and suffered loss because of an "untrue statement" in a prospectus.[3] Directors were provided with a number of defences, the most important of which was that they "had reasonable ground to believe, and did . . . believe" in the truth of the statements complained of (excluding expert opinion and material from public official documents).[4] The Act has descendants in one form or another in the United Kingdom,[5] Canada,[6] and the United States.[7]

---

* Faculty of Law, University of Windsor. The author gratefully acknowledges the assistance given during the writing of this article by the following individuals: Peter J. Dey, Professors Frank Iacobucci, R. A. Macdonald, Edward Veitch and Edward Rosenbaum.

[1] *See, e.g.*, Trade Practices Act, S.B.C. 1974, c. 96, s. 20, *as amended by* S.B.C. 1974-75, c. 80, s. 11; The Business Practices Act, 1974, S.O. 1974, c. 131, s. 4(1)(b). For the most prominent example in the federal sphere, *see* The Combines Investigation Act, s. 31.1 (S.C. 1974-75-76, c. 76, s. 12), and *see* note 155 *infra*.

[2] 53 & 54 Vict., c. 64. It would seem that one of the reasons for the passage of the Act was to overcome the decision in Derry v. Peek, 14 App. Cas. 337, [1886-90] All E.R. Rep. 1 (H.L. 1889). *See also* Clark v. Urquhart, [1930] A.C. 28, at 67, 99 L.J.P.C. 1, at 15-16 (H.L. 1929) (*per* Lord Atkin).

[3] 53 & 54 Vict., c. 64, s. 3(1). This section also made liable "every promoter of the company, and every person who has authorised the issue of the prospectus".

[4] S. 3(1)(a).

[5] *See* Companies Act, 1948, 11 & 12 Geo. 6, c. 38, s. 43(1).

[6] *See, e.g.*, J. WILLIAMSON, SECURITIES REGULATION IN CANADA 143 n. 24 (1960), referring to The Securities Act, R.S.O. 1950, c. 351, s. 68, of which the now-repealed legislation's corresponding provisions are largely a copy. *See also* ONTARIO SECURITIES

However, in Ontario (probably the most influential province in Canada in the area of securities regulation)[8] and in the rest of the country, over seventy-five years of experience with the original legislation has resulted in surprisingly few changes, particularly in the type of documents covered by the Act. In fact, Ontario's recently repealed Securities Act,[9] introduced in 1966, contained two provisions — sections 142 (with respect to buyers of securities in distributions of a new issue or from a control block covered by a prospectus)[10] and 144*a* (dealing with offeror companies' take-over bid circulars, and offeree companies' directors' circulars, required on a non-exempt take-over bid) — which were direct descendants of the 1890 Act. Neither provision traveled far from its ancestral model. Perhaps the greatest departure was that the plaintiff was relieved of the burden of proving that he relied on the untrue statement.[11]

The recently proclaimed replacement for the 1966 Act, The Securities Act, 1978,[12] adopts these two provisions, but with some further changes. For present purposes, the most notable of these is the extension of liability in the take-over circular provision (a) to the individual director's or officer's circulars issued during a non-exempt take-over bid, and (b) to circulars required in non-exempt "issuer bids".[13] The prospectus liability provision now adds to the class of potential defendants the issuer or a selling security holder, the managing underwriter of the issue, persons filing the required consent to the inclusion in the prospectus of opinions, statements or reports made by them, and other persons signing the prospectus.[14] These provisions also break new ground in reversing the onus of proof with respect to a defendant's reasonable belief in those parts of the relevant disclosure document not based on an expert's views. The

---

COMMISSION, REPORT OF THE COMMITTEE OF THE ONTARIO SECURITIES COMMISSION ON THE PROBLEMS OF DISCLOSURE RAISED FOR INVESTORS BY BUSINESS COMBINATIONS AND PRIVATE PLACEMENTS paras. 2.40, 7.19 (1970) [hereinafter cited as O.S.C. DISCLOSURE REPORT].

[7] *See* text accompanying notes 90-123 *infra*; Landis, *The Legislative History of the Securities Act of 1933*, *28* GEO. WASH. L. REV. 29, at 34-35 (1959); THE AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE s. 1704, "Source" Notes (Proposed Official Draft 1978) [hereinafter cited as A.L.I. CODE, 1978 Draft].

[8] *See* D. JOHNSTON, CANADIAN SECURITIES REGULATION 5-6 (1977).

[9] R.S.O. 1970, c. 426, *as amended by* S.O. 1971 (Vol. 2), c. 31; S.O. 1972, c. 1, s. 55; S.O. 1973, c. 11 (*repealed by* S.O. 1978, c. 47, s. 142) [hereinafter cited as The Securities Act, 1970].

[10] It is arguable that, as a matter of construction, s. 142 is capable of covering any purchaser of a security which is traceable back to the original distribution. *See* WILLIAMSON, *supra* note 6, at 150.

[11] The Securities Act, 1970, ss. 142, 144a.

[12] S.O. 1978, c. 47 (in force Sept. 1, 1979) [hereinafter cited as The Securities Act, 1978].

[13] Ss. 127(2),(3). "Issuer bid" is defined in s. 88(1)(d). S. 127(10) extends the liability provisions concerning take-over bid circulars to include offerors' disclosure documents issued under the stock exchange exemption in s. 88(2)(a) or s. 88 (3)(c), as the case may be.

[14] S. 126(1)(a),(b),(d),(e).

plaintiff must now show the absence of such belief, rather than the defendant its presence.[15]

Detailed criticisms of the terms of the old and new Ontario provisions can be made,[16] but it is their *pattern*, in light of the history of securities regulation in the province, that is of greater interest. The rising tide of securities reform in Ontario (from the 1965 report[17] which produced much of the 1966 Act to the 1970 report[18] which produced many of the reforms in The Securities Act, 1978) has shown a great concern for the buyer of securities in the secondary markets, a person whom we might call the *market investor*: someone who buys or sells a security on the stock exchanges, or other secondary or trading market. For his information, and for that of his advisers, new disclosure rules have been introduced, the most notable requiring the production and filing of periodic reports from issuers whose securities are publicly traded.[19] Yet in neither the repealed nor the new legislation are there express civil liability rules, similar to those benefiting the new issue purchaser or the take-over offeree, which would protect these market investors. This apparent anomaly has been noted by at least one commentator.[20]

Still, on closer examination, is this position so anomalous? Concern for the market investor expressed by federal securities regulators in the United States has greatly influenced securities reform in Ontario. Yet the current federal scheme for securities regulation in that country also has no express civil liability provision protecting the market investor.[21] However, in the proposed replacement for that scheme, embodied in the American Law Institute's Official Draft Federal Securities Code, a break is made. The culmination of more than eight years' work and six tentative drafts,

---

[15] Ss. 126(5), 127(7).

[16] *See, e.g.*, P. ANISMAN, TAKEOVER BID LEGISLATION IN CANADA: A COMPARATIVE ANALYSIS 324 (1974), for a criticism of The Securities Act, 1970. The new legislation may be criticized particularly for its "deemed reliance" component. It improves its predecessor by giving as a defence plaintiff's knowledge of the defect in the disclosure document sued upon. But it does not allow a defendant to negative loss causation in other ways; for example, by showing that the document's defect was discounted by the plaintiff's professional adviser, and had no effect on the market price for the defendant's security. That would be in accord with the role conventionally seen for the statutory disclosure documents. *See* text accompanying notes 34-35 *infra*. *Cf.* A.L.I. CODE, 1978 Draft, *supra* note 7, at ss. 1704(h), 1708(c), 1708(b)(2), 220, with THE AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (Tentative Draft No. 2), s. 215A, Comment (5) [hereinafter cited as A.L.I. CODE, TD-2]. *See also* Blackie v. Barrack, 524 F. 2d 891, at 905-08 (9th Cir. 1975), *cert. denied*, 45 U.S.L.W. 3220 (U.S. Oct. 4, 1976).

Further, it may be argued that, in view of the variable standard by which directors' conduct will be assessed (*see* notes 62-84 *infra*, and accompanying text) and their greater knowledge, the reversal of onus on the reasonable belief issue, referred to in the text accompanying note 15 *supra*, is not justified.

[17] REPORT OF THE ATTORNEY GENERAL'S COMMITTEE ON SECURITIES LEGISLATION IN ONTARIO (J. Kimber Chairman 1965) [hereinafter cited as the KIMBER REPORT].

[18] O.S.C. DISCLOSURE REPORT, *supra* note 6.

[19] *See* The Securities Act, 1970, Part XII and the Securities Act, 1978, Part XVII.

[20] *See* ANISMAN, *supra* note 16, at 319 n. 102.

[21] *See* text accompanying notes 112-14 *infra*.

the new Code extends a limited form of express civil liability protection to the market investor in respect of the central periodic disclosure document required under the Code's scheme of continuous disclosure.[22]

This background to legislation on both sides of the border has suggested the central purpose of this article: to examine more closely the apparent anomaly in the Ontario regulatory scheme. Included will be an examination of the most obvious purposes of directors' civil liability in a scheme of regulation based largely on a philosophy of disclosure, a familiarization with the outlines of relevant civil liability in the United States, and a consideration of the extent to which the common law's emerging tort of negligent mis-statement fills the gap in Ontario's statutory scheme. Although the reform proposed in the United States will be found to have much to commend it for this province, questions will be raised about our understanding of the role of directors' civil liability in our scheme of securities regulation. Finally, the article will deal with the validity of the approach taken by securities regulators to the philosophy of disclosure itself, in the light of data from the United States which cast some doubt on the accepted value of the disclosure process embodied in that scheme.

II. THE DISCLOSURE PHILOSOPHY IN SECURITIES REGULATION

The notion that disclosure is an important tool of investor protection found clear expression in the government report[23] which preceded the 1844 English legislative ancestor[24] of much modern corporate and securities law in the United States and Canada.[25] Modern legislation goes much further than its ancestor, with regard to both the occasions upon which disclosure is required and the detail in which disclosure must be made. The disclosure theme is prominent in the *Kimber Report*,[26] which preceded the passage of the 1966 Ontario Securities Act. The 1966 Act contained provisions, suggested in the Report, for improving the quality of financial disclosure in the prospectus required to be filed with the Ontario Securities Commission (O.S.C.) whenever a "distribution to the public" of new securities or of securities from a control block is proposed.[27] The Act also introduced the regulation of take-over bids by, *inter alia*, requiring offerors' circulars

---

[22] *See* text accompanying notes 140-42 *infra*.

[23] The report was prepared under the direction of William Gladstone, and is summarized in B. HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867 at 92-101 (1936).

[24] An Act for the Registration, Incorporation, and Regulation of Joint Stock Companies, 7 & 8 Vict., c. 110.

[25] *See* WILLIAMSON, *supra* note 6, at *v*; Kilbride, *The British Heritage of Securities Regulation in the United States*, 17 SW. L.J. 258, at 263 (1963); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, at 612 (1964).

[26] *Supra* note 17, at para. 4.01.

[27] The Securities Act, 1970, ss. 43-46.

and, in certain circumstances, offeree companies' directors' circulars and circulars of individual directors or officers.[28] Provisions were also introduced requiring that annual and interim (semi-annual) financial statements by corporations with publicly traded securities be filed at the offices of the O.S.C.[29] The disclosure theme was further intensified in the 1970 Report of the O.S.C.,[30] whose influence on The Securities Act, 1978 reflects the Commission's concern with continuous disclosure for the secondary markets and the coordination of the new issue and the continuous disclosure schemes.[31]

The basis of the disclosure philosophy is that the decision process with which it is concerned requires adequate information. Securities regulation has been distinguished from corporate law in that the former is seen to emphasize investment decisions, while the latter emphasizes the exercise of the corporate franchise.[32]

Securities regulators have evidently reasoned from the philosophy of disclosure that much of the information necessary for investment analysis with respect to the issuer and its securities is best supplied by the issuer.[33] With respect to users of the analysis, regulators appear to have concluded early that the person performing the analysis need not be the investor himself, but rather his professional investment adviser.[34] There is more recent concern with the role of disclosure in fostering efficient capital markets. In this regard, it is seen as enhancing the quality of the competing judgments of buyers, sellers and their advisers, so that the best possible estimates of the value of securities in the marketplace will result. Capital will thus be directed to its most productive uses, thereby improving the allocational efficiency of the market.[35] A further concern has been to

---

[28] Part IX.

[29] Part XII.

[30] O.S.C. DISCLOSURE REPORT, *supra* note 6.

[31] *Id.* at paras. 2.01-2.48; The Securities Act, 1978, Parts XVI, XVII. Particularly notable are the following features of the 1978 legislation: (a) s. 76, introduction of quarterly financial disclosure, replacing semi-annual reports; (b) s. 74, statutory requirement to make timely disclosure of material changes in the issuer's affairs (formerly a matter of O.S.C. policy); (c) s. 80(2), requirement of annual reports. All of these are to be filed with the Commission.

[32] *See Re* Niagara Wire Weaving Co., [1971] 3 O.R. 633, at 636-38, 21 D.L.R. (3d) 305, at 308-10 (C.A.); O.S.C. DISCLOSURE REPORT, *supra* note 6, at para. 2.17.

[33] *See* HUNT, *supra* note 23, at 92-94; KIMBER REPORT, *supra* note 17, Parts IV, V; O.S.C. DISCLOSURE REPORT, *supra* note 6, at para. 2.01; Knauss, *supra* note 25, at 612. *But see* text accompanying notes 312-15 *infra*.

[34] *See* HUNT, *supra* note 23, at 94; L. LOSS, 1 SECURITIES REGULATION 125 (2d ed. 1961); O.S.C. DISCLOSURE REPORT, *supra* note 6, at para. 2.25.

[35] *See* KIMBER REPORT, *supra* note 17, at paras. 1.06, 1.07. Earlier concern is to be found in the U.S. House of Representatives report which preceded the passage of the federal statute, discussed in text accompanying notes 90-123 *infra*, which chiefly concerned primary (or new issue) markets. *See* H.R. Rep. No. 85, 73rd Cong., 1st Sess. 2-3 (1933), quoted in Saari, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, at 1032 n. 7 (1977).

ensure maximum market participation of the sources of capital by fostering public confidence in market pricing mechanisms.[36]

The disclosure required by Ontario's new securities legislation is intended to bring about these effects through both delivery of the relevant disclosure documents to prospective investors[37] and filing of disclosure documents in a public office.[38] Obviously, carefully constructed disclosure requirements would be diminished in value to the extent that they were not fully complied with, or that the disclosure actually provided was false or misleading. In this context the civil liability provisions of the Act on defective disclosure have been seen by securities regulators as serving a deterrent or prophylactic purpose, as well as a compensatory one for those investors injured when a defective disclosure document is disseminated.[39] While these latter views are commonplace in any discussion of the aims of civil liability in tort,[40] what may not be obvious is why, until recently, directors have been chosen to bear the liability burden virtually alone.

III. DIRECTORS, DISCLOSURE AND THE PROVISIONS FOR DAMAGES ACTIONS

A. *Directors and Disclosure*

The statutory disclosure scheme in Ontario evidences an expectation that directors are in a position to contribute significantly to adequate, accurate disclosure. All of the documents to which the civil liability provisions for defective disclosure apply must be signed or certified by each director, or by some of them, on behalf of the board.[41] In respect of the periodic disclosure documents of Ontario-incorporated companies, either directors are themselves signatories, or there is a signing on their behalf.[42] There has been a relatively recent change in Ontario's Business Corporations Act to give directors (or at least some of them) a greater

---

[36] *See* KIMBER REPORT, *supra* note 17, at para. 1.12; Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, at 319 (1974).

[37] Prospectuses, s. 70; take-over bid circulars, ss. 89(1)1, 94(1), 96(1), 96(3). Issuer bid circulars (*see* note 13 *supra*) are required to be delivered to holders of shares. *See* ss. 89(1)1, 95(1). The position of disclosure documents (which are also covered, *see* note 13 *supra*) required by the exchange will depend on its rules. In addition, all financial statements required to be filed must be delivered to the shareholders.

[38] Periodic financial reports, ss. 76, 77, 81. *See also* s. 78. Prospectuses, s. 52. Take-over and issuer bid circulars, Regulations, ss. 169-71. The Act provides in s. 137(1) that material filed as required is, subject to s-s.(2), open to public inspection.

[39] *See* O.S.C. DISCLOSURE REPORT, *supra* note 6, at para. 2.39.

[40] *See* J. FLEMING, THE LAW OF TORTS 2 (5th ed. 1977).

[41] Prospectuses, s. 57(1). Take-over bid circulars, ss. 94(2), 96(1),(3) and Regulations, Forms 31-33. Issuer bid circulars, s. 95(2) and Regulations, Form 34.

