Case Name:

Rahimi v. SouthGobi Resources Ltd.

Between
Paiman Rahimi, Plaintiff, and
SouthGobi Resources Ltd., Alexander A. Molyneux, Terry Krepiakevich, Matthew O'Kane, Andre Deepwell, Pierre B. Lebel, Gordon Lancaster and Deloitte LLP, Defendants
PROCEEDINGS UNDER the Class Proceedings Act, 1992

[2015] O.J. No. 5758

2015 ONSC 5948

Court File No.: CV-14-495869-CP

Ontario Superior Court of Justice

E.P. Belobaba J.

Heard: September 16-18, 2015.
Judgment: November 5, 2015.

(70 paras.)

Counsel:

Michael Robb, Paul Bates and Alex Dimson for the Plaintiff/Moving Party.

John Campion for all Defendants/Responding Parties except Deloitte LLP.

Matthew Fleming for Deloitte LLP.

DECISION ON LEAVE MOTION

1 E.P. BELOBABA J.:-- This is a motion for leave under s. 138.8 of the *Securities Act*[1] ("OSA") and certification under s. 5(1) of the *Class Proceedings Act*[2] ("CPA"). Counsel agreed that I should decide and release the leave motion first and then deal with certification.

2 The context for the leave motion is this. The defendant coal mining company announced a restatement to its consolidated financial statements to correct errors that were made in earlier revenue recognition. Over the next several days, the company's share price dropped dramatically. The plaintiff alleges misrepresentation in the earlier financials and seeks to bring a class action to recover damages for the losses sustained by the putative class members. The defendants acknowledge the revenue restatement but maintain that the earlier financial representations were actually true when made and thus not misrepresentations, and in any event, the defendants had conducted a reasonable investigation at the time and are therefore not liable. As for the restatement, the defendants say it reflected a change of judgment on the part of the company's auditors that management and the board of directors were forced to accept because of other corporate and financial pressures.

Decision

3 For the reasons that follow, the motion for leave is granted but only as against the defendant company. I acknowledge the compelling evidence of the defendant company (that may well prevail at trial) but I find that at this point the plaintiff has established a reasonable possibility of success. However, the motion for leave as against the individual defendants is dismissed on the basis of the reasonable investigation defence.

Background

The defendants

4 The defendant coal mining company, SouthGobi Resources Ltd. ("SGR"), trades on the Toronto and Hong Kong stock exchanges. During the time in question, SGR was obliged to use the International Financial Reporting Standards ("IFRS") rather than U.S. GAAP ("GAAP") which is generally acknowledged to be more rigid and rules-based.

5 On the other hand, SGR's parent, Ivanhoe Mines, which changed its name to Turquoise Hill Resources after it was acquired by Rio Tinto, was required as an SEC registrant to use GAAP. Given that the financial statements of SGR and Turquoise Hill had to be consolidated, it was inevitable that a conflict between the IFRS and GAAP standards for revenue recognition would arise - as in fact happened.

6 The individual defendants include two former CFOs (Mr. Krepiakevich and Mr. O'Kane) and three directors and members of the SGR audit committee (Messrs. Deepwell, Lebel and Lancaster.) The final individual defendant, Mr. Molyneux, a former CEO, lives in Taiwan. The action against him has been adjourned until he has been formally served under the rules of the Hague Convention.

The action against the defendant Deloitte LLP has settled.

The "bill and hold" arrangements

7 SGR derived all of its revenue from the coal-mining operations in Mongolia of its wholly-owned subsidiary SouthGobi Sands LLC "(SGS"). The main coal mine, Ovoot Tolgoi, is located a mere 40 kilometres from the Chinese border. In short order, it became a significant coal supplier to a booming Chinese economy. By 2010 all of the mine's customers were Chinese.

8 Responding to specific customer demands, SGS agreed to a "bill and hold" contractual arrangement for certain customers. The ordered coal was stockpiled by SGS for customer pickup in a custom-bonded coal yard under the control and supervision of the Mongolian authorities. The handful of customers that requested this arrangement did so to lock in the (rising) coal price and enjoy greater transport flexibility to better deal with unpredictable road, rail and border-crossing problems. The "bill and hold" customer was obliged to pay the contract price as soon as the coal was delivered to the stockpile but agreed to do so in return for the important logistical benefits.