[42] The Business Corporations Act, R.S.O. 1970, c. 53, s. 183, *as amended by* S.O. 1972, c. 138, s. 53. *See also* The Securities Act, 1978, s. 77, and Regulations, s. 11.

statutory role in relation to the periodic financial reports: a company "that is offering its securities to the public" must have an "audit committee" made up of directors, a majority of whom must not be officers or employees of the issuer or an "affiliate".[43] The audit committee's job is to "review" the financial statements in the periodical disclosure documents before they are submitted to shareholders,[44] the company's auditor being entitled to attend the committee's meetings.[45]

Directors are also charged by statute with the management, or the supervision of management, of the company,[46] although the extent to which directors actually fulfil this role and thus acquire detailed knowledge of company affairs has been questioned both in Canada and elsewhere.[47] The main impediment to directors acquiring such detailed knowledge, *qua* directors, is the infrequency of occasions upon which they must perform their duties: namely, at meetings of either the board or its committees.[48] Consequently, vis-à-vis executive management, directors may be at a disadvantage regarding detailed day-to-day knowledge of the company's affairs — a disadvantage which may be expected to grow with the size and complexity of the company's business.[49] Many directors, of course, by virtue of other relationships which they have with the company, will have greater knowledge than this model would suggest.[50] It is probable, however, that a significant number of directors do not have any relationships with the company other than their directorships.[51] For such "outside" directors, there may be additional impediments to acquiring detailed knowledge of company affairs: the pressure of outside commitments and a sense of obligation to the executive management (which may,

---

[43] The Business Corporations Act, R.S.O. 1970, c. 53, s. 182(1). The term "affiliate" is defined in s. 1(1)1 (read with s. 1(4)). The phrase "offering its securities to the public" is the subject of a deeming provision, s. 1(9), *as amended by* S.O. 1978, c. 49, s. 1(6).

[44] S. 182(3). The audit committee is discussed in F. IACOBUCCI, M. PILKINGTON & J. PRICHARD, CANADIAN BUSINESS CORPORATIONS 400-03 (1977).

[45] S. 182(4).

[46] S. 132(1).

[47] *See* T. WHITE, POWER OR PAWNS: BOARDS OF DIRECTORS OF CANADIAN CORPORATIONS 13-25, 39-52 (1978). *See also* REPORT OF THE ROYAL COMMISSION APPOINTED TO INQUIRE INTO THE FAILURE OF ATLANTIC ACCEPTANCE CORPORATION LIMITED 1496-1513, 1609-11 (Hughes J. Comm'r 1969) [hereinafter cited as ATLANTIC ACCEPTANCE REPORT]. *And see* Willett, *Conflict Between Modern Managerial Practice and Company Law*, 5 MELBOURNE L. REV. 481 (1967).

[48] *See* IACOBUCCI, PILKINGTON & PRICHARD, *supra* note 44, at 235-36; Willet, *supra* note 47, at 486.

[49] Ziegel, *The New Look in Canadian Corporation Laws*, in 2 STUDIES IN CANADIAN COMPANY LAW 42 (J. Ziegel ed. 1973).

[50] *E.g.*, the defendant counsel and underwriter directors in the American prospectus liability case of Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 2 A.L.R. Fed. 86 (S.D.N.Y. 1968). This seminal case is discussed in the text accompanying notes 75-80 *infra*.

[51] *See* WHITE, *supra* note 47, at 31-32.

through the proxy machinery, have got them on the board and kept them there).[52]

That directors may fall short of the statutorily-expected level of detailed knowledge of company affairs has prompted one Canadian observer to recommend the restriction of directorships to persons who are employees of the corporation.[53] On the other hand, Professor Melvin Eisenberg, viewing the scene in the United States, has recommended enhancement both of the outside director's knowledge of company affairs, and of his independence of management.[54] Legislation in Ontario has in fact followed the latter course of enhancing the role of the outside director. In determining the effectiveness of such an approach, Professor Eisenberg's study and that of a Canadian observer[55] must be heartening to the legislator. Professor Eisenberg concludes that a board of directors "comprised in significant part of non-executives [is] optimally suited to perform [a monitoring rule]".[56] He discerns, however, an "iron paradox which governs corporate affairs.... Only those who are involved in an enterprise full-time have sufficient knowledge to direct an enterprise, while only those who are not involved full-time can be trusted to monitor those who direct."[57]

On the basis of the foregoing, there is evidence that directors have such a significant role to play in the disclosure process that it seems appropriate to fix them as a class with civil liability. This conclusion, however, is one we will have occasion to return to.[58] But if it is appropriate to fix directors with civil liability, the diversity of both directors and companies, and the "iron paradox", taken together, suggest that it is inappropriate to hold all directors to the same standard. To some extent, at least, that standard should vary with the actual involvement of the director in corporate affairs.

B. *The Standard of Care for Directors under the Provisions for Damages Actions*

A variable standard of care in fact emerges from the cases on the common law duty of care owed by directors *to their companies*.[59] The

---

[52] IACOBUCCI, PILKINGTON & PRICHARD, *supra* note 44, at 235-36; M. MACE, DIRECTORS: MYTH AND REALITY ch. 5 (1971).

[53] Ziegel, *supra* note 49. For a much narrower definition of "outside" directorship, *see* WHITE, *supra* note 47, at 23-25.

[54] Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants*, 63 CALIF. L. REV. 375, at 398-402 (1978).

[55] WHITE, *supra* note 47.

[56] Eisenberg, *supra* note 54, at 402. *Accord*, WHITE, *supra* note 47, at 21-25; REPORT OF THE ROYAL COMMISSION ON CORPORATE CONCENTRATION 294 (R. Bryce, Chairman 1978). *But see* Solomon, *Restructuring the Corporate Board of Directors: Fond Hope — Faint Promise?*, 76 MICH. L. REV. 581 (1978).

[57] Eisenberg, *supra* note 54, at 439.

[58] Text at pages 668-72 *infra*.

[59] IACOBUCCI, PILKINGTON & PRICHARD, *supra* note 44, at 287-89.

cases in the Commonwealth dealing with the reasonable belief defences found in the Directors Liability Act, 1890,[60] and its Commonwealth progeny are, however, much sparser. There are in fact only four such cases, none of them Canadian.[61] However, as the case of *Adams v. Thrift*[62] most clearly illustrates, it seems that a variable standard will be applied here as well. Also, that case offers some useful guidance to directors as to the content of the standard.

In *Thrift*, the plaintiff sued in respect of a prospectus for an issue of shares by a newly incorporated company to finance its acquisition of two businesses (one American, one English), both of which dealt in an allegedly patented communication device for the deaf. The court of first instance experienced no difficulty in finding false statements of fact in the prospectus. It fell to the court to test, for each defendant director (who had not acted fraudulently) whether he had reasonable grounds to believe in the truth of four false statements in the prospectus. The excepted director was a promoter of the issuing company, and the vendor of the English business. The other four defendant directors were Dr. Clarke (a physician), Lord Rosemead, Mr. R. Buddicom (a Justice of the Peace), and Sir John Thrift (a retired Chief Inspector of Stamps and Taxes for the United Kingdom). Each saw his defence fail when tested by the trial court's approach of weighing the importance to the company of the subject-matter of the false statements along with the difficulty of testing them against the steps taken by the board and by each defendant to test them. To ground a reasonable belief required "any facts or circumstances which would induce the belief in the mind of a reasonable man, that is to say, a man who stands midway between the careless and easy-going man on the one hand and the over-cautious and straw-splitting man on the other".[63]

All of the four false statements in issue in the case were found to concern matters which were determinate and important to the company, and testable, if only by commissioning the appropriate experts.[64] Lord Rosemead's reliance on a report from his solicitor, received three months before the issue of the prospectus, that the company would be "a good thing", was found to be insufficient;[65] Dr. Clarke's reliance on that report and his inquiries within his profession as to the efficacy of the hearing aid

---

[60] 53 & 54 Vict., c. 64.

[61] Adams v. Thrift, [1915] 1 Ch. 557, *aff'd* [1915] 2 Ch. 21, 84 L J Ch. 729 (C.A.); Stevens v. Hoare, 20 T.L.R. 407 (Ch. D. 1904); J. & P. Coats (Ltd.) v Crossland, 20 T.L.R. 800 (Ch. D. 1904); Bundle v. Davies, [1932] N.Z.L.R. 1097, [1932] Gaz. L.R 379 (S.C.).

[62] *Supra* note 61. *But see* Howard Marine & Dredging Co. v. A. O. Ogden & Sons (Excavations) Ltd., [1978] 1 Q.B. 574, [1978] 2 All E.R. 1134 (C A. 1977). It is submitted that the majority view there, so far as it suggests that the variability referred to in the text is excluded by the defence's type of wording, is incorrect. *See* especially Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y 1971); Escott v BarChris Constr. Corp., *supra* note 50, discussed in text accompanying notes 75-84 *infra*.

[63] Adams v. Thrift, *supra* note 61, at 565 (first instance).

[64] *Id.* at 564-65.

[65] *Id.* at 566-67.

devices and his reliances on the signatures to the prospectus of the other defendant directors (none of whom did he know to have engaged in any verification activities other than those they relied on in the litigation), were similarly held to be insufficient;[66] Mr. Buddicom could show no grounds other than those relied upon by Dr. Clarke;[67] and Sir John Thrift's frequent inspection visits to the offices of the English business which the issuer was to acquire, and his reliance on Lord Rosemead's solicitor's report, were not enough.[68] In fact, Sir John's persistent attempts to obtain the books of account and financial statements of the English business were characterized as giving rise to "[a]n accumulation of incidents calculated at least to put any businessman on inquiry... more particularly in the case of a businessman possessing the peculiar knowledge which Sir John Thrift's long discharge of public duties ha[d] enabled him to acquire".[69] Dr. Clarke's, Mr. Buddicom's and Sir John Thrift's reliance on the statements of their fraudulent promoter/vendor/co-director were dismissed as unreasonable by reference to the latter's interest as vendor.[70] On the appeal by Dr. Clarke, the Court of Appeal approved the result in terms which suggest no disapproval of the approach adopted by the trial judge.[71]

The lessons of the case for a reasonable belief defence such as the one pleaded in *Thrift* are relatively easy to extract. Where important matters are involved, exclusive reliance on generalized assurances by co-directors, not known by the defendant to be better informed than he, is not sufficient. Depending upon the subject matter of the statement and the difficulty of testing it, a director may be obliged to conduct or have conducted an inquiry in order that his belief might be held to be reasonable. In that inquiry, reliance may be placed on the reports of agents, such as professional men commissioned by the board,[72] but it appears that there must be reasonable grounds to believe in their competence. Moreover, the reports must be timely and to the point.[73] Perhaps of greatest importance for present purposes is the standard of reasonableness applied throughout: that of the ubiquitous reasonable man, charged with the defendant's actual or presumed knowledge of his company, and with the benefit of any relevant special skills he might have.

What is lacking from the case law is a modern application of the relevant defences. This is of concern because *Thrift* might be regarded as an exceptional case. Also, in the related context of the directors' common law duty of care to the company, it has been suggested that the standard of

---

[66] *Id.* at 567-68.
[67] *Id.* at 568.
[68] *Id.* at 569-71.
[69] *Id.* at 570.
[70] *Id.* at 567-69.
[71] *Supra* note 61 (on appeal).
[72] A case pre-dating *Thrift* would include reports by executives of the company. *See* Stevens v. Hoare, *supra* note 61, at 409.
[73] *See also* J. & P. Coats (Ltd.) v. Crossland, *supra* note 61, at 806.

care will likely be determined by reference to higher modern day standards rather than the standards of past cases.[74]

In the United States, the two major examinations of the reasonable belief defences in the present federal securities regulation scheme descended from the Directors Liability Act — *Escott v. BarChris Construction Corp.*[75] and *Feit v. Leasco Data Processing Equipment Corp.*[76] — are both more recent and evince the same general approach as did *Thrift*. In fact *Thrift* was expressly drawn upon in *BarChris*.[77] Of particular interest in this regard is the holding as to the liability of one outside director in *BarChris*. This individual was outside counsel to the company, and the person "most directly concerned with writing the [relevant disclosure document] and assuring its accuracy". The court went on to say that therefore "more was required of him in the way of reasonable investigation than could fairly be expected of a director who has no connection with [such] work".[78] With the aid of a reference (in the American reasonable belief provision) to a "reasonable investigation" duty,[79] the court concluded that he had unreasonably neglected to use facilities at hand to verify a number of matters. These modes of verification included inspection of company minutes and contracts and important company correspondence. He had also unreasonably neglected to have auditors check the company's books of account during the course of their tag-end financial review for certain data concerning which his suspicions ought to have been aroused.[80]

In *Leasco*,[81] the court, in the course of discussing the *BarChris* holdings, concluded that

---

[74] *See* Menzies J., *Company Directors*, 33 AUST. L.J. 156, at 162-63 (1959). *See also* E. PALMER, D. PRENTICE & B. WELLING, COMPANY LAW: CASES, NOTES AND MATERIALS at p. 6-9 (2d ed. 1978). *But see* ZIEGEL, *supra* note 49, at 45. It does not follow, however, that the severity of the standard applied to the duty to manage will necessarily be the *same* as that applied to the reasonable belief defences. *See* Hawes & Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, at 111 (1976).

[75] *Supra* note 50, on ss. 11(b)(3)(A),(C) of the Securities Act of 1933 [hereinafter cited as 1933 U.S. Act], 15 U.S.C.A., s. 77k(b)(3)(A),(C). The s. 11 cause of action is referred to in text accompanying notes 99-100 *infra*. The discussion in the text relates to the general defence. For a discussion of the expertised statements defence, *see* note 82 *infra*.

[76] *Supra* note 62, on the defence under s. 11(b)(3)(A) of the 1933 U.S. Act, 15 U.S.C.A., s. 77k(b)(3)(A).

[77] *Supra* note 50, at 688, 2 A.L.R. Fed. at 153.

[78] *Id.* at 690, 2 A.L.R. Fed. at 155. Apart from his closer involvement with the company, it is not clear what difference the outside counsel's professional expertise made. *See* Folk, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case Part I*, 55 VA. L. REV. 1, at 35 (1969). Consider the treatment of Sir John Thrift in *Thrift*, discussed in text accompanying note 70 *supra*.

For a full discussion of every defence of every defendant in *BarChris*, *see* Folk, *passim*.

[79] *See* s. 11(b)(3)(A) of the 1933 U.S. Act, 15 U.S.C.A., s. 77k(b)(3)(A).

[80] *Supra* note 50, at 690-92, 2 A.L.R. Fed. at 156-59.

[81] *Supra* note 62.

> [w]hat constitutes "reasonable investigation" and a "reasonable ground to believe" will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions.[82]

Although there are differences in the terms of the American defences applied in these cases which detracted from their value as precedent under the old Ontario Act, the terms of the new Act make those two cases more relevant in the province.[83] Statutory differences notwithstanding, the similarity in general approach of these major American cases to that of the major Commonwealth case (*Thrift*), as well as the terms of the latter's holdings, make *BarChris* and *Leasco* of great interest to Ontario lawyers. Their director clients can derive some reassurance from the flexible approach to the standard of care taken by those American cases, which can readily accommodate the "iron paradox" under which those clients live.[84]

The discussion of the American experience under their federal securities regulation scheme is particularly apposite in light of the recent *Pacific Coast Coin Exchange* case.[85] In that case, a majority of the Supreme Court of Canada identified the major purposes of the American scheme with elements of the Ontario scheme.[86] The case gives strong encouragement to the use of authoritative case law on the American scheme, at least *arguendo*, where the statutory context in Ontario is congenial. The common origin, and continuing verbal similarity of the

---

[82] *Id.* at 577-78. All the director defendants in *Feit* were insiders. The reasonable belief defence of each failed. His insider status fixed him with such involvement, expertise and access as to make him practically a "guarantor" of accuracy. *Id.* at 578.

[83] One of the principal differences, the general American statutory defence (*see supra* note 75) of a "reasonable investigation" requirement, was eliminated by The Securities Act, 1978.

The other principal difference is the express standard of reasonableness, for both the general and expertised statement defences, of "that required of a prudent man in the management of his own property". S. 11(c) of 1933 U.S. Act, 15 U.S.C.A., s. 77k(c).This may be higher than *Thrift*'s standard, of "reasonable man in the circumstances" (*see* text accompanying note 63 *supra*). *Cf.* Selheimer v. Manganese Corp. of America, 423 Pa. 563, at 573-79, 224 A. 2d 634, at 640-43 (1966). It may also be higher than The Securities Act, 1978, s. 128 standard, of a "prudent man in the circumstances of the particular case". *See Selheimer, id. But see* A.L.I. CODE, TD-2, *supra* note 16, at s. 1402(d), comment. The final answer to these conundra awaits judicial application of the Ontario legislation. *Cf.* IACOBUCCI, PILKINGTON & PRICHARD, *supra* note 44, at 291.

[84] Even greater reassurance would be derived from a statutory standard of reasonableness, such as that in A.L.I. CODE, 1978 Draft, *supra* note 7, at s. 1704(g), which defines the standard in terms of "a prudent man under the circumstances in the conduct of his own affairs", and then goes on to spell out what the "relevant circumstances" include. One is "another relationship to the registrant when the defendant is a director or proposed director".

[85] Pacific Coast Coin Exch. of Canada Ltd. v. Ontario Sec. Comm'n, [1978] 2 S.C.R. 112, 80 D.L.R. (3d) 529 (1977), *noted in* this volume.

[86] *Id.* at 126, 80 D.L.R. (3d) at 538.

present American federal scheme to the Ontario provisions would favour a finding of such congeniality here.

In this part, the pattern of civil liability in Ontario and its rationales have been examined. Focus has also been given to the origin of the corresponding American provisions, which form part of a scheme whose development has greatly influenced that of Ontario at the legislative,[87] administrative,[88] and, as recently acknowledged, judicial[89] levels. With that in mind, the following part will briefly examine the American provisions as part of the American securities regulation scheme, and proceed to a description of its proposed replacement.

IV. THE AMERICAN CIVIL LIABILITY PATTERN

A. *The Present Pattern*

The present American federal regulatory pattern has two major parts: the Securities Act of 1933[90] and the Securities Exchange Act of 1934,[91] both administered by the Securities and Exchange Commission (S.E.C.).[92] The 1933 U.S. Act is chiefly concerned with disclosure in relation to "securities offered for public sale by an issuing company or any person in a control relationship to such company", and with the prohibition of "misrepresentation, deceit and other fraudulent acts and practices in the sale of securities generally".[93] In pursuance of the first of these objects, issuers or control persons must file a "registration statement"[94] and ensure that, at or before the delivery of the security pursuant to the sale, the investor has received a "prospectus", which takes the salient information from the "registration statement".[95] The detailed contents of the

---

[87] *See* JOHNSTON, *supra* note 8, at 9; O.S.C. DISCLOSURE REPORT, *supra* note 6, at paras. 1.21, 1.22, 1.25, 1.26, 2.06, 2.07.

[88] *See* O.S.C. DISCLOSURE REPORT, *supra* note 6, at para. 1.76; O.S.C. Policy Statement 3-18, quoted in THE ONTARIO SECURITIES ACT AND REGULATIONS 1978 WITH POLICY STATEMENTS 365-70, particularly 367 (DeBoo 1978).

[89] *See* text accompanying notes 85, 86 *supra*.

[90] 1933 U.S. Act, 15 U.S.C.A., ss. 77a, 77aa.

[91] Securities Act of 1934 [hereinafter cited as 1934 U.S. Act], 15 U.S.C A., ss. 78a-78kk.

[92] The S.E.C. was formally established by the 1934 U.S. Act. *See* D. RATNER, SECURITIES REGULATION: MATERIALS FOR A BASIC COURSE 7 (1975).

[93] THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION (S.E.C. pub. Apr. 1974), appearing in R. JENNINGS & H. MARSH, SECURITIES REGULATION: CASES AND MATERIALS 29, at 30 (4th ed. 1977). All page references are to the latter work.

[94] *Id.*

[95] *Id.* As part of the recent trend towards integration of the disclosure required in the 1933 U.S. Act with that required in the 1934 U.S. Act, the S.E.C. has expanded the situations in which prospectuses need not be delivered. *See* Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327, at 345 n. 88 (1977). This trend is discussed in text accompanying notes 127-32 *infra*.

registration statement and prospectus are prescribed by the 1933 U.S. Act itself and S.E.C. rules.[96] Under the 1933 U.S. Act, the registration statement must be signed by a majority of the board of directors of an issuer.[97] In fact, one of the subsidiary purposes of the 1933 U.S. Act was to foster greater involvement of directors in the affairs of their companies.[98] With respect to the registration statement/prospectus process, the 1933 U.S. Act provides three express provisions for an action in damages. Only one of these, however — section 11, in relation to the registration statement — expressly makes directors (among others) potential defendants.[99] Section 11 was based on, but is broader than, then existing U.K. legislation descended from the English Directors Liability Act. It is broader, too, than Ontario's 1966 Securities Act and, to a lesser extent, the 1978 Act.[100] In the commentary on the section, its principal purposes — to deter and to compensate — are stated in terms familiar from the discussion of the Ontario provisions.[101]

The 1934 U.S. Act is similarly concerned with the disclosure of information for investors,[102] and the curbing of "misrepresentations and deceit, market manipulation and other fraudulent acts and practices".[103] Further to the first concern, and focusing on the secondary markets, the 1934 U.S. Act requires companies that exceed a certain size (in terms of assets and number of shareholders), or wish to be listed on a national securities exchange, to file a registration statement, the contents of which are prescribed by the S.E.C.[104] The information in that form must be kept current by filing "annual and other periodic reports" with the S.E.C. It is intended that the reports be used primarily by securities market professionals for the benefit of the secondary trading markets generally.[105] Most of these filings are not required to be delivered to investors.[106]

---

[96] *See* ss. 7, 10 of 1933 U.S. Act, 15 U.S.C.A., ss. 77g, 77j.

[97] *See* s. 6(a) of 1933 U.S. Act, 15 U.S.C.A., s. 77f.

[98] *See* Anderson, *supra* note 36, at 326.

[99] The other provisions are ss. 12(1),(2) of the 1933 U.S. Act, 15 U.S.C.A., ss. 77*l*(1),(2) discussed in JENNINGS & MARSH, *supra* note 93, at 839-41. For other provisions of the Act making directors liable, see 2 & 3 LOSS, *supra* note 34, at 781-82, 1808, 1811. *See also* Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, in Pari Delicto, Indemnification and Contribution*, 120 PA. L. REV. 597 (1972).

[100] *See* Landis, *supra* note 7, at 35. *Cf.* The Directors Liability Act, 1890, 53 & 54 Vict., c. 64; The Securities Act, 1970, ss. 142, 144a; The Securities Act, 1978, ss. 126, 127; s. 11 of the 1933 U.S. Act, 15 U.S.C.A., s. 77k.

[101] *See* 3 LOSS, *supra* note 34, at 1730, 1734 (discussing early judicial treatment of s. 11). *But see* Dooley, *The Effects of Civil Liability on Investment Banking and the New Issues Market*, 58 VA. L. REV. 776, at 809-10 (1972), who maintains that deterrence was Congress' only aim; thus it was important only that underwriters face liability to *someone*. This, however, may be an overstatement. *See* Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227, at 227 (1933-34).

[102] *See* JENNINGS & MARSH, *supra* note 93, at 34-41.

[103] *Id.* at 36.

[104] *Id.* at 34.

[105] *Id.* This disclosure includes annual and quarterly reports. *See* 17 C.F.R., ss. 240.13a-1, 240.13a-13 (1978). It also includes timely disclosure of specified changes in

The 1934 Act also stipulates standards for disclosure in proxy solicitation materials, and under it there are certain filing requirements.[107] There is a further stipulation that the maker of a "tender offer"[108] which would result in the offeror acquiring more than five per cent of certain equity securities must file with the S.E.C., and deliver to the offeree company, a take-over circular whose contents are prescribed by both the Act and S.E.C.[109] Furthermore, those who make a solicitation or recommendation to offeree shareholders (for example, the offeree company) must, as a result of the exercise of the S.E.C.'s rule-making power, file with the S.E.C. a statement whose contents are prescribed by the S.E.C. The person filing must include in his solicitation or recommendation part of the information contained in the filed statement.[110] Neither the 1934 U.S. Act nor the S.E.C. rules thereunder require the involvement of directors *eo nomine* in any of this disclosure, although one would naturally expect some director involvement.[111]

The 1934 U.S. Act contains two express civil liability provisions: sections 9 and 18.[112] Section 9, as it concerns liability for defective disclosure by a person offering to sell or purchase, or selling or purchasing, a security registered on a national securities exchange, requires *wilful* participation in the defective disclosure. Section 18, in respect of defective disclosure in any filing with the S.E.C., provides a defence of good faith and no knowledge of the disclosure defect. Neither provision makes directors *eo nomine* defendants,[113] and neither appears to have produced much reported litigation.[114]

In striking contrast to the relative disuse of the express civil liability provisions under the 1934 U.S. Act stands the litigation record for implied civil liability arising under the S.E.C.'s rule 10b-5. This rule was

---

the affairs of the issuer. *Id.*, s. 240.13a-11. To compare this with the Ontario position, *see* text accompanying notes 27-31 *supra*.

[106] *See* JENNINGS & MARSH, *supra* note 93, at 34. *But see* 17 C.F.R., s. 240.14c-3 (1978).

[107] *See* JENNINGS & MARSH, *supra* note 93, at 35. Considerable importance has been attached to disclosure in connection with proxy solicitations. *See* 2 LOSS, *supra* note 34, at 1027, referred to in the KIMBER REPORT, *supra* note 17, at para. 6.17. *See*, however, text accompanying note 127 *infra*.

[108] *See* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 69-76 (1973).

[109] *Id.* at 77-78.

[110] S. 14(d)(4) of the 1934 U.S. Act, 15 U.S.C.A., s. 78n(d)(4), 17 C.F.R., s. 240.14d-4(c) (1978).

[111] For the role accorded directors under most state corporation laws, *see* H. HENN, HANDBOOK OF THE LAW OF CORPORATIONS 415-17 (2d ed. 1970). *See also* Somner, *Directors and the Federal Securities Laws*, in PREVENTING DIRECTORS' LIABILITY UNDER THE FEDERAL SECURITIES LAWS 132-52 (B. Mann chairman 1974). The Ontario position is discussed in text accompanying note 46 *supra*.

[112] Ss. 9, 18 of 1934 U.S. Act, 15 U.S.C.A., ss. 78i, 78r.

[113] *But see* s. 20 of 1934 U.S. Act, 15 U.S.C.A., s. 78t, and the provisions of the 1933 U.S. Act, 15 U.S.C.A. ss. 77*l*(1),(2).

[114] *See* W. CARY, CASES AND MATERIALS ON CORPORATIONS 1457-58 (4th ed 1969); JENNINGS & MARSH, *supra* note 93, at 872.

introduced pursuant to section 10(b)[115] of the 1934 Act. In connection with the purchase or sale of any security, section 10(b) prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules . . . as [the S.E.C.] may prescribe".[116] Rule 10b-5, one of the implementing S.E.C. rules, prohibits any of the following: the use of any device, scheme or artifice to defraud; the making of false or misleading statements of material facts; and the engaging in any act, practice or course of business which operates, or would operate, as a fraud or deceit upon any person.[117] The volume of case law applying the implied civil liability aspect of rule 10b-5 has been enormous.[118] One large area of application has been defective disclosure: rule 10b-5 has been invoked by plaintiffs both in situations involving primary distributions qualified by registration statements and situations involving take-overs.[119] It has also been applied to periodical disclosure documents filed with the S.E.C. under the 1934 U.S. Act.[120] Directors involved in approving defective disclosure documents would seem to be potentially liable under rule 10b-5.[121]

Subsequent to, and modelled after, rule 10b-5 was section 14(e) of the 1934 U.S. Act.[122] Section 14(e) prohibits the making of any false or misleading statements, the engaging in any fraudulent, deceptive or manipulative acts or practices in connection with tender offers, or any solicitation of security holders in opposition to, or in favour of, such offers. Section 14(e), like its progenitor, has been found to give rise (impliedly) to civil liability.[123]

Recently, however, a series of decisions of the United States Supreme Court has restricted the explosive growth of rule 10b-5.[124] Perhaps the most important of these decisions was that in *Ernst & Ernst v. Hochfelder* in 1976,[125] dealing with accountants' liability under rule 10b-5, where the court resolved a difference of opinion among the circuit courts as to the fault element in rule 10b-5 cases: in its view, something more than mere negligence was required to ground a defendant's liability.[126]

---

[115] 15 U.S.C.A., s. 78j(b).

[116] 15 U.S.C.A., s. 78j(b).

[117] 17 C.F.R., s. 240.10b-5 (1978).

[118] *See* CARY, *supra* note 114, at 713-14; Loss, *Introduction: The Federal Securities Code — Its Purpose, Plan and Progress*, 30 VAND. L. REV. 315, at 315 (1977).

[119] JENNINGS & MARSH, *supra* note 93, at 861-63 (primary distributions); A. JACOBS, THE IMPACT OF RULE 10B-5 Part 8 (Rev. ed. 1979) (tender and exchange offers). It is not clear if rule 10b-5 can be relied upon as a remedy where the plaintiff might have sued under s. 11 of the 1933 U.S. Act, 15 U.S.C.A., s. 77k. *See* JENNINGS & MARSH, *supra* note 93, at 862-63.

[120] *See* Blackie v. Barrack, *supra* note 16.

[121] *See* JENNINGS & MARSH, *supra* note 93, at 1122-25.

[122] 15 U.S.C.A., s. 78n(e), discussed in JENNINGS & MARSH, *supra* note 93, at 868-75.

[123] *See* JENNINGS & MARSH, *supra* note 93, at 873-74.

[124] *See* Whitaker & Rotch, *The Supreme Court and the Counter-Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979).

[125] 425 U.S. 185, 47 L. Ed. 2d 668 (1976).

[126] *See* Whitaker & Rotch, *supra* note 124, at 362-76. It is not clear how much more

B. *The Proposed Pattern*

In recent years the S.E.C., using its rule-making powers under the 1933 and 1934 U.S. Acts, has been working toward upgrading the level of disclosure in the secondary markets to that provided in the primary ones, and toward co-ordinating disclosure under the two Acts.[127] In this respect the S.E.C.'s work has served as a precursor of, and inspiration to, The Securities Act, 1978.[128] In the United States, the apparent limitations on the efficacy of the S.E.C.'s rule-making powers for these purposes,[129] combined with a perceived need for a systematization of the legislative framework to eliminate "needless complexity, . . . overlaps and gaps . . ., [and] inconsistencies between similar provisions . . .",[130] fuelled the thrust toward codification of the federal securities laws which found expression in the latter half of the 1960's.[131] Not least of the aims of this codification exercise has been the systematization of the civil liability position, especially in view of the growth of rule 10b-5, which has been seen to have "dwarfed, upstaged, outshone and made wide end runs around the [1933 and 1934 U.S. Acts'] express civil liability provisions".[132]

Under the auspices of the American Law Institute, a collaboration by senior representatives of the S.E.C. and senior members of the academic community and the practising bar, which was co-ordinated by the Reporter, Professor Louis Loss of Harvard (perhaps the dean among scholars of securities regulation), has borne fruit in the 1978 Draft of the Federal Securities Code (the Code).[133] The Code in its present form represents, with amendments, the consolidation of six tentative drafts, as well as a Reporter's Revision of Tentative Drafts One to Three, with further amendments made when the Institute approved the consolidated work on May 19, 1978.[134]

The Code retains the 1933 U.S. Act's scheme of "advance notice of an offering of securities [in the form of an 'offering statement', the replacement for the 1933 U.S. Act's 'registration statement'] and of

---

than "mere" negligence is required. *See* Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TUL. L. REV. 50 (1978).

[127] *See* Bialkin, *supra* note 95, at 330-31, 345.

[128] *See* The Securities Act, 1978, Parts XVI, XVII; Baillie, *Securities Regulation in the 'Seventies*, in 2 STUDIES IN CANADIAN COMPANY LAW, *supra* note 49, 343, at 346.

[129] *See* Loss, *supra* note 118, at 316. *But see* Schneider in *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW 793, at 808-09 (1967).

[130] Loss, *supra* note 118, at 317.

[131] *Id.* at 317-18.

[132] *Id.* at 315.

[133] *See* A.L.I. CODE, 1978 Draft, *supra* note 7, at xviii.

[134] For a legislative history of the Code, *see* Loss, *supra* note 118, at 319-20; A.L.I. CODE, 1978 Draft, *supra* note 7, at xviii-xx; A.L.I. FEDERAL SECURITIES CODE SUPPLEMENT TO PROPOSED OFFICIAL DRAFT 1 (1978) [hereinafter cited as SUPPLEMENT to 1978 Draft], which also records the May 19, 1978 changes. All references to "the Code" in the text are to the 1978 Draft as amended by the SUPPLEMENT.

requiring the delivery of a prospectus to a purchaser". The Code has, however, rendered the scheme of the Act "somewhat more simple and workable".[135]

With reference to the concerns of the 1934 U.S. Act, the Code furthers the process of upgrading disclosure for the secondary markets by recognizing the annual report, required to be filed by all companies which have entered the Code's continuous disclosure system (by registration), as the "central device for continual disclosure", replacing in this respect the present prospectus and proxy system.[136] Delivery of this document is required to such of the issuer's securities holders of record as the S.E.C. prescribes by rule.[137]

Finally, with reference to tender offers, the Code (as does the 1934 U.S. Act) leaves it to the S.E.C. to spell out the contents of a filed tender offer statement, and to prescribe rules for persons making recommendations with respect to tender offers.[138]

In a separate part of the Code, Part XVII, are collected the civil liability provisions. For non-trading defendants, the bulk of the provisions for an action in damages for mis-statement which cover the point require a level of fault above mere negligence.[139] Of particular interest to this discussion, however, is section 1704, successor to the Directors Liability Act (through section 11 of the 1933 U.S. Act).[140] Section 1704 imposes liability with respect not only to the Code's offering statement but also to the centrepiece of its scheme of continuous disclosure, the annual report.[141] Its application to the annual report is expressed to run in favour of market investors, something no other derivative of the Directors Liability Act has yet done.[142] It does so against the background of Professor Loss' belief, expressed in both his other writings[143] and his commentary to the Code,[144] in the value of civil liability to the enforcement of the regulatory scheme.

C. *Liability to Market Investors: Transplanting the American Provision?*

This account of the present and proposed regulatory pattern illustrates

---

[135] Bialkin, *supra* note 95, at 345.

[136] A.L.I. CODE, 1978 Draft, *supra* note 7, s. 602: THE AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (Tentative Draft No. 1, 1972) s. 601(a)(2), comment 2(a) (source of quotation).