9 Under the IFRS revenue recognition rules, and in particular the related International Accounting Standard known as IAS-18, revenue from the sale of the coal on the "bill and hold" contracts could be recognized as soon as the coal was delivered to the stockpile in the bonded yard. If a reasonable judgment could be made that the risks and rewards of ownership had been transferred to the buyer upon delivery to the bonded yard, and customer payment was probable,[3] then revenue could be booked at that point. One did not have to wait until the coal was actually loaded onto the customer's truck. Consequently, beginning in 4Q2010, SGR implemented first one and never more than five "bill and hold" arrangements and recognized the revenue upon delivery of the customer's coal to the bonded yard.

A convergence of events

10 The revenue restatement at issue herein can be traced to the convergence of several events. In March and April, 2012, Rio Tinto acquired SGR's parent company, Ivanhoe Mines, and in due course changed the latter's name to Turquoise Hill Resources ("TQR"). Because of a conflict of interest arising from this acquisition, Deloitte had to resign as auditor and was replaced by PricewaterhouseCoopers. PwC had long been the auditor for SGS in Mongolia and now assumed the same role for SGR and its parent TQR.

11 Meanwhile, SGR was in the process of being sold to a Chinese company. The Mongolian government, although initially supportive, changed its mind and in retaliation shut down the SGS coal mining operation over April and May, 2012. There would be no further coal production from the Ovoot Tolgoi mine for the next 17 months, until September, 2013. To make matters worse, the Chinese economy was no longer booming, coal prices were falling and by about the middle of 2012 the "bill and hold" customers were having trouble making timely payments. This resulted in a growing number of forfeitures and repossessions by SGS. Thus, the guidelines for reasonable

revenue recognition as set out in IAS-18 (i.e. likelihood of payment) were no longer being met.

12 As a result, SGR (with PwC's approval) stopped using "bill and hold" in mid-2012 (even though no coal was being produced) and changed its revenue recognition policy from "delivery to the customer's stockpile" to "loaded onto the customer's truck". The transfer of title provisions in the affected sales agreements were amended to take effect on January 1, 2013. Both the company and its auditor agreed that the change in revenue recognition would be implemented on a going-forward basis. There was no reason to change the earlier financials. Indeed, PwC reviewed the earlier financials from 2010 to mid-2012 and concluded that no changes or restatements were needed.

13 In the summer of 2013, in the course of reviewing TQR's consolidated financials, the SEC decided to challenge SGR's earlier revenue recognition decisions relating to the "bill and hold" agreements because they were not GAAP-compliant. Both TQR and its parent Rio Tinto, supported by PwC, defended SGR's financial statements as based on IFRS but the SEC did not relent and the discussion continued for many months. Eventually, SEC made clear that it would not approve TRQ's 3Q2012 financials unless the "bill and hold" revenues were restated. The 3Q financial statements were not only required by TRQ for regular reporting purposes but were also needed to complete a significant financing (a rights offering) that was being planned for November, 2013.

14 In early November, 2013 the intransigence of the SEC became time-sensitive. While chairing a meeting of the SGR board of directors, the TQR president told the board that the SEC was pressing for a financial restatement to bring the SGR/SGS "bill and hold" revenue recognition practices over the 2010 to 2012 time-period into line with GAAP and asked if SGR would restate.

The restatement

15 The uncontroverted evidence of the defendant directors is that SGR reluctantly agreed to restate the 2010 to 2012 financials for three reasons: one, to accommodate TQR's dispute with the SEC and allow TQR to conclude its rights offering financing; two, to itself avoid default on a convertible debenture held by the Chinese Investment Corporation by making a required interest payment that depended on financial support from TQR, who would only fund the company's operations if SGR's earlier financials were restated; and three, because PwC was now taking the position, despite agreeing in 2012 that no restatements were necessary, that it would not approve SGR's 3Q2013 financials unless the earlier financials were restated.

16 It appears from the evidence that PwC changed its mind because of a perceived increase in customer payment problems and coal forfeitures (almost all of which took place in the second half of 2012 as already noted and did not affect the earlier financials) and a determination that the customer coal yard, which was no longer in operation in 2013, was not a bonded facility (even though PwC concluded in 2012 that it was).[4] In any event, PwC did not relent.

17 On November 8, 2013, SGR issued a press release announcing, amongst other things, the following revenue restatement (emphasis added):

SouthGobi Resources ... announced today that it anticipates a delay in the filing of its interim statements (the "Interim Statements") for the three and nine month periods ended September 30, 2013 and the related Management's Discussion and Analysis ("MD&A") and certifications by the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") (collectively, the "Required Filings").

The anticipated delay is a result of the decision by the Company board of directors today to restate the Company financial statements for 2011 and 2012, and consequently its comparative interim financial statements for 2013 and the related MD&A (collectively, the "Restated Financials").