[137] A.L.I. CODE, 1978 Draft, *supra* note 7, s. 602(a).

[138] Ss. 606(d)(1), 607(a), 606(c), read with ss. 299.68, 606(a).

[139] Ss. 1705(a), 1706, 1707(a), read with s. 299.50.

[140] That is the only liability provision concerning a non-trading defendant's negligent mis-statement to catch directors *eo nomine*.

[141] S. 1704(a). *But see* SUPPLEMENT to 1978 Draft, *supra* note 134, ss. 1704(b)(3), 1705(b), and s. 1704, Note (1)(c), with respect to the liability of *outside* directors for the annual report. *See* 1 A.L.I. REPORTER 3 (1979) with respect to such liability for *all* directors.

[142] S. 1704(c)(2).

[143] *See* 3 LOSS, *supra* note 34, at 1819.

[144] A.L.I. CODE, TD-2, *supra* note 16, s. 1403, comment (11)(c).

the striking similarity in disclosure regulation between the American federal securities scheme and that in Ontario. Yet despite this similarity — especially marked in respect of the importance accorded in the two jurisdictions to continuous disclosure — the Ontario legislation has not extended to its required disclosure documents a Directors Liability Act provision of the type which observers in both jurisdictions see as serving useful deterrent and compensatory aims.[145] The American Code has broken the ground; ought Ontario to follow?

Perhaps there is no need to follow the American lead if the remedy in tort for negligent mis-statement operates to fill the gap. As we shall see, however, it is not at all clear that such a remedy does perform that function. An examination of the probable reasons for this uncertainty is particularly fruitful for two reasons. First, such an examination illuminates possible explanations for the legislative caution in Ontario. Secondly, a greater appreciation of the distinctive feature of section 1704 — limitation of liability to a stated but more or less arbitrarily determined dollar amount[146] — in its application to defendant directors may result. The examination of the common law position also reveals some gaps in our understanding of how in fact civil liability operates. Those gaps should at least be recognized — and preferably filled — before the Code's approach to reform is adopted.

V. Liability at Common Law: Negligent Mis-statement

In the post-*Hedley Byrne*[147] era, the question whether accountants (although not directors) are liable to market investors for negligently prepared corporate disclosure documents has been the subject of substantial commentary.[148] The latest pronouncement from the Supreme Court of Canada showed a reluctance to express a conclusion on whether accountants who certify periodic disclosure documents are liable to any investor who relies on them to his detriment.[149] Academic commentary seems to favour imposing such liability.[150] However, an examination of

---

[145] The relevant Canadian conditions, however, may well be different. *See* Baillie, *supra* note 128, at 350-51, 363, 366.

[146] *See* text accompanying notes 299-301 *infra*.

[147] Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd., [1964] A.C. 465, [1963] 2 All E.R. 575 (H.L.).

[148] *See, e.g.*, Baxt, *The Liability of Accountants and Auditors for Negligent Statements in Company Accounts*, 36 MOD. L. REV. 42 (1973); Paterson, *Liability of Auditors to Third Parties in Canada: Haig v. Bamford*, 2 CAN. BUS. L.J. 68 (1977-78).

[149] Haig v. Bamford, [1977] 1 S.C.R. 466, at 477ff., 72 D.L.R. (3d) 68, at 75ff. (1975). *See also* text accompanying notes 187-91 *infra*.

[150] *See* Baxt, *supra* note 148; Benston, *Accounting Standards in the United States and the United Kingdom: Their Nature, Causes and Consequences*, 28 VAND. L. REV. 235, at 258 (1975); Hansen, *Annual Survey of Canadian Law: Corporation Law*, 10 OTTAWA L. REV. 617, at 652-53 (1978); Paterson, *supra* note 148. A. LINDEN, CANADIAN TORT LAW 389 (1977), seems to incline in this direction.

those appellate judgments (all non-Canadian) in which opinions have been expressed on the point would suggest a likely finding of no liability.[151] The question is a difficult one meriting careful scrutiny. Such an examination throws into relief some major factors deserving of legislative attention before a rule of statutory liability is established to fill any gap in the common law.

The American experience with rule 10b-5[152] raises the question whether *implied* civil liability might fill the gap here. Two factors militate against such a result. First, the judiciary in the Commonwealth has demonstrated an antipathy towards recognizing an action based on a statute where the common law has not recognized an analogous duty of care.[153] Secondly, the pattern of express civil liability in the existing and proposed legislation invites an *expressio unius, exclusio alterius* argument.[154] However, this does not preclude more subtle uses of the statutory context — principally as an input into the determination of the common law duty of care, as discussed below.[155]

A. *The Principle of Hedley Byrne Applied*

Fifteen years after the epochal judgments in *Hedley Byrne*,[156] there is still considerable difficulty in formulating from the Canadian decisions a statement of general principle on which liability in tort for economic loss caused by careless words might be made to depend.[157]

There are in fact two major questions that arise in relation to directors' liability on defective disclosure documents: (a) are directors suable? (b) who can sue them? Of the two questions, the second is the more troublesome.

The question of suable defendants requires one to ask whether *Hedley Byrne* is, with some exceptions, restricted to defendants possessing or professing "special skill or competence" in the subject-matter of the advice. This restriction flows from *Mutual Life and Citizens' Assurance Co. v. Evatt*,[158] a 1971 Privy Council decision on appeal from the High Court of Australia. The minority view in that case would have placed a defendant, whether or not he is specially skilled or competent, under a duty to use reasonable care when speaking "on a business occasion or in the

---

[151] For a discussion of the case law, *see* text accompanying notes 181-201 *infra*.

[152] 17 C.F.R., s. 240.10b-5 (1978).

[153] *See* ANISMAN, *supra* note 16, at 317; J. FLEMING, *supra* note 40, at 124.

[154] *See* Heerey, *Directors and Public Issues*, 5 MELBOURNE L. REV. 429, at 455-47 (1967).

[155] *See* text accompanying notes 213-17 *infra*. *But see* Combines Investigation Act, R.S.C. 1970, c. C-23, *as amended by* R.S.C. 1970 (1st Supp.), c. 10, s. 34; R.S.C. 1970 (2nd Supp.), c. 10, s. 65 (Item 9); S.C. 1974-75-76, c. 76, ss. 12,18(1), which may create an *express* statutory rule of liability here.

[156] *Supra* note 147.

[157] *See* Fridman, *Negligent Misrepresentation*, 22 MCGILL L.J. 1 (1976).

[158] [1971] A.C. 793, [1971] 1 All E.R. 150 (P.C. 1970).

course of [his or her] business activities".[159] The point here is that directors, unlike accountants, are not members of a recognized profession which requires special training. A recent discussion in this *Review* of whether the majority opinion in *Evatt* was good law in Canada concluded that the position was unclear.[160]

Basically, two approaches can be taken to the problem *as it affects directors' liability*.[161] One is to consider whether the restrictive view in *Evatt* might now extend beyond the traditional professions to encompass persons who, like directors, have a job which (in the case of directors, by statute) requires them to assume a highly visible role in the preparation of information for use by others. There is support for this view in the Commonwealth case law.[162] Moreover, its particular application to directors has been promoted by at least one author.[163] As a variation on this theme, it can be argued that the ill-defined exception in the majority view in *Evatt*, *viz.*, the direct substantial financial interest of the defendant in the transaction for which his information or advice is to be used, should be extended. It would cover any situation where, although the defendant does not have or profess any skill or competence, the plaintiff "in the ordinary course of his business acquires and passes on raw information — a task which does not require special skill".[164] There seems to be no explicit support for this extension in the case law, although it is an attractive explanation of what was stated by the majority in *Evatt*.[165] A recent Ontario Court of Appeal case has, without mentioning *Evatt*, imposed liability in circumstances which can perhaps best be explained consistently with *Evatt* by resorting to this first approach.[166]

---

[159] *Id.* at 811, [1971] 1 All E.R. at 162 (*per* Lord Reid, Lord Morris of Borth-y-Gest, dissenting).

[160] Schwartz, *Hedley Bryne and Pre-Contractual Misrepresentations: Tort Law to the Aid of Contract?*, 10 OTTAWA L. REV. 581, at 598-613 (1978).

[161] *See* Smillie, *Liability for Negligent Misstatements: Continuing Uncertainty*, 3 OTAGO L. REV. 512 (1973-76).

[162] *Cf.* Bernadine Fisheries Ltd. v. Allan (unreported, N.Z.S.C., April 15, 1975, no. A132/70), discussed in Smillie, *supra* note 161, at 517-18 (accountant performing task not requiring his or any special skill); Capital Motors Ltd. v. Beecham, [1975] 1 N.Z.L.R. 576 (S.C. 1974), discussed in Smillie, at 517-18 (salesman of car dealer representing number of previous owners of vehicle). The latter case could clearly have turned on defendant's financial interest in the transaction, an established exception to *Evatt* (*see* text accompanying note 164 *infra*). But Casey J. seems to support an extended view of the main rule in *Capital Motors*, *id.* at 580. *Cf.* also *Hedley Byrne*, *supra* note 147, at 516, [1963] 2 All E.R. at 602, where Lord Devlin stated: "Today it is unthinkable that the law could permit directors to be as careless as they liked in the statements they made in a prospectus." *But see* Presser v. Caldwell Estates (Pty.) Ltd., [1971] 2 N.S.W.L.R. 471, at 491 (C.A.) (*per* Mason J.A.); Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164, at 179, [1951] 1 All E.R. 426, at 433 (C.A.) (*per* Denning L.J.), set out in text accompanying note 191 *infra*.

[163] ANISMAN, *supra* note 16, at 311.

[164] Smillie, *supra* note 161, at 525-27. *Cf.* Schwartz, *supra* note 160, at 605-13.

[165] *See* Smillie, *supra* note 161, at 525.

[166] Patrick L. Roberts Ltd. v. Sollinger Ind. Ltd., 19 O.R. (2d) 44, at 50, 84 D.L.R. (3d) 113, at 118 (C.A. 1978): "Although [the representor] was not a 'professional

The alternative approach is to disregard *Evatt*. It seems, however, that only one reported Canadian case has yet found it necessary to decide an action solely by reference to *Evatt*.[167] With that exception, the desirability of ignoring *Evatt* has yet to be squarely addressed.[168]

It is suggested that the statutory disclosure scheme and the duties imposed by it on directors would influence a Canadian court to refuse to dismiss an action against a director in respect of a defective disclosure document solely by reference to *Evatt*.[169]

As suggested above, however, the more difficult problem for the courts is that of the class of potential plaintiffs.[170] There appear to be two competing formulations of the plaintiff class: (a) liability to the general class of plaintiffs foreseeable (or perhaps reasonably foreseeable) by the defendant; or (b) liability to a more limited class, although wider than a specific plaintiff or plaintiffs who are known to the defendant and who are likely to be affected in their economic relations by his words.[171] This dichotomy, however, may be misleading in at least two respects. First, is not the term "foreseeable" susceptible of an interpretation which yields the same result as the supposedly narrower formulation?[172] Secondly, the "limited class" formulation may be too restrictive in the situation which is of main concern here: the filing of disclosure documents pursuant to a statutory duty in an office of public record. The court may, in this situation, be especially concerned with identifying, as a suitably "limited" one, the class of persons the statute was intended to protect.[173]

It seems clear, however, that there is judicial concern over the liability potential if the plaintiff class is extended to the limits allowable by

---

man'. . .he had a special responsibility and a special knowledge, which left him in a position to given reliable advice which advice he knew would be acted upon." The negligent mis-statements relied upon were assurances by an Ontario Development Corporation officer as to the financing it would be supplying. This case is discussed in Schwartz, *supra* note 160, at 603-04.

[167] Zahara v. Hood, [1977] 1 W.W.R. 359 (Alta. Dist. C. 1976).

[168] For Canadian judicial opinion on the majority view in *Evatt*, *see* ANISMAN, *supra* note 16, at 311; Schwartz, *supra* note 160, at 598-605.

[169] *Cf.* Haig v. Bamford, *supra* note 149, at 475-76, 72 D.L.R. (3d) at 74 (on the role of accountants).

[170] This problem (as it relates to auditors' liability) has recently been discussed in Hansen, *supra* note 150, at 647-53, where the author acknowledges the uncertainty of the Canadian position.

[171] *See* Haig v. Bamford, *supra* note 149, at 476-77, 72 D.L.R. (3d) at 75. *Cf.* Hansen, *supra* note 150, at 649.

[172] *See* Hansen, *supra* note 150, at 649. *Cf.* Green, *The Wagon Mound (No. 2) — Foreseeability Revised*, [1967] UTAH L. REV. 197, at 205-06; Linden, *Foreseeability in Negligence Law*, in [1973] SPECIAL LECTURES L.S.U.C. 66.

[173] *See* RESTATEMENT (SECOND) OF TORTS (Tentative Draft No. 12, s. 552(3)); Craig, *Negligent Misstatements, Negligent Acts and Economic Loss*, 92 L.Q.R. 213, at 227-29 (1976). *Cf.* Solomon & Feldthusen, *Recovery for Pure Economic Loss: The Exclusionary Rule*, in STUDIES IN CANADIAN TORT LAW 167, at 185-86 (L. Klar ed. 1977). *But see* text accompanying note 218 *infra*.

analogy from foreseeability in the context of physical harm.[174] The preferred judicial formulation of this concern is Cardozo C.J.'s warning against a finding of "liability in an indeterminate amount for an indeterminate time to an indeterminate class".[175] A favoured academic formulation is the felicitous "pragmatic objection" to liability of Professor Fleming James, Jr.: concern lest a multiplicity of claims and an enormous liability bill impose "ruinous consequences on useful activity".[176] It has been suggested that liability should only be imposed when this concern can be neutralized.[177] Neutralization might be said to occur when there is sufficient certainty that both the weight of the liability and the multiplicity of claimants are reduced to acceptable proportions.[178] What "acceptable" proportions are, however, does not seem susceptible of precise definition.[179] What assistance can be derived from the Commonwealth case law?[180]

In *Hedley Byrne* some of the Law Lords expressed approval of *dicta* contained in the case of *Nocton v. Lord Ashburton*,[181] where the House of Lords was concerned with a solicitor's unsound advice to his client. In the course of his judgment, Viscount Haldane discussed *Derry v. Peek*,[182] which dealt with a defective prospectus, sued upon by a person apparently having no prior relationship with either the company or its directors.[183] Viscount Haldane in *Nocton* indicated that in his view *Derry v. Peek* was

---

[174] *See Hedley Byrne, supra* note 147, at 534, [1963] 2 All E.R. at 613-14 (*per* Lord Pearce); Weller & Co. v. Foot and Mouth Disease Research Inst., [1966] 1 Q.B. 569, [1965] 3 All E.R. 560 (Q.B.). *See also* Craig, *supra* note 173, at 218; Harvey, *Economic Losses and Negligence: The Search for a Just Solution*, 50 CAN. B. REV. 580, at 599-600 (1972).

[175] Ultramares Corp. v. Touche, 255 N.Y. 170, at 179, 174 N.E. 441, at 444 (1931), referred to in Haig v. Bamford, *supra* note 149, at 476-77, 72 D.L.R. (3d) at 74-75.

[176] James, *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 12 J. SOC. PUB. T.L. 105, at 109-10 (1972).

[177] Craig, *supra* note 173, at 239-40. The author seems also to urge the courts not to take too narrow an approach to neutralization. *Id.* at 233. *See* Caltex Oil (Aust.) Pty. Ltd. v. Dredge "Willmstad", 11 A.L.R. 227, at 274-75 (H.C. 1976) (*per* Mason J.).

[178] Craig, *supra* note 173, *passim*.

[179] *Id.* at 240.

[180] Craig, *supra* note 173, at 229-33, draws heavily on a review of American cases and the RESTATEMENT (SECOND) OF TORTS, (Tentative Draft No. 12, s. 552). With respect to s. 552, *see* James & Gray, *Misrepresentation — Part I*, 37 MD. L. REV. 286, at 306-13 (1977). *See* Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, at 91 (D.R.I. 1968) (favouring liability). *See also* RESTATEMENT (SECOND) OF TORTS, s. 552, illustration 10 (1977), which appears to resolve the problem at common law in a manner unfavourable to the plaintiff.

[181] [1914] A.C. 932, [1914-15] All E.R. Rep. 45 (H.L.), cited in *Hedley Byrne, supra* note 147, at 484-86, [1963] 2 All E.R. at 581-82 (*per* Lord Reid), at 500-02, [1963] 2 All E.R. 592-94 (*per* Lord Morris of Borth-y-Gest), at 508-09, [1963] 2 All E.R. 597 (*per* Lord Hodson), at 520-24, [1963] 2 All E.R. 604-07 (*per* Lord Devlin).

[182] *Supra* note 2.

[183] *See* the decisions at trial and in the Court of Appeal, 37 Ch. D. 541, and in the House of Lords, *supra* note 2.

simply a case where the relationship of the parties as proved did not impose any special duty on the directors other than the duty of honesty.[184] He also said that other facts might have led to a different result, giving as an example the case of directors issuing to existing shareholders a prospectus inviting them to subscribe for additional shares.[185]

In *Candler v. Crane, Christmas & Co.*[186] the English court of Appeal was dealing with accountants preparing, for their client company, accounts which they knew were to be shown to the plaintiff, a potential investor in the company. Denning L.J., as he then was, in a dissent from the court's holding of no liability, dealt with the problem of how widely the plaintiff class should be drawn.[187] After citing what was later termed the "pragmatic objection",[188] he indicated that an accountant who negligently prepared accounts included in a prospectus may be liable to subscribers who were injured by those accounts.[189] He indicated, however, that it would be "going too far" to make an accountant liable to *any* person who chose to rely on his accounts.[190] He also said that he would not impose liability where "promoters" (apparently including directors) were at fault with respect to the injurious contents of the prospectus, because it was not the "profession and occupation" of "promoters" to use care and skill in making the kinds of statements they do in a prospectus.[191] With respect to directors in a modern scheme of securities regulation like that in Ontario, that is probably too narrow a view and not a sufficient reason for distinguishing the two cases.[192]

Finally, two New Zealand Court of Appeal cases, both decided after *Hedley Byrne*, have had occasion to discuss at length the point at issue here.[193] In *Dimond Manufacturing Co. v. Hamilton*[194] the court found

---

[184] *Supra* note 181, at 947, [1914-15] 3 All E.R. Rep. at 49.

[185] *Id.* at 955, [1914-15] All E.R. Rep. at 53. *But see* Candler v. Crane, Christmas & Co., *supra* note 162, at 183, [1951] 1 All E.R. at 435 (with respect to accountants), referred to in the text at notes 188-91 *infra*. *Accord* Anns v. London Borough of Merton, [1978] A.C. 728, at 768-69, [1977] 2 All E.R. 492, at 512-13 (H.L.) (*per* Lord Salmon).

[186] *Supra* note 162.

[187] Lord Denning's dissent was explicitly approved in *Hedley Byrne, supra* note 147, at 509, [1963] 2 All E.R. 597 (*per* Lord Hodson), at 530, [1963] 2 All E.R. 611 (*per* Lord Devlin), at 538-39, [1963] 2 All E.R. 617 (*per* Lord Pearce).

[188] *Supra* note 176.

[189] *Supra* note 162, at 183, [1951] 1 All E.R. at 435. *See also* the *dictum* of Lord Salmon in Anns v. London Borough of Merton, *supra* note 185.

[190] *Supra* note 162, at 183-84, [1951] 1 All E.R. at 435-36. *See also* Fridman, *Negligent Misrepresentation: A Postscript*, 22 McGill L.J. 649, at 657 (1976). *But see* Comment, *Liability Under Rule 10b-5 for Negligently Misleading Corporate Releases: A Proposal for the Apportionment of Losses*, 122 U. Pa. L. Rev. 163, *passim*, but particularly at 174-75 (1973).

[191] *Supra* note 162, at 179, [1951] 1 All E.R. at 433.

[192] *See* text accompanying notes 161-69 *supra*.

[193] There is a tentative opinion (unfavourable to plaintiff) on point in Toromont Indus. Holdings Ltd. v. Thorne, Gunn, Helliwell & Christenson, 10 O.R. (2d) 65, at 86, 62 D.L.R. (3d) 225, at 246 (H.C. 1975), *modified* 14 O.R. (2d) 87, 73 D.L.R. (3d) 122 (C.A. 1976), discussed in Hansen, *supra* note 150, at 649-50.

[194] [1969] N.Z.L.R. 609 (C.A.).

accountants liable to an investor in respect of negligently prepared accounts. All three members of the court, however, relied on the fact that one of the members of the defendant firm had showed the accounts to the plaintiff.[195] Two judges emphasized that, in the absence of such special circumstances, no duty of care would have been owed to any of the class of persons who might possibly rely on the accounts of the company to purchase its shares.[196] The third appears to have reserved judgment on the issue.[197]

In 1977, a majority of the New Zealand Court of Appeal, in *Scott Group Ltd. v. McFarlane*,[198] held that auditors owed a duty of care, in respect of a negligent certification of accounts, to a company which relied on them in making a successful take-over bid. But only Woodhouse J. was prepared to so find by reference to a general duty of care that would have availed at least some market investors.[199] The other majority justice, Cooke J., relied on the peculiar probability of a take-over in the circumstances known to the accountants here, and declined to express an opinion on the broader question.[200] The dissenting judge, Richmond P., relying heavily on Denning L.J. in *Candler* and *dicta* in *Dimond Manufacturing*, would have denied the plaintiff's claim by virtue of the defendant's lack of awareness of any factors pointing to an inevitable take-over.[201]

Hence, it is submitted that there is support for the view that subscribers on a prospectus — and by analogy offerees on take-over bid and issuer bid circulars — are likely to be viewed judicially as a sufficiently determinate or limited class to neutralize the pragmatic objection.[202] Given the following two factors, (a) the likely common law measure of damages in these situations[203] and (b) the class of plaintiffs,

---

[195] *Id.* at 628 (*per* McArthur J.), at 637 (*per* Turner J.), at 644 (*per* North P.).

[196] *Id.* at 635-36, 644.

[197] *Id.* at 628.

[198] [1978] 1 N.Z.L.R. 553 (C.A. 1977), discussed in Hansen, *supra* note 150, at 650-52; Note, 8 N.Z.U.L. REV. 175 (1978).

[199] *Supra* note 198, at 576.

[200] *Id.* 581-82. (With respect, I disagree with Hansen's view, *supra* note 150, at 651-52, that Cooke J.'s opinion can be aligned with that of Woodhouse J. on this point.) It should be noted that Cooke J. also relied upon the accountant's ability to disclaim liability vis-à-vis the public: *supra* note 198, at 580-81. Beyond stressing the professional's dislike for disclaimers, this point is not a very helpful one. *Cf. id.* at 569 (*per* Richmond P.). Directors, assuming that they can disclaim, are likely to be less inhibited.

[201] *Id.* at 556, 562-65, 566-68.

[202] The application of *Hedley Byrne* to pre-contractual situations now appears to have been resolved. Schwartz, *supra* note 160, at 583-92.

[203] *Viz.* the difference, at the date of purchase, acceptance or non-acceptance, between the "true" or intrinsic value of what was "parted with" (the price paid for a security or the security given the offeror, or the offeror's offer in the event it was declined), and what was received or retained (the security purchased, the offeror's consideration, or the security retained).

See West Coast Finance Co. v. Gunderson, Stokes, Walton & Co., [1975] 4 W.W.R. 501, at 506, 56 D.L.R. (3d) 460, at 464-65 (B.C.C.A.); New Zealand Refrigerating Co. v.

then three certainties seem to follow. First, liability is limited in amount, being at most, the total consideration received on a new issue, or the securities accepted or the offeror's offer as declined. Secondly, liability is determined in duration: the claimable losses will occur within the duration of the distribution to the public or the take-over offer or issuer bid. Thirdly, liability is limited in the class of plaintiffs: investors in the new issue, offerees in the take-over or issuer bid.

To some extent, this analysis aids in the solution of the far more difficult problem of the injured market investor who suffers injury because of defective disclosure in a statutory disclosure document. It has been shown previously that the weight of judicial opinion on the subject is inclined against imposing such liability. There is no doubt that liability is potentially greater here: in theory it is the total *market* value of all of the securities of the issuer (not just those newly issued, or sought after) or the amount of proffered consideration therefor. Duration is more difficult to measure, but may be defined as the length of time over which the effect of the defective disclosure would be felt. The class of market investors is large because it embraces all those injured in respect of all of the corporation's securities. To that extent, the dual concerns of the pragmatic objection, the amount of liability, and the multiplicity of plaintiffs, are more seriously engaged. But is the difference in degree enough? One author has discerned sufficient "certainty" to overcome the pragmatic objection here.[204] Woodhouse J., in *Scott Group v. McFarlane*, appears to have reached a similar conclusion,[205] although Richmond P., like Denning L.J. before him, entertained the opposite view.[206]

The reason that the pragmatic objection, as phrased above, is not of great assistance is, it seems, its intuitive character. At one extreme, the objection is irresistably engaged, as in the case of a negligent misstatement causing a massive electric power failure in a heavily industrialized area;[207] at the other extreme, it seems to have no place, as in a face-to-face transaction where the plaintiff suffers loss by reliance on information requested from the defendant. There is, then, considerable room for debate as to the proper scope for the objection's application.

A more satisfying approach, however, is possible: analyzing the problem in terms of policy factors.[208] Such an approach would suggest that

---

Scott, [1969] N.Z.L.R. 30, at 33-35 (S.C. 1968); McLaughlan, *Precontractual Negligent Misrepresentation*, 4 OTAGO L. REV. 23, at 38 (1977). *But see* Hansen, *supra* note 150, at 653-54.

[204] Baxt, *supra* note 148, at 54-55. *But see* the discussion in the text at notes 225, 228-29 *infra*.

[205] *Supra* note 198, at 571-72, 576. He would seem to exclude non-reliant persons as plaintiffs, however, while including not only reliant market investors but also anyone having business dealings with the company. *Id.* at 575-76.

[206] *Id.* at 566-67.

[207] *See* James, *supra* note 176, at 113 n. 4.

[208] *See* Rivtow Marine Ltd. v. Washington Iron Works, [1974] S.C.R. 1189, 40 D.L.R. (3d) 530 (1972); Feldthusen, *Pure Economic Loss Consequent Upon Physical Damage to a Third Party*, 16 WESTERN ONT. L. REV. 1 (1977); Solomon & Feldthusen,

the pragmatic objection may simply be a shorthand way of expressing the predominance of these factors: (a) How is the loss best borne here? (with the implication that it is better spread over the community suffering the loss than heaped on the defendant); (b) How administrable is such a rule of liability? (with the implication that the potential volume of litigation may be excessive).[209] This in turn suggests that an investigation of those factors might illuminate the scope of the pragmatic objection in the area of investor losses suffered because of defective disclosure. Such an investigation could look into questions such as the following: What are the relative abilities of plaintiff and defendant to bear the losses? What is the potential volume of litigation? How much work would it involve? In Canada, at least, such policy factor investigations are seldom openly undertaken by the courts.[210] The fact they are undertaken at all makes the analysis that follows of some value in predicting judicial behaviour. The exercise may have even greater value in formulating useful proposals for statutory reform.

Are other policy factors relevant? There are a number of further policy factors which are mentioned in the literature. The most important of them seem to be capable of summary as deterrence, appeasement, ethical compensation and ethical retribution.[211] In a system of civil liability based on fault, however, judicial *dicta* and academic commentary suggest that deterrence is probably the most significant other factor in the determination of liability.[212] This factor, along with the loss-bearing and administrative ones, will be examined in detail below.

One matter, raised briefly before, should first be re-examined. Given that the disclosure documents here are signed and filed by or on behalf of directors under *statutory* directions devised for the benefit of investors, might it not be argued that the pragmatic objection is irrelevant? After all,

---

supra note 173, at 169; Symons, *The Duty of Care in Negligence: Recently Expressed Policy Elements — Part I*, 34 MODERN L. REV. 394, at 408 (1971).

It is submitted that it is *not* necessary, for present purposes, to decide whether the problem here is one of duty of care or remoteness. *See* Spartan Steel & Alloys Ltd. v. Martin & Co. (Contractors) Ltd., [1973] 1 Q.B. 27, at 37, [1972] 3 All E.R. 557, at 562-63 (C.A.) (*per* Lord Denning M.R.); *see also* Feldthusen, *id.* at 11 n. 43.

[209] *See* Stevens, *Negligent Acts Causing Pure Financial Loss. Policy Factors at Work*, 23 U. TORONTO L.J. 431, at 451 (1973).

[210] *See* Solomon & Feldthusen, *supra* note 173, *passim*.

[211] They will be returned to in the discussion of deterrence. *See* Glasbeek & Hasson, *Fault — the Great Hoax*, in STUDIES IN CANADIAN TORT LAW, *supra* note 173, 395, at 399-401; Stevens, *supra* note 209, at 464-65; Williams, *The Aims of the Law of Tort*, 4 CURR. LEG. PROB. 137 (1951). *Cf.* Steiner, *Economics, Morality and the Law of Torts*, 26 U. TORONTO L.J. 227 (1976).

[212] *See* Rondel v. Worsley, [1969] 1 A.C. 191, at 272, [1967] 3 All E R 993, at 1027 (H.L.) (*per* Lord Pearce). *But see* Banks v. Reid, 18 O.R. (2d) 148, 81 D.L.R. (3d) 730 (C.A. 1977); Demarco v. Ungaro, 21 O.R. (2d) 673 (H.C. 1979); Paterson, *A Role for Civil Liability in Canadian Securities Regulation? — Remedies for Breach of the Take-Over Bid Disclosure Requirements of the Securities Act 1967*, 12 U.B.C. L REV. 32, at 33 n. 3 (1978); Prichard, *Professional Civil Liability and Continuing Competence*, in STUDIES IN CANADIAN TORT LAW, *supra* note 173, 377, at 380-88; Stevens, *supra* note 209, at 465.

the *Restatement (Second) of Torts*, section 552,[213] in establishing a duty of care owed to the limited class it describes, sets out a separate duty of care for one under a public duty to give information for use by others, which is applied in respect of any transactions "in which it is intended to protect them". Two recent English Court of Appeal cases concerning the liability of persons performing a public duty, *Dutton v. Bognor Regis Urban District Council*[214] and *Ministry of Housing and Local Government v. Sharpe*,[215] contain some support for such an approach. In both cases, that support consists of an invocation of foreseeability in the language of *Donoghue v. Stevenson*,[216] which courts concerned with the pragmatic objection have been at pains to eschew. This might be interpreted as giving paramount weight to the legislative policy of protection of a favoured class in determining whether to impose liability.[217] It should not, of course, be confused with a finding of an implied right of action in the body of the statute (*i.e.* an action on the statute), a finding which was thought to be unlikely here for the reasons given above.

While admitting the attraction of this argument, it is thought that it would accord greater weight to legislative policy than Anglo-Canadian courts have, on many occasions, given it.[218] Furthermore, neither *Dutton* (involving liability to a house purchaser in respect of negligent certification of structural soundness) nor *Sharpe* (involving liability to a chargee in respect of a negligent certification of a title as clear of any such charge) obviously engaged the pragmatic objection. In each case, a single item of property largely fixed the defendant's liability.[219] The number of potential plaintiffs was limited to those who, in *Dutton*, purchased (or, possibly, leased or took charges over) that land, and, in *Sharpe*, to those who had or took an interest in the subject charge (or more generally

---

[213] RESTATEMENT (SECOND) OF TORTS s. 552 (1977), following Tentative Draft No. 12 (1966). *See* note 180 *supra*. *See also* Miller v. Bargain City, U.S.A., Inc., 229 F. Supp. 33 (E.D. Pa. 1964).

[214] [1972] 1 Q.B. 373, [1972] 1 All E.R. 462 (C.A. 1971). *See also* Anns v. London Borough of Merton, *supra* note 185.

[215] [1970] 2 Q.B. 223, [1970] 1 All E.R. 1009 (C.A.).

[216] [1932] A.C. 562, [1932] All E.R. Rep. 1 (H.C.).

[217] *See* Craig, *supra* note 173, at 229.

[218] On the reluctance of the courts to infer civil rights of action from statutes, *see* FLEMING, *supra* note 40, at 125. *See also* the policy discussions in Anns v. London Borough of Merton, *supra* note 185, at 758-59, [1977] 2 All E.R. 504 (*per* Lord Wilberforce), at 767, [1977] 2 All E.R. 511 (*per* Lord Salmon); Dutton v. Bognor Regis U.D.C., *supra* note 214, at 397-98, [1972] 1 All E.R. at 475-76 (*per* Lord Denning M.R.), at 407-08, [1972] 1 All E.R. at 483-84 (*per* Sachs L.J.); Ministry of Housing & Local Gov't v. Sharp, *supra* note 215, at 269, [1970] 1 All E.R. at 1019 (*per* Lord Denning M.R.); Scott Group Ltd. v. McFarlane, *supra* note 198, at 575-76 (*per* Woodhouse J.). *But see also Sharp, supra* note 215, at 265-66, [1970] 1 All E.R. at 1016 (*per* Lord Denning M.R.). *Cf.* Phegan, *Public Authority Liability in Negligence*, 22 MCGILL L.J. 605, at 625-29 (1976); Symons, *supra* note 208, at 536-38.

[219] In *Dutton*, Sachs L.J. said (*supra* note 214, at 408, [1972] 1 All E.R. at 484) that Mrs. Dutton could also recover for inconvenience from living in a defective house, and the disturbance suffered during repair work. It seems unlikely, however, that these would add much to her recovery.

whatever was the item of property in respect of which a particular negligent certification was given).

It is suggested, then, that even in the face of a legislative policy such as the one behind the Ontario securities legislation, the pragmatic objection remains judicially relevant. On the basis of the preceding argument, however, the legislative policy does have a role to play in determining the weighting of the factors which favour an imposition of liability; at the least it should strengthen the argument for such imposition.

Even in determining what the position *ought* to be, the legislative policy is of some assistance, indicating as it does that the documents are viewed as important devices for investor protection. That there may be a serious problem with such a view is considered later.

B. *Policy Factor Analysis*

1. *Introduction: Compensation and the Pragmatic Objection*

When liability is imposed, it can compensate, in part at least, for the loss suffered. The two factors discussed below seem to relate most directly to the compensatory aspect of a finding of liability, and suggest that, pragmatically, what compensation there is may, in certain circumstances, be too costly in social terms.