The restatement and anticipated delay in filing the Required Filings follows a review by the Company of its prior revenue recognition practices for its coal sales in the fourth quarter of 2010, full year 2011 and in the first half of 2012. This review has been conducted in consultation with PricewaterhouseCoopers LLP ("PwC"), the Company's current auditors, and Deloitte LLP ("Deloitte"), the Company's auditors during the 2010 and 2011 fiscal years.

As a result of this review*, the Company has determined that certain revenue transactions were previously recognized in the Company's consolidated financial statements prior to meeting relevant revenue recognition criteria. These transactions relate to coal that had been delivered to the customer's stockpile in a stockyard located with the SouthGobi Ovoot Tolgoi mining license area ("the Stockyard") ...The restatement of the Company's consolidated financial statements will reflect a change in the point of revenue recognition from: (A) the delivery of coal to the customer stockpiles with the Stockyard to (B) the loading of coal onto the customer's trucks at the time of collection ...*

Until the recent review, it was determined that a restatement of financial statements for the periods prior to the second half of 2012 was not required. The restatement of the Company 2011 and 2012 financials in order to reflect this change in the point of revenue recognition will in turn require restatements to the comparative information in the Company's previously filed interim financial statements for 2013.

As a result of the potentially material effects on the Company's financial statements, the previous financial information provided by the Company in

> *respect of the periods to be covered by the Restated Financials are no longer accurate and should not be relied upon.*

18 The news release went on to note that the Company was also "re-examining the Company's internal controls over financial reporting and disclosure controls and procedures in order to identify material weaknesses with such processes which gave rise to the decision to prepare the Restated Financials."

19 In a news release issued on November 14, 2013, SGR management advised, amongst other things, that they had identified "a material weakness in the Company's internal controls over the financial reporting..." This was explained as a failure to ensure that "all aspects of sales arrangements were considered" in the determination of the appropriate accounting for the "bill and hold" contracts at the Ovoot Tolgoi mine. In other words, the internal control weakness was in not ensuring that the recognition of revenue in the earlier "bill and hold" contracts was IFRS-compliant. And yet, as already noted, SGR together with both sets of auditors, Deloitte and PwC, reviewed these very arrangements at the time and again in mid-2012 and concluded they were IFRS-compliant. Deloitte had also evaluated the internal controls for the year ending December 31, 2011 and found no deficiencies.

20 A final comment about the November 8 press release. The news release was not confined to the revenue recognition point. It also noted that the company was being investigated by Mongolian authorities for possible breaches of the country's bribery, money laundering and taxation laws -- and that these investigations "could result in one or more Mongolian, Canadian, United States or other governmental or regulatory agencies taking civil or criminal action against the Company, its affiliates or its current or former employees." I make this point only to suggest the obvious: SGR may well argue at trial under s. 138.5(3) of the OSA that the November, 2013 drop in share price was attributable to matters other than a belated restatement of revenues that affected financial statements that were by then a year and a half old.

21 In any event, in the days following the November 8 press release, the SGR share price dropped dramatically, in all about 18 per cent. Class actions were filed in New York and here in Toronto.

The proposed class action

22 The plaintiff, Paiman Rahimi, is a medical nurse who lives in Mississauga. He follows the market and often buys and sells shares. He alleges that during the proposed Class Period - March 30, 2011 to November 7, 2013 - SGR released public documents (financial statements and MD&As) that contained one or more of the following three misrepresentations:

- that its financial statements were prepared in accordance with IFRS ("the Compliance Representation");

* that the financial statements presented fairly, in all material respects the financial position, financial performance, and cash flows of SGR and its subsidiaries ("the Fair Presentation Representation"); and,

* that SGR had in place internal controls effective to provide reasonable assurance regarding the reliability of financial reporting free of material misstatement ("the Internal Control Representation").

23 The plaintiff purchased SGR shares during the Class Period and was still holding some of them when the alleged misrepresentations were publicly corrected in November, 2013. He says he lost money and that "somebody has to be held accountable." He seeks to recover damages on behalf of a Class defined as:

> All persons and entities, other than Excluded Persons, wherever they may reside or be domiciled, who acquired SouthGobi's Shares during the Class Period and who held some or all of those Shares at the close of trading on the TSX on November 7, 2013.

24 SGR's fiscal year end is December 31. In all, eleven financial reporting periods were affected by the alleged misrepresentations -- three annual reporting periods in fiscal 2010, 2011 and 2012 and eight quarterly disclosures (the first three quarters of 2011 and 2012, and the first two quarters of 2013). The plaintiff says that approximately $36.8 million in revenues were ultimately shifted to financial periods beyond the proposed Class Period.