(a) *The Administrative Factor*

This factor focuses on the manageability of the predicted increase in the workload of the courts if liability is imposed in favour of market investors.[220] Two separate issues are blended here: first, the difficulty of processing this type of litigation; secondly, whether the predicted increase, or any significant increase, will in fact materialize.

The first issue is relatively easy to dispose of. The expense, in time and personnel, of *personal injury* litigation in negligence has been well documented.[221] In the securities context, the triable issues could quite readily be as complex and as time-consuming. Where, for example, defective financial statements are relied upon, substantial volumes of accounting evidence might be involved.[222] Whether the defect was the

---

[220] *See* Stevens, *supra* note 209, at 450-53.

[221] *See* ATIYAH, ACCIDENTS, COMPENSATION AND THE LAW ch. 21 (2nd ed 1975).

[222] *See* Baxt, *True and Fair Accounts — A Legal Anachronism*, 44 AUST. L.J. 541, at 545 (quoting from reply of the Attorney-General in The King v. Kylsant, [1932] 1 K B 442, 23 Cr. App. R. 83 (C.C.A. 1931)). *See also* United States v. Simon, 425 F 2d 796 (2d Cir. 1969), *cert. denied* 397 U.S. 1006, 90 S. Ct. 397 (1970), discussed as to its accounting aspects in Eisenberg, *supra* note 54, at 430-32.

proximate cause of the loss would make necessary, at the least,[223] analysis of the issue of the materiality of the defect: would (or possibly, might) a reasonable investor have been influenced by this defect?[224] This might necessitate substantial expert testimony as well. Such testimony would clearly be necessary if, in fact, causation is extended beyond direct reliance (which the analysis of the disclosure philosophy could invite) by the investor to take account of: (a) the influence of the defect in the document on a number of intermediaries in the marketplace, on whose judgment their investor clients rely (indirect reliance); or (b) on the market's pricing mechanism itself, on whose integrity investors depend (non-reliant investors).[225] Moreover, the assessment of damages is compounded by the difficulty of establishing the "true" value components of the damages equation at the date of the transaction causing the loss.[226] Finally, the standard of care will likely depend on the circumstances of the individual director: what was reasonable care for him in his position of responsibility?[227]

The second issue, the increase in litigation likely to result from the establishment of a rule of liability to market investors, is difficult to satisfactorily answer. To begin with, the reliance element, or lack of it, in such a rule would need to be clarified. A rule confining the number of plaintiffs to those directly reliant on the defective disclosure document in issue would almost certainly keep the number of actions significantly lower than if the duty were also owed to indirectly reliant or even non-reliant investors. However, while one author has suggested the former

---

[223] This assumes that Commonwealth courts would follow the lead of recent American authorities under S.E.C. Rule 10b-5, 17 C.F.R., s. 240.10b-5 (1978): *see* Note, *The Reliance Requirement in Private Actions under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975). *See also* Blackie v. Barrack, *supra* note 16, at 901; note 225 *infra*. *But see* note 231 *infra*.

[224] *See* the variety of formulations of a materiality requirement in Young v. Smith, 8 Alta. L.R. 256, at 261, 21 D.L.R. 97, at 102 (C.A. 1915); Broome v. Speak, [1903] 1 Ch. 586, at 627, 72 L.J. Ch. 251, at 258 (*per* Romer L.J.), at 629, 72 L.J. Ch. at 259-60, (*per* Cozens-Hardy L.J.), *aff'd sub nom.* Shepheard v. Broome, [1904] A.C. 342, [1904-07] All E.R. Rep. Ext. 1576 (H.L.). *Cf.* The Securities Act, 1978, ss. 1(1), 21 & 22. There seem to be no discussions of materiality in the *Hedley Byrne* case law.

[225] It is not clear that S.E.C. Rule 10b-5, 17 C.F.R., s. 240.10b-5 (1978), has been taken this far. The bulk of the opinions to the effect that reliance will be presumed from materiality would cast the burden of disproving it on the defendant. *See* Blackie v. Barrack, *supra* note 16, at 906 n. 22. The weight of Commonwealth opinion would exclude non-reliant investors. *See* note 231 *infra*.

[226] *See* the damages equation referred to in note 203 *supra*. For a measure of relief which the common law recognized in the area of deceit, *see* Burke v. Cory, [1959] O.W.N. 129, 19 D.L.R. (2d) 252 (C.A.); FLEMING, *supra* note 40, at 625. If allowance is made for non-reliant plaintiffs complaining of the distortion of the market price, a different measure of damage is clearly appropriate, broadly, the extent of the distortion as it affected the plaintiff. *See* Note, *The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities*, 26 STAN. L. REV. 371 (1974). This would clearly require expert testimony.

[227] *See* text accompanying notes 62-86 *supra*.

more restrictive class,[228] it is submitted that the broader class best comports with the disclosure philosophy underlying the statute.[229] *Sharpe*[230] shows that the law of negligent mis-statement can extend beyond a reliance analysis, especially where a statutory context so invites.[231] This matter of the required causal link between defective disclosure and the plaintiff's loss would seem to be the single most important factor to affect the potential number of actions.

Much more difficult, however, is the problem of quantifying the litigation potential, and then indicating whether the potential *will* be realized. The size of the litigation potential would depend on the size of the defective disclosure problem. In Canada, there is some evidence of directors' negligence, both in general and in relation to defective disclosure documents.[232] However, substantial evidence is lacking on how wide-spread these occurrences are. Commentary in the Code stresses the importance of the enforcement of disclosure quality standards and of consequent civil liability as a complement to the limited resources of the S.E.C.[233] It might be fairly inferred from this that in the United States there is a significant incidence of negligently caused defective disclosure. Assuming from this that a potential for a significant increase in litigation exists in Canada in general, and Ontario in particular, the question arises, would such an increase in fact take place?

---

[228] Baxt, *supra* note 148, at 55.

[229] *See* text accompanying notes 34-36 *supra*. *See also* Coté, *The Underwriter's Civil Liability and Investor Protection*, 10 R.J.T. 137, at 149 (1975). Where the plaintiff's loss flowed not from a purchase or sale, but a decision to hold on to his security, however, a different conclusion is appropriate. *See* Note, *Limiting the Plaintiff Class: Rule 10b-5 and the Federal Securities Code*, 72 MICHIGAN L. REV. 1398, at 1423-26, 1428 (1974).

[230] *Supra* note 215.

[231] It seems, however, that at least two members of the court in Dutton v. Bognor Regis U.D.C., *supra* note 214, would have excluded at least non-reliant investors in this context. *See id.* at 395, [1972] 1 All E.R. at 473-74 (*per* Lord Denning M.R.), at 405, [1972] 1 All E.R. at 482 (*per* Sachs L.J.). Woodhouse J., in Scott Group Ltd. v. McFarlane, *supra* note 198, at 576 would also seem to exclude non-reliant investors.

[232] *See* Atlantic Acceptance Report, *supra* note 47, at 1496-1513, 1609-11. (*But see id.* at 1620-25.) *See, e.g.*, Kryzanowski, *Misinformation and Security Markets*, 24 MCGILL L.J. 123, at 123, 130 (1978). *But see* Note, *infra* note 233.

[233] A.L.I. CODE, TD-2, *supra* note 16, at s. 1403, Comment (11). This seems to be based on the experience of those who collaborated in the Code project and who could be expected to be good witnesses. *See* text accompanying note 133 *supra*. *See also* S.E.C., REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. No. 95, 88th Cong., 1st Sess. pt. 1, at 513-14 (1963), referred to in Note, *Causation of Damages Under Section 11 of the Securities Act of 1933*, 51 NEW YORK U.L. REV. 217, at 226 (1976).

It does not follow from the new issue experience that civil liability is necessarily appropriate to the continuous disclosure process. There is perhaps a greater likelihood of alternative disclosure being available. *See* Saari, *supra* note 35, at 1054-55. Nor is it clear that the incidence of defective disclosure in new issues justifies the present panoply of regulation and supportive civil liability. *Cf. id.* at 1058 (referring to Stigler, *Public Regulation of the Securities Markets*, 37 J. BUS. 117 (1964)). *See generally* the summary and conclusions in text at 677-79 *infra*.

To date, the best Canadian evidence on this question would seem to be the experience with the existing statutory provisions for an action in damages, under which relatively few actions have been commenced.[234] We have already discarded one natural inference to explain this, namely a lack of defective disclosure documents or directors' negligence. Are there alternative explanations?

Again, Canadian empirical evidence is lacking. Reasoning principally from accounts of experiences with securities litigation in the United States, there may be at least three factors at work in situations where there was a breach of an existing duty of care: (a) the difficulty of discovering defects; (b) the expense of bringing suit, especially if the investor's loss is relatively small; and (c) investor apathy.[235] Looking at these factors, and at a recent Canadian study of American procedural rules as they operate in the context of enforcement of the American antitrust laws,[236] alleviation of the expense factor seems to be the surest way of realizing a significant portion of the litigation potential in this area. That study identifies two major economic disincentives in Canadian procedural law: one arising out of the restricted rules on availability of class action; the other arising from costs rules.[237] Ontario's class action rule, with its potential for co-operative cost sharing, has undergone some judicial liberalization since that study, but it is not at all clear that this liberalization is of much value to prospective plaintiffs in this area.[238] Ontario's cost rules, under which the plaintiff, if he loses, usually pays not only his own costs but also those of the defendant, are a significant problem here.[239]

At present, the reform of Ontario's class action rules and some of its costs rules is being investigated at an official level.[240] It is difficult to

---

[234] *See* 3 LOSS, *supra* note 34, at 1876 (referring to Cameron, *Regulation and Distribution of Securities in Ontario*, 10 U. TORONTO L.J. 199, at 211 (1954)). There has been no such case reported in Canada since Mr. Cameron wrote.

[235] *See* Comment, *The Impact of Class Actions on Rule 10b-5*, 38 U. CHI. L. REV. 337, at 368 (1971); Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, [1972] DUKE L.J. 895, at 905-06; Dooley, *supra* note 101, at 112.

[236] Williams, *Damages Class Action Under the Combines Investigation Act*, in A PROPOSAL FOR CLASS ACTIONS UNDER COMPETITION POLICY LEGISLATION 1 (1976) (Supply and Services Canada, Cat. no. RG35-3/1976-2).

[237] *Id.* at Parts IV, VII. *But see* Kennedy, *Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas*, 14 HOUS. L. REV. 769, at 823 (1977) (increased recognition of causes of action more significant than change in procedural rules). For a contrasting view, *see* Miller, *Of Frankenstein Monsters and Shining Knights: Myth, Reality, and the "Class Action Problem"*, 92 HARV. L. REV. 664, at 673-74 (1979), suggesting that some form of liberal class action procedure was probably essential in this area.

[238] *See* Naken v. General Motors of Canada Ltd., 21 O.R. (2d) 780 (C.A. 1979) (Class action competent because plaintiffs' claimed measure of damages was set to yield a *uniform* amount). For an alternative measure of damages in the securities field that may produce the desired degree of uniformity, *see* Hansen, *supra* note 150, at 653-54; Paterson, *supra* note 148, at 71.

[239] *Cf.* Prichard & Trebilcock, *Class Actions and Private Law Enforcement*, 27 U.N.B.L.J. 5, at 14-17 (1978) (on proposed revisions to the Combines Investigation Act).

[240] *See Eleventh Annual Report of the Ontario Law Reform Commission*, 13 GAZETTE 178, at 180-81 (1978).

predict, however, whether class action procedures will be reformed to facilitate the aggregation of smaller claims that might otherwise not be litigated, or costs rules will be reformed, to mitigate the other major economic disincentive.

In view of the current rules on class actions and costs, the difficulty of discovering defects and the possible apathy of investors, one is left with the feeling that establishment of a rule of liability in favour of market investors (which seems most likely to cover at least indirectly reliant and possibly non-reliant investors) may have *no* significant impact on the judicial workload. If the first of the factors, namely the expense of bringing suit, is reduced in whole or in part, then this conclusion may have to be re-examined. In the present circumstances, the administrative factor would not seem to preclude establishment of such a rule of liability. The issue remains, however, as to whether administrative reform is justifiable in light of the factors described below.

(b) *The Loss-bearing Factor*

Turning now to the other half of the pragmatic objection, *viz.*, its crippling burden of liability, the focus becomes, as it has been put, "the over-all ability of plaintiffs to cope with financial loss [which] has been a major policy factor influencing the courts in refusing to impose liability for such loss".[241] This judicial sentiment becomes most apparent where losses are numerous but small, or at least easily borne by the plaintiff, and where heaping them on the defendant would threaten the continuance of a useful activity.[242] However, where the losses are not easily borne by the plaintiff, and the defendant is in a superior position to that of the plaintiff as regards assessment of the risk and insurance against it, such judicial sentiments would be misplaced.[243] Recognizing that independent variables are involved here,[244] it is evident that a whole spectrum of possibilities is created — as the plaintiff's ability to bear his losses or insure against them decreases, and as the defendant's ability to bear a liability burden or insure against it increases.

Applying this in the context of the duty owed to market investors for defective disclosure documents, a number of comments can be made. First, while investors' loss insurance is quite conceivable, the fact that no mention of it is made in the literature casts doubt on its existence.

Secondly, to the extent that the investor community is made up of financially stronger individuals or institutions with their own diversified investment programmes, the overall ability of that community of plaintiffs to bear its own losses is improved.[245] The most recent detailed studies of

[241] Stevens, *supra* note 209, at 459.

[242] *Id.* at 458.

[243] *See* Calabresis, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, at 543 (1961).

[244] *See* James, *supra* note 176, at 114.

[245] *See* Conard, *supra* note 235, at 912, 916.

securities ownership in Canada's capital markets indicate that institutions hold a substantial number of publicly traded securities, but that individuals (mainly financially stronger individuals) in aggregate are also very significant.[246] Other evidence suggests the possibility that securities with the worst incidence of defective disclosure escaping the present regulatory net tend to be held by investors in the best position to absorb the resulting losses, although more work seems to be called for.[247]

Thirdly, the size of the total losses, or a substantial part thereof, suffered by market investors in these situations would in all probability vastly exceed the personal worth of all but a very few directors.[248] Of course one may reply that suits to recover these losses are unlikely in view of such factors as the class action barrier, the cost rules disincentives, the difficulty of detection, and investor apathy. It is suggested in rebuttal that with the rule of liability here under discussion the possibility cannot be completely discounted. And, of course, if reform of either of the class actions or costs rules is forthcoming, the possibility will increase.

Further, however, it can be replied that directors could seek indemnification or insurance for these losses. Indemnification of directors by their company against negligence liability of this sort would appear to be permissible in Ontario.[249] Whether a company would agree to indemnify, especially in the case of a catastrophic liability burden, is less certain. However, to the extent the loss cannot be passed on to customers, employees or suppliers, any indemnification would effectively cause the burden to be borne by the whole body of shareholders in the company — of which body the plaintiff may form a part.[250] Similarly, purchase of directors' insurance by the company against this kind of liability — whether directly, or indirectly, through directors' fees — would appear to

---

[246] *See* G. CONWAY, THE SUPPLY OF, AND DEMAND FOR, CANADIAN EQUITIES (1968); D. SHAW & R. ARCHIBALD, THE MANAGEMENT OF CHANGE IN THE CANADIAN SECURITIES INDUSTRY: STUDY ONE, CANADA'S CAPITAL MARKET 19, 29-31 (1972). The latter notes a trend towards "institutionalization" of savings. *Id.* at 18, 35.

[247] *See* B. KALYMON, P. HALPERN, J. QUIRIN & W. WATERS, FINANCING OF THE JUNIOR MINING COMPANY IN ONTARIO 228-38 (1978); Kryzanowski, *supra* note 232.

[248] *See* Conard, *supra* note 235, at 899. *See also* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, at 1093 (1968). *But see* Comment, *supra* note 190, at 171.

Of course. contribution among defendants would lessen the burden for each. *See* Fischer, *Contribution in 10b-5 Actions*, 33 BUS. LAW. 1821 (1978). But it is not at all clear that this will preclude the remaining chance of a crushing burden.

[249] *See* The Business Corporations Act, R.S.O. 1970, c. 53, s. 147; Iacobucci, *The Business Corporations Act, 1970: Creation and Financing of a Corporation*, 21 U. TORONTO L.J. 543, at 554-55 (1971).

Directors might also seek contribution from others who are jointly liable with them for the mis-statements. *See* The Negligence Act, R.S.O. 1970, c. 296.

[250] *See* Conard, *supra* note 235, at 911. But some losses here might be so large as to exceed the ability of the company to bear or distribute them. *See* Comment, *supra* note 190, at 171. In the event the company can distribute them, it is not clear that this addition to the class of loss-bearers makes it worthwhile to shift losses at some expense, if the plaintiff class is. in fact, in as good a position as the defendant to bear them. *See* text accompanying note 245 *supra* and note 255 *infra*.

be permissible in Ontario.[251] However, it is not clear that it is available for some companies whose directors might be thought to be most in need of it; namely, new companies without exposure to the rigours of public disclosure, or acquisitions-oriented ones whose burden of disclosure might be among the heaviest.[252]

In any event, losses here would, in fact, be borne by the community of corporate premiums-payers (and thus their shareholders) to the extent premiums could not be passed on to customers, employees or suppliers. Augmenting the loss, in the case of both indemnification and insurance, would be the transaction costs involved, including, in the case of insurance, a portion of the cost of administering the insurance scheme. This creates the potential anomaly of benefiting one class of investors at the expense of another, without regard to the ability of the former to bear the loss, or the ability of the latter to pay the amounts (including transaction costs) involved.

This can be seen most clearly in an example synthesized by an American commentator[253] from the facts of the leading case on section 11 of the 1933 U.S. Act, *Escott v. BarChris Construction Corp.*[254] That case concerned the liability of, among others, the issuing company's directors to purchasers of its convertible debentures. Let it be supposed that *BarChris* had carried liability insurance. Then, to the extent of the shift of the debenture buyers' losses,

> the perils of buying debentures would be diminished, and the rewards of owning stock in insurance-buying companies would be reduced. If the debenture-buyers were widows and orphans, a humanitarian gain would result. If the buyers were pension funds, which is more likely, the loss shift from one group of investors to another would seem to have negligible social advantages. Considering the fact that the costs are doubled or tripled in the process of redistributing them, the social gain may even be negative.[255]

Finally, if insurance is unavailable and indemnification uncertain, the liability spectre may well be too much for a prospective director to tolerate. This might be particularly true of outside directors of the corporation: prominent educators and lawyers, to take two examples.[256] For any of those persons it would be "simple improvidence to risk losing his fortune of a few hundred thousand or a few million dollars, where the only gain would be a few thousands in fees".[257] Of course, one may argue that

---

[251] *See* The Business Corporations Act, R.S.O 1970, c. 53, s. 147(3). IACOBUCCI, PILKINGTON & PRICHARD, *supra* note 44, at 337-40.

[252] *Cf.* Hinsey, Delancey, Stahl & Kramer, *What existing D & O Policies Cover*, 27 BUS. LAW. 147, at 155 (Special Issue, Feb. 1972).

[253] Conard, *supra* note 235.

[254] *Supra* note 50.

[255] Conard, *supra* note 235, at 912.

[256] *Id.* at 899; Trebilcock, *The Liability of Company Directors for Negligence*, 32 MODERN L. REV. 499, at 512-13 (1969). *See also* Cohen, *The Outside Director — Selection, Responsibilities, and Contribution to the Public Corporation*, 34 WASH. & LEE L. REV. 837, at 839 (1977).

[257] Conard, *supra* note 235, at 899.

litigation experience under the existing provisions would suggest that the probability of being sued at all, let alone of being sued at that level of liability, must be ranked very low. Unfortunately, a single finding of liability might suffice to raise the perceived probability to unacceptably high levels.[258] That liability may be avoided by taking reasonable care may not be sufficient comfort to a prospective director, who might feel that even the most careful make mistakes,[259] and that such conduct will be viewed, from the perspective of hindsight, to his detriment.[260] However, as in other areas, empirical data are unavailable to ascertain the incidence of such attitudes among prospective directors.

The two factors comprising the pragmatic objection — the administrative factor and the loss-bearing factor — have now been examined. It is clear from such an examination that the pragmatic objection serves as a counterweight to the value of a finding of liability to compensate injured investors. It is equally clear that without reform of the rules on class actions and costs the fear of a multiplicity of actions may be an unfounded one. More serious, perhaps, is the danger of simply shifting large losses (augmented by transaction costs) from one class of blameless investors to another equally blameless class, without regard to their respective abilities to bear the burden or pay the amounts concerned. Equally undesirable might be a consequent chilling of the "corporate director market". Comparatively small individual losses may help to explain investor apathy even where a rule of liability exists to protect them, and class action and costs norms are present to facilitate recovery. If such apathy exists in Canada, and can be so explained, then a rule of liability to market investors would not seem justified, even from a compensatory point of view.

The argument presented here is, however, rife with questions[261] which demand empirical testing not yet performed in Canada. Do

---

[258] Consider the announcement of the Financial Post Conference, "The Corporate Director: Coping With Change in the Canadian Board Room", at which one topic was "The New Responsibilities of the Director". Financial Post, April 29, 1968, at 23 (full page). *See also* Professor Kennedy's conclusions with respect to his Texas data, *supra* note 237.

[259] *See* Ziegel, *supra* note 49, at 50.

[260] *Cf.* Benston, *supra* note 150, at 263 (on the liability of accountants).

[261] This list of questions is also suggested by the account in Prichard, *supra* note 212. There appears to have been some systematic study of investor use of civil litigation in the United States. *See* Comment, *supra* note 235; Kennedy, *supra* note 237 (where, however, the issue was more one of a *large* volume of litigation). It does not seem, however, that a systematic study of the last two questions in the text has been done. The fact of involvement of experts in the securities reform process in Ontario is no guarantee that these questions have been systematically examined. *Cf.* Wolfson, *The Need for Empirical Research in Securities Law*, 49 S. CALIF. L. REV. 287 (1976) (the effectiveness of examining the "private offering" exemption from the registration provisions of the 1933 U.S. Act). As mentioned in the text, there does not seem to have been such a study in Canada. But this sort of exercise may be the coming thing. *See* B. MONTADOR & H. BAUMANN, GOVERNMENT INTERVENTION IN THE MARKETPLACE AND THE CASE FOR SOCIAL REGULATION (1977). The whole area of regulation is currently being studied by The Economic Council of Canada.

difficulties of detection, the expense of suing, and investor apathy account for the paucity of existing litigation in respect of defective disclosure documents, or are there simply very few disclosure documents which are in fact defective? Is there a pattern of defective disclosure, associated with investors best able to absorb the consequent loss? What would be the effect on the "corporate director market" of the establishment of a rule of liability? However, the judicial decision-making process will not await the answers to such inquiries, in the absence of which one may expect, at best, judgments based on the type of arguments advanced above.[262]

2. *Deterrence*

In the deterrence model, a rule of liability increases the chances of detection of substandard conduct by rewarding loss-sufferers who discover such conduct. The incidence of substandard conduct is reduced by the potential violator's perception of both that heightened detection risk and his exposure to liability.[263] Federal securities regulators in the United States, contemplating what they see to be limited administrative resources for the detection and punishment of substandard conduct, are strong supporters of the civil liability claimant as a "private attorney general".[264] There seems to be no reason to doubt that limited administrative resources are a feature of securities regulation in Ontario as well.[265] If civil liability operates in the way described, it would indeed have a valuable role in enforcing the regulatory scheme. In order to assess the value of civil liability in this respect, however, a number of matters must be dealt with.

First, if liability is considered as a deterrent, it seems appropriate to ask whether "the punishment fits the crime".[266] Such a question appears to subsume the policy factors of ethical compensation and ethical retribution, referred to earlier: society might not think it ethical to compensate or punish, at least not to the full extent of tort recovery. Imposing liability to the full extent of the damages allowable in tort may, as has been indicated, bring about "director impoverishment".[267] It is open to question whether the sort of unpremeditated conduct caught here merits this degree of punishment.[268]

Of course, it may be that tort liability here could perform a vital appeasement function, another policy factor mentioned earlier. However,

---

[262] *Cf.* Solomon & Feldthusen, *supra* note 173, at 185 n. 115.

[263] LINDEN, *supra* note 150, at 6, 10-11.

[264] *See* A.L.I. CODE, TD-2, *supra* note 16, s. 1403, Comment (11)(c). *See also* Benston, *supra* note 150, at 262.

[265] *See* JOHNSTON, *supra* note 8, ch. 2, especially at 72; KIMBER REPORT, *supra* note 17, at para. 8.02. This is not to deny that public law enforcement may be more efficient than private. *See* Prichard & Trebilcock, *supra* note 239.

[266] *See* Fleming, *The Role of Negligence in Modern Tort Law*, 53 VA. L. REV. 815, at 817 (1967); Trebilcock, *supra* note 256, at 513.

[267] Conard, *supra* note 235, at 897.

[268] *Cf.* the references cited in note 266 *supra*. *See also* note 299 *infra*.

it is open to question whether, in a modern society, appeasement is a matter of sufficient significance to warrant a rule of liability.[269]

Secondly, where there is liability insurance or a promise of indemnity, either will militate not only against the destructive effect of the imposition of liability, but also against any deterrent effect.[270] It can be conceded that, even in the case of complete indemnity or full insurance coverage, the demands on the director's time resulting from the plaintiff's suit, and "the injury to prestige and peace of mind",[271] would result in some deterrent effect. In addition, insurers may initiate some preventive activity to reduce the incidence of claims, although realistically, little such activity is to be expected.[272] Taking all this into account, insurance and indemnification would seem to detract seriously from the deterrent value of an imposition of liability.[273]

Thirdly, the issue logically prior to both of the above should be addressed: whether the deterrence model corresponds to reality. Supporters of the view that the deterrent role of liability is a "myth" are not lacking.[274] Their point is quite apparent. One begins with the proposition that deterrence depends upon an ability to conform behaviour to the required standard, such an ability being a function of both the capacity of the director to conform, and of his awareness of the exposure to liability as a guide to conduct. It is conceivable that some directors may be incapable of exercising reasonable care because of physical, emotional, intellectual, or more probably, temporal limitations. Given these limitations, the risk of liability could not be expected to affect their performance. However, it may have the effect of inducing directors to cut down on the number of directorships they hold, or causing a company to replace less capable directors with more capable ones.[275] This assumes, however, that it is

[269] *See* Williams, *supra* note 211, at 138-39.

[270] Conard, *supra* note 235, at 903. Allowance for *contribution*, however, (*see* note 249 *supra*) should *always* (arguably) be made to preserve incentives for all directors to participate in the disclosure process. *See* Note, *The Role of Contribution in Determining Underwriters' Liability Under Section 11 of the Securities Act of 1933*, 63 VA. L. REV. 79, at 96-97 (1977).

[271] Conard, *supra* note 235, at 903. In fact, there are deductibles, co-insurance, and policy provisions prohibiting indemnification of these, under the Lloyd's policy which is apparently the model for the United States and Canada. *Id.* at 902; M. SCHAEFTLER, THE LIABILITIES OF OFFICE: INDEMNIFICATION AND INSURANCE OF CORPORATE OFFICERS AND DIRECTORS 104-05 (1976); Potter, *Directors' and Officers' Liability Insurance*, 9 ALTA. L. REV. 331, at 339 n. 65, 341 (1971). *See generally* Prichard, *supra* note 212, at 388. To the extent premiums are simply built into directors' fees, however, there will be no deterrence added back (unless by the corporation itself) by risk categorization in the insurer's calculation of premiums (as to which *see* Prichard, *id.*).

[272] *See* ATIYAH, *supra* note 221, at 516-17.

[273] *See* Conard, *supra* note 235, at 913.

[274] *See* ATIYAH, *supra* note 221, at 502-14 and authorities referred to in the discussion in LINDEN, *supra* note 150, at 6. For a fundamental attack on the fault system in torts generally, with special reference to physical injuries, *see* Glasbeek & Hasson, *supra* note 211, particularly at 423.

[275] *Cf.* H.R. REP. No. 85, 73rd Cong., 1st Sess. 5 (1933), quoted in Anderson, *supra* note 36, at 326 n. 77. It, however, might *also* have the effect of replacing risk-shy directors with others not necessarily more capable.

possible to perceive in advance the inability of a director to exercise reasonable care by virtue of the factors listed above. But the observer must appreciate the standard of reasonable care required of the subject. It is precisely on the ability of this standard to function as a guide to conduct that the deterrent model has been questioned.

The criticism points to the variability with the circumstances of the standard of care.[276] In the context of directors' negligence, such variability has already been referred to as a strength of a rule of liability.[277] This variability would be tolerable only if there were "a right way or a wrong way" of discharging a duty of care in the circumstances.[278] However, in relation to the acquisition or verification of corporate information, there appears to be considerable scope for differences of opinion as to what is reasonably required. Thus in *Escott v. BarChris Construction Corp.*,[279] decided against the background of the directors' due diligence standard in section 11 of the 1933 U.S. Securities Act,[280] it was affirmed that the outside director-counsel to the company was not required to conduct an independent "audit" of the issuer's affairs.[281] In the circumstances, it was held that the director had not discharged his burden of showing due diligence in relation to a mis-statement about the delinquencies of the issuer's customers.[282] The circumstances highlighted by this holding were his failure to check either the internal corporate records of delinquents or the file of the issuer's correspondence with the principal factor of its accounts receivable, or to check directly with the factor.[283] Yet one American securities lawyer at a symposium on *BarChris* was able to say that "securities lawyers with whom I have discussed this point agree that the investigation of these items is not required unless counsel's suspicions have been aroused".[284] Another American securities lawyer at the same symposium entertained quite the opposite view.[285]

While a variable standard of care may be justifiably criticized, it is submitted that judicial application of the standard does offer some worthwhile guidance. Some of the lessons to be derived from the Commonwealth and American cases in relation to the existing defences to statutory actions for damages have already been discussed.[286] In the United States, the *BarChris* decision has occasioned considerable comment, which appears to have led principally to the practice of "procuring written statements from lawyers, accountants and others for the sole

276 *See* ATIYAH, *supra* note 221, at 506-07.

277 Text accompanying notes 58-84 *supra*.

278 *See* LINDEN, *supra* note 150, at 7.

279 *Supra* note 50.

280 S. 11 of the 1933 U.S. Act, 15 U.S.C.A., s. 77k.

281 *Supra* note 50, at 690, 2 A.L.R. Fed. at 56.

282 *Id.* at 690-92, 2 A.L.R. Fed. at 156-59.

283 *Id.* at 692, A.L.R. Fed. at 158.

284 Weiss, in Symposium, *BarChris: A Dialogue on a Bad Case Making Hard Law*, 57 GEO. L.J. 221, at 229 (1968).

285 Israels in Symposium, *id.* at 234, 236.

286 *See* text accompanying notes 72-84 *supra*.

purpose of showing 'due diligence'''.[287] But even if these procedures have a tendency to become established as rituals, they would appear to represent marked improvements over the conduct shown by the directors in *Thrift* or *BarChris*.[288]

But again one is left with questions that seem to call for answers based on empirical evidence. Is there a social attitude that tort liability should result from the sort of conduct at issue here? Would such liability have a valuable appeasement effect?[289] Would the costs of the due diligence procedures likely to result from a rule of liability outweigh their usefulness in reducing the incidence of defective disclosure?[290] In fact, how likely is it that *any* due diligence procedures would result from a rule of liability?[291] Again, courts are unlikely to wait for empirical evidence.

3. *Weighing the Factors*

In view of all this, a pragmatic objection to creation of a rule of liability in favour of market investors, based on the administrative and loss-bearing factors, is to be expected. Whether those factors would be outweighed by the deterrence factor is much more problematic. Sufficient weight might be ascribed to deterrence by reference to the statutory policy of involving directors in mandatory disclosure, although the impulse to do so might be countered by the objection that the degree of civil liability, as a punishment, is inappropriate to the crime. If one had to venture an opinion, it would be that a rule of liability, in favour of at least some market investors, will be found in Ontario. In the final analysis, however, the division of opinion between the academics and some of the judiciary is eminently understandable.

Finally, a consideration of the administrative and loss-bearing factors might suggest that a pragmatic objection be made to a rule of liability in favour of disappointed new issue purchasers and take-over offerees in respect of defective prospectuses and circulars. Disregarding the existence of the express provisions for an action in damages, the deterrent factor would seem to be no more or less significant here than for market investors. One may question whether there is in fact a sufficient distinction between these cases and that of the market investor to justify a different result.[292]

---

[287] Conard, *supra* note 235, at 905.

[288] As to which *see* text accompanying notes 65-70, 79-80 *supra*.

[289] *See* LINDEN, *supra* note 150, particularly at 28.

[290] *Cf.* Prichard, *supra* note 212, at 391 ("defensive medicine" syndrome), 383 (Calabresi calculus: minimize the sum of the costs of avoiding the accident and the costs of the accident).

[291] *See* Comment, *supra* note 235, at 370-71.

[292] The *dicta* discussed at notes 182-201 *supra* might suggest a different result. Compare the approach under A.L.I. CODE, 1978 Draft, *supra* note 7, at s. 1704, discussed in the next section of the text. But consider also the more direct benefit to the director's company in the prospectus, take-over bid circular and issuer-bid circulars situations in light of the ethical contribution and retribution factors, referred to in the text accompanying note 211 *supra*.

VI. STATUTORY REFORM?

As is evident from the previous discussion, there are many reasons for statutory reform in this area: the disclosure philosophy, the importance of compulsory disclosure, the value to directors of compulsory disclosure, the express civil liability pattern, and the failure of the common law to impose civil liability where the present statute fails to do so. Such reform would take into account two factors. The first is the deterrent value of civil liability, viewed against a background of limited administrative resources for enforcement of disclosure. The second is the possible detrimental effect of common law liability. This second factor must, however, be viewed against a background of present and possible future class actions and costs rules.

As previously indicated, reform of the rules of civil liability under the American federal securities laws is well underway. Although that reform was motivated by a quite different civil liability pattern in the previous law, its shape was, as we shall see, greatly influenced by the most significant of the factors just discussed: the administrability of any resultant scheme, its loss-bearing aspects and its deterrent value, and the extent to which the civil liability burden is thought merited by the offending conduct.