What makes this case unusual

25 On one level this is a relatively straight-forward secondary market leave motion - the plaintiff points to a defendant company's revenue restatement that clearly acknowledges earlier reporting errors (misrepresentations) and stands as a public correction that apparently caused loss to a large class of shareholders. On these facts, one may fairly ask, how can the plaintiff not be granted leave?

26 What makes this case unusual, however, is that while the defendants acknowledge the clear language in the revenue restatement they argue that the earlier financial "misrepresentations" were actually true when made and, in any event, rely on the reasonable investigation defence. To this end, the defendants have presented a large volume of compelling evidence supporting these submissions.

27 In my view, a reasonable finder of fact could readily agree that the earlier financials were IFRS-compliant having been subjected to diligent corporate review and approved by both Deloitte and PwC who consistently provided clean and unqualified audit opinions. And that it was only an unusual juxtaposition of events, precipitated in large part by the position taken by the SEC and by a questionable change in judgment on the part of PwC that best explains the revenue restatement.

28 Yet the restatement was explicit. SGR publicly and definitively acknowledged that more than two years of revenues had to be corrected and restated -- that the earlier financials were "no longer accurate and should not be relied upon." And, a few days later, SGR's management added that there was a "material weakness" in the company's system of internal financial controls. These are serious pronouncements that may be explained and rebutted on a balance of probabilities by the defendants at trial but on a leave motion they remain significant.

29 That is why I must find, for the reasons set out below, that leave will be granted as against the company SGR but not as against the five individual defendants.

Analysis

30 My reasons for this decision are presented under two heads: first, whether as the defendants submit the earlier financials were true when made and thus were not misrepresentations; and secondly, whether SGR and the individual defendants are not liable in any event because of the reasonable investigation defence under s. 138.4(6).

31 I should note that both sides filed expert reports on the accounting and corporate governance issues that arise herein. However, I do not find it necessary to rely on these reports -- I am able to assess the evidence before me without the assistance of the two distinguished experts.[5] I will begin with misrepresentation and then turn to reasonable investigation.

(i) Misrepresentation

32 Section 138.3(1) of the OSA creates a statutory cause of action for secondary market misrepresentation available to any person who acquires or disposes of an issuer's securities between the time that documents containing misrepresentations were publicly released and the time when the misrepresentations were publicly corrected.

33 An action for secondary market misrepresentation under s. 138.3 requires leave of the court under s. 138.8. Leave will be granted if the court is satisfied that the action is brought in good faith and "there is a reasonable possibility that the action will be resolved at trial in favour of the plaintiff."[6] I am satisfied that the plaintiff is bringing this action in good faith. The only question is whether he can clear the second hurdle and show a reasonable possibility of success at trial.

34 As I write these reasons, the Supreme Court has not yet released its decision in *Green.*[7] I will therefore continue to employ the leave test that was set out by the Court in *Theratechnologies*[8] as augmented by the earlier decision of the Court of Appeal in *Green.* This is the leave test that I have been using to date:

> [W]hether, having considered all the evidence adduced by the parties and having regard to the limitations of the motions process, the plaintiffs' case is so weak or has been so successfully rebutted by the defendant, that it has no reasonable

possibility of success.[9]

35 Is the plaintiff's case so weak or has it been so successfully rebutted by the defendant, that it has no reasonable possibility of success? I have reviewed the large volume of evidence filed by the defendants -- the binders of financial statements and MD&As covering the eleven reporting periods in question, the minutes of the relevant audit and board of directors meetings, the affidavits of the individual defendants and their cross-examination transcripts, as well as assorted additional exhibits -- and I find that the defendants' evidence, as already noted, is compelling. I do not accept the plaintiff's dismissive submission that the evidence of the individual defendants, and in particular the evidence of Messrs. Krepiakevich and O'Kane, is "conclusory" and unpersuasive. Quite the contrary.

36 There is clear evidence that the defendant CFO's and directors were not only alive to the IFRS and IAS-18 criteria regarding revenue recognition, they considered and assessed actual "bill and hold" customer credit risks, bad debt evidence, and forfeiture and repossession data. In one instance, at the end of December, 2011 when a particular "bill and hold" customer, the Hong Chang Mining Company, failed to make the requirement payments and SGS was obliged to invoke the contractual forfeiture clause, an immediate and appropriate revenue adjustment was made to the SGS/SGR financial statements.