The provision of the proposed Federal Securities Code[293] (section 1704) which is relevant here covers three required disclosure documents: the "registration statement", the "offering statement", and the annual reports filed under section 602(a)(1).[294] For the "offering statement", section 1704(c)(1) imposes liability for the benefit of those persons who bought a security of the class covered by the document.[295] In respect of the registration statement and the annual report, section 1704(c)(2) imposes liability for the benefit of all persons who bought or sold a security of the issuer after the relevant document became effective. Liability thus benefits market investors. A consideration of one of the defences to liability, lack of causation, would suggest that the plaintiff class potentially includes, directly, or indirectly, non-reliant investors.[296]

---

[293] As to which *see* text accompanying notes 135-44 *supra*.

[294] It also covers (but not for directors *eo nomine*) "distribution statement": *see* A.L.I. CODE, 1978 Draft, *supra* note 7, at s. 1706 & Introduction, xxxii-iv

[295] Market investors injured by a defective offering statement, as is readily conceivable (*cf.* A.L.I. CODE, TD-2, *supra* note 16, at ss. 601(a)-(c), Comment (2)), would have a remedy, but only under s. 1705 (for directors, read with s. 1724, if necessary). S. 1705 has a requirement of *scienter* defined in s. 299.50. The reason for this differentiation may be that s. 1704 liability on the offering statement, to *class* investors (given the fungibility of securities of the same class) is thought "merited" (because they are most immediately affected), while such liability to them *and* to the market investor class is not thought "merited" by the conduct in issue. *See* notes 212, 268 *supra*

[296] *See* A.L.I. CODE, 1978 Draft, *supra* note 7, at ss. 1704(h), 1708(b)(2), 220; A.L.I. CODE, TD-2, *supra* note 16, at s. 1403, Comment (11)(b).

The commentary on the measure of damages for permitted plaintiffs in respect of registration statements and section 602(a)(1) annual reports indicates that the scale of liabilities under such a measure, unless limited, would give rise to "the possibility of utterly outlandish recoveries for material but nevertheless relatively insubstantial lapses".[297] The commentary continues by stating that "unless liability is high enough to attract able lawyers who are willing to undertake class actions on a contingency basis, there may not be any practical enforcement; for it would be unrealistic to rely solely on the [Securities and Exchange] Commission".[298] The solution adopted is an arbitrary maximum of one hundred thousand dollars per defendant per defect for recoveries on defects in any of the disclosure documents covered by the provision.[299] Further provision is made for consolidation of actions and pro-ration of recoveries, "if the race is not to go to the swift".[300]

From the analysis in the preceding sections of this article, there is much to commend these provisions. They bring the benefits, such as they are, of express civil liability to market investors, while limiting for

[297] A.L.I. CODE, TD-2, *supra* note 16, at s. 1403, Comment (11)(b). No account appears to be taken of any appeasement function in this area, however.

[298] *Id.* at s. 1403, Comment (11)(c). For the Code's preference for deterrence over compensation, *see id.* at s. 1409, Comment (5).

[299] A.L.I. CODE, 1978 Draft, *supra* note 7, at ss. 1704(h), 1708(c)(2) (so far as non-trading individual defendants are concerned). For corporate defendants, *see* s. 1708(c)(2)(B). For trading defendants, *see* ss. 1708(c)(1),(2)(C). The limit does not apply to "consequential damages", if any, but these ought not to be extensive. *See* s. 1723(a); A.L.I. CODE, TD-2, *supra* note 16, at s. 1417(a), Comment.

The limit does not apply, *inter alia*, if the defendant had "knowledge" of the defect. *See* A.L.I. CODE, 1978 Draft, *supra* note 7, at ss. 1708(c)(2), 287. This seems to reflect the Code's concern that civil liability "punishment" match the "crime". *See* A.L.I. CODE TD-2, *supra* note 16, at s. 1404, Comment (4), and the quotation in the text accompanying note 297 *supra*.

See also Feldthusen, *supra* note 208, at 22 n. 84, which acknowledges the utility of limiting recoveries, but indicates two difficulties. Of those, pro-ration (if the author is referring to equitably distributing such costs where the plaintiff succeeds) does not seem insuperable. Costs could simply come out of recovery. Inflation is taken care of by A.L.I. CODE, 1978 Draft, *supra* note 7, at s. 2005.

It could be argued that the limit in s. 1708(c)(2) might be draconian for some directors and derisory for others. *See supra* note 248; *cf.* Fiflis, *Current Problems of Accountants' Responsibilities to Third Parties*, 28 VAND. L. REV. 31, at 113 (1975). A better limit might be one relating to income from the directorship. *Cf.* Conard, *supra* note 235, at 914, although this would present problems of definition and, in the case of many directors (*see* note 248 *supra*), would be derisory.

The Code also appears to subject any common law remedies to the statutory limits. A.L.I. CODE, 1978 Draft, *supra* note 7, s. 1722(f). *See also id.*, s. 1722(a), except para. (4).

For the controversy surrounding s. 1704, *see* A.L.I. CODE, 1978 Draft, SUPPLEMENT 2, *supra* note 134, ss. 1704(b)(3), 1705(b), 1704(l)(c), and Lowenfels, *The Case Against The Federal Securities Code*, 65 VA. L. REV. 615, at 654 (1979). *See also* 1 A.L.I. REPORTER 3 (1979).

[300] A.L.I. CODE, 1978 Draft, *supra* note 7, at s. 1711 & Introduction, lviii (source of quotation), lix.

directors, in respect of both market investors and new issues purchasers, the destructive potential of liability and the costs of a multiplicity of actions. Without the benefit of the American Federal Rules of Civil Procedure[301] to facilitate class actions, or the American cost rules facilitating plaintiffs' actions (neither the defendant nor the plaintiff, on failure, being liable for costs), statutory reform of this sort in Ontario would have to go further and encompass facultative provisions in these areas.

Less commendable perhaps are the Code's rules as to indemnification for and insurance against liability. Under the relevant provision, "indemnification" apparently does not include a payment by an insurance company under an insurance contract.[302] "Indemnification" for liability under the Code is permissible only to the extent determined by the Securities and Exchange Commission rules or by a court on consideration of "such factors as the respective gains and losses of the indemnitor and indemnitee, the conduct of the indemnitee, and the deterrent effect of the particular type of liability".[303] It appears, however, that there are no rules, or rule-making or judicial power, that would interfere with the enforceability of "an insurance company's contract. . .against liability under this Code".[304] The rationale for allowing any indemnification or insurance in respect of section 1704 liability, whereby the Code appears to give priority to deterrence so far as civil liability is concerned,[305] must be that sufficient deterrence will remain after the exercise of the Commission's rule-making power. While this may be so, there may also be a tendency to greater attention to negligence prevention activity from an arms length insurance company than from a corporate indemnitor. However, it is submitted that all of this is insufficient reason for the Code to deny to the Commission or to a court the same power with respect to insurance contracts by an insurance company as they have with respect to "indemnification".[306]

At this point we should note that all of the preceding analysis should be treated with caution because it takes at face value the validity of a concern with too expansive a rule of liability as well as the deterrent value of liability. The lack of empirical data to test those concerns has already been discussed. If those concerns are unfounded, the Code's provisions may, with respect to limitation of liability at any rate, be an unwarranted

---

[301] Discussed in Williams, *supra* note 236.

[302] *See* A.L.I. CODE, SUPPLEMENT to 1978 Draft, *supra* note 134, at s. 1704(e)(2),(3). It must be admitted that this is not altogether clear from the wording of the subsections cited. The alternative construction, however, would represent a major substantive change from s. 1724(e) of the 1978 Draft. This is not consistent with the Note to s. 1724(e) in the SUPPLEMENT to the 1978 Draft.

[303] A.L.I. CODE, SUPPLEMENT to 1978 Draft, *supra* note 134, at s. 1724(e)(2)(A). The quotation is taken from s. 1724(e)(2)(A)(i). There is a saving for the costs of a successful defence.

[304] *Id.* at s. 1724(e)(3).

[305] *See* note 298 *supra*.

[306] *But see* the consideration raised by Prichard, *supra* note 212, at 388, discussed in note 271 *supra*.

protection of directors. If the deterrent effect is minimal, or of insufficient value to warrant a scheme of civil liability, the value of facultative procedural rules would have to be reconsidered.

An even more fundamental assumption underlies the above analysis: the importance to investors of compulsory disclosure. In the United States, this assumption has been challenged by reference to an hypothesis about the efficient formation of securities market prices, an hypothesis which now has extensive supporting empirical data.[307] Termed the "efficient capital market hypothesis", it holds, in its strongest form, that all data relevant to the evaluation of the securities of an issuer, whether public or non-public, are taken into account in determining market prices in a rapid and unbiased manner.[308] Tests of the hypothesis seem to have confirmed, for example, that the American market begins taking account of changes in earnings of an issuer long before the full extent of those changes are "revealed" in Securities and Exchange Commission filings.[309] The hypothesis has not been as extensively tested in Canada, however.[310]

The implications of this hypothesis for mandatory disclosure, according to one school of thought,[311] are extremely significant in the present context. The disclosure compelled by securities regulation may not be as important to the investor as securities regulators believe.[312] It has also been suggested that there may exist alternative mechanisms to the existing enforcement tools for ensuring the reliability of disclosure.[313] If the hypothesis holds in Canada and if these two propositions are correct, civil liability may be unnecessary, or at best may produce insufficient benefit to warrant its cost. Furthermore, without denying that directors are useful verifiers of corporate information, there may be more efficient verification mechanisms which would develop if civil liability did not focus so much attention on directors.[314]

---

[307] The analysis here is taken from Saari, *supra* note 35. The supportive evidence was apparently derived "primarily" from studies of price behaviour on the New York and American Stock Exchanges. *Id.* at 1031 n. 2.

See also R. POSNER, ECONOMIC ANALYSIS OF LAW 315-34 (2d ed. 1977).

[308] *Supra* note 35, at 1039, 1041-54. It also implies that prices move in a "random" manner. *Id.* at 1039.

[309] *Id.* at 1045-47.

[310] I am indebted for this information to Professor Paul Halpern of the Faculties of Management Studies and Law, University of Toronto. He informs me that, of the work that has been done, a significant amount is, unfortunately, unpublished.

[311] *Supra* note 35, at 1057-76.

[312] *Id.* at 1057-59. *See also* note 233 *supra*; POSNER, *supra* note 307, at 331-34. *But see* Saari, *supra* note 35, at 1057-58. *See also* Sommer, *Survey: Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission: Foreward,* 26 U.C.L.A.L. REV. 48, at 49-50 (1978); Kripke, *Where Are We on Securities Disclosure After the Advisory Committee Report?*, 6 SEC. REG. L.J. 99, at 101-02, 108-09 (1978).

[313] *Supra* note 35, at 1065-67. One given there is the issuer's interest in minimizing the cost of capital. Investors are said to demand a high rate of return on uncertain investments. There may, however, be offsetting benefits to non-disclosure. *Cf.* Posner, *The Right of Privacy,* 12 GA. L. REV. 393, at 397, 403 (1978).

[314] *Supra* note 35, at 1066, 1068-69.

However, it may be that the efficient capital market hypothesis does not hold in Canada. Our markets are said to be thinner than those in the United States, and it may be that the large congeries of judgments by financial analysts, based on information aggressively sought from disparate sources (which may largely account for the data supporting the hypothesis),[315] are simply not to be found here.[316] If they are not, then it may be that compulsory disclosure is more important here than in the United States.

VII. SUMMARY AND CONCLUSION

Securities reform in Ontario in recent years, inspired by regulation in the United States, has seen a progressive widening of the disclosure required of corporate issuers, with a special emphasis on the secondary trading markets. The philosophy underlying the mandatory disclosure in both jurisdictions maintains that the information will filter through professional intermediaries to the market investor, and that market prices which are true indices of value, or at least the best attainable, will result.

Company law developments in the province in the same period have affirmed that the role of directors is to manage or to supervise the management of the company. Accordingly, company law and securities regulation in Ontario have imposed considerable responsibilities on the directors in the disclosure process. Although experience casts doubt on the notion that all directors actually manage their companies, it does indicate that they are well placed to serve a monitoring role. However, recognizing the different functions and involvements of directors in their companies, both Commonwealth case law and recent American decisions based on their regulatory scheme, have applied a variable test for liability in the area of statutory civil liability for negligent mis-statement.

In this context, civil liability is seen by the regulators as serving to deter defective disclosure and as providing those injured by such disclosure with an opportunity to recoup their losses. If that is to, it is not easy to see why that benefit should be withheld from any of the disclosure documents in the regulatory scheme — particularly the continuous disclosure documents. So far, the liability in this area has only emerged in a qualified

---

[315] *Id.* at 1054-55. Insider trading is also said to lead to efficient markets. *Id.* at 1055-56.

[316] *See* study quoted in S. BECK, D. JOHNSTON & M. CONNELLY, CASES AND MATERIALS ON SECURITIES REGULATION IN CANADA pp. I-6 to I-8 (3d ed. 1977); Baillie, *supra* note 145, at 360-62. Consider also Ontario's mining and junior industrial markets. *See* Kryzanowski, notes 232, 233 *supra*, read with note 307 *supra*. As to mines, *see* KALYMON, HALPERN, QUINN & WATERS, *supra* note 247.

One Canadian author's study of the allocation efficiency of the Canadian bond market suggests that it is less efficient in generating information than the U.S. market. J. PETERS, THE ECONOMICS OF THE CANADIAN BOND MARKET 9, 95, 99 (1971); *but see id.* at 112, 118.

manner in the United States, and has yet to surface in Ontario. Perhaps a statutory rule would be unnecessary if the law of torts supplied the necessary liability, but an examination of its role reveals that no such assurance in Canada can yet be given. In fact there are strong *dicta* against such findings of liability in some Commonwealth jurisdictions, and the Supreme Court of Canada has so far chosen not to venture its opinion.

From a policy standpoint there seems to be a need for a delicate balance to be drawn with respect to the desirability of extending statutory liability to continuous disclosure documents. On the positive side, any such extension could serve to make information more reliable, compensate for insufficient administrative resources in Ontario, serve to appease aggrieved investors and provide them with a scheme of compensation. All of this would lead to a more efficient and attractive future for market investment. On the negative side is the danger of an unmanageable judicial workload (an affront to our sense of equity in this area) and undesirable loss distribution effects, where damages awards or insurance against them lead to inequities between different classes of investors. Finally the unavailability of indemnification or insurance could lead numerous candidates to decline directorships.

Linked to these opposing considerations is the problem of insufficient data. How serious is the negligent mis-statement problem? If it is serious, how likely is it that litigation will ensue? Is that likelihood sufficiently great to discourage potential directors? What effect will removing the class action and costs rules as disincentives to suit have here? Is the litigation avenue in fact going to move loss at great expense from one class of investor, able to bear the loss, to another that is no more able to bear the amounts involved? Will the liability deterrent in fact produce due diligence procedures? Will the cost of those procedures outweigh whatever usefulness they may have in reducing defective disclosure? Is society's sense of equity likely to be affronted by a rule of liability here? Would such a rule have any value in appeasing aggrieved investors?

All of these questions call for field research in Ontario which does not appear to have been done. The form that field research should take is problematic — many of the questions call for answers which could be wholly convincing only after experience with an extension of statutory liability to continuous disclosure documents. Alternatively, suitable questions might be put to those in the securities markets, such as investors, their advisors and the Ontario Securities Commission, as well as to securities lawyers, company management, directors and potential directors.[317]

The answers obtained may accord with the perceptions of the draftsmen of the Federal Securities Code, who appear to conclude that

[317] The survey design would probably benefit from a federal government regulatory activity study to be published shortly: Proulx, *Evaluation Methodologies for Social Regulations*, *in* TREASURY BOARD SECRETARIAT, ADMINISTRATIVE POLICY MANUAL ch. 490, app. E (1979).

directors' liability in negligence has an indispensable enforcement function, especially considering the problem of limited administrative resources, and the procedural and costs rules facilitating investors' class actions. They perceive civil liability as performing a valuable compensatory (but apparently not an appeasement) role, provided that potentially crippling and unmerited liability is reduced by imposing more or less arbitrary per defendant recovery maxima. In the event the answers in Ontario do accord with those perceptions, then section 1704 of the Code and its supporting provisions, if supplemented by reform of Ontario's class action and costs rules, will merit introduction into our securities regulation scheme. Until such answers are available, however, adoption of the Code's provisions here would be premature.

But the assumption with which we began remains: that required disclosure by issuers of securities is of sufficient value to investors to warrant all the resources expended on its expansion and enforcement. This axiom of securities regulation in the United States has recently come under attack as a result of empirical work done there on the securities markets' processing of investment data. That work would suggest that there may exist in American securities markets more efficient sources of useful disclosure than the required disclosure documents, and more efficient mechanisms than imposition of directors' civil liability to ensure the reliability of useful disclosure. Should similar work be done in Canada, and similar evidence be produced, then directors' civil liability may turn out not to be a cost-effective way of maintaining useful disclosure of high quality for Canadian securities markets. Such work should be done, it is submitted, before we go to the trouble and expense of answering the other questions raised here. Now that a new Act has given reformers of securities legislation some breathing space, getting such work done in Ontario would be a worthwhile exercise.