37 In short, the uncontroverted evidence of Messrs. Krepiakevich, O'Kane, Deepwell, Lebel and Lancaster coupled with the fact that both Deloitte and PWC had reviewed and approved the revenue recognition decisions at the time and consistently provided clean and unqualified audit reports provides strong support for SGR's submission that the earlier financial representations were true when made and therefore were not misrepresentations.

38 Nonetheless, I must grant leave on the misrepresentation issue (recall that the plaintiff actually alleges three inter-related misrepresentations) because of the specificity and force of the November 8, 2013 restatement. SGR publicly disclosed that the earlier financials contained errors relating to the "bill and hold" agreements that had to be corrected and could no longer be relied upon. And then, a few days later, SGR management proceeded to announce a material weakness in internal financial controls relating, again, to the very same agreements. Given the explicit language in the restatement, and notwithstanding my suggestion that the defendants may well prevail at trial, I must in fairness conclude that there is a reasonable possibility that the plaintiff's claims of misrepresentation will be resolved in his favour at trial.

39 I recall the admonition of the Supreme Court in *Theratechnologies* that the courts must undertake a reasoned consideration of the evidence "to ensure that the action has some merit ... so that cases without merit are prevented from proceeding."[10] It cannot be said that the plaintiff's claim is without merit. All the more so when I consider the following observations that were made by the plaintiff:

(i) SGR described the restatement as the correction of prior period errors. It was not

obliged to do so if its only purpose was to rectify the discrepancy between GAAP and IFRS. If that were the only concern, the restatement could have been presented as a voluntary change in accounting policy. Instead, the company used words such as "correction" and "errors."

(ii) If the only concern was to make the SGR financials GAAP-compliant, why did SGR management go further and announce that there was a material weakness in its internal controls over financial reporting? There was no need to do so. Changing the point at which the defendant company recognized revenue is quite different from admitting a material weakness in its internal financial controls.

(iii) The defendants have filed no evidence from PwC, TQR or SGR management who was in place at the time of the restatement. This evidence will no doubt be available following discoveries and related motions and may well provide a better understanding or explanation as to why the restatement said what it did.

40 For these reasons, I grant leave under s. 138.8 of the OSA on the misrepresentation claim against the defendant company. The action herein has some merit -- it is clearly not a strike suit - and, absent a reasonable investigation defence, should proceed to trial or summary judgment. However, as I explain below, I do not grant leave as against the individual defendants who, in my view, are protected by the s. 138.4(6) reasonable investigation defence.

(ii) Reasonable investigation

41 Section 138.4(6) of the OSA provides that a person company is not liable in an action under s. 138.3 if that person or company proves two things: one, that it conducted or caused to be conducted a reasonable investigation before the document containing the misrepresentation was released, and two, that it had no reasonable grounds to believe at the time of the document's release, that the document contained the misrepresentation. Section 138.4(7) requires the court to consider "all relevant circumstances" in deciding whether the investigation was reasonable and sets out a list of suggested considerations.

42 The defence of reasonable investigation is usually mounted at trial and if so then the onus is on the defendants to prove the defence on a balance of probabilities. However, if the defence is raised at the leave motion, as it is here, then as the Court of Appeal noted in *Green,* the test is "whether there is a reasonable possibility that the defendants will not be able to establish one or both branches of the reasonable investigation defence."[11] In *Silver v. Imax,*[12] this court went a bit further and noted that the onus is on the defendant at the leave motion to show that "their defence will of necessity succeed at trial."[13] For my part, I will employ the test as set out by the Court of Appeal.

43 Even so, this is a relatively high hurdle for the defendants. It is not enough for the defendants to show reasonable investigation on a balance of probabilities as suggested by the defendants. This is not the test on a leave motion. Rather, if there is a reasonable possibility that the defendants will not be able to establish both elements of this defence at trial, the motion for leave must be granted.

44 I am persuaded that the action as against the five individual defendants has no reasonable possibility of success at trial. I say this because I have found on the evidence that there is no reasonable possibility that the five individual defendants will not be able to establish both branches of the reasonable investigation defence at trial.

45 Recall the factual backdrop. The handful of "bill and hold" contracts from 4Q2010 to 2Q2012 were consistently found to be IFRS-compliant (not only internally by the defendants but also by the two external auditors, Deloitte and PwC) even after the dramatic events of mid-2012 and SGR's decision to change its revenue recognition policy on the "bill and hold" arrangements. Recall that in 2012 PwC approved the earlier 2010 to mid-2012 financials.

46 It was only after the GAAP-related intervention of the SEC in the summer of 2013 following Rio Tinto's acquisition of Ivanhoe/TQR that SGR's revenue recognition on the handful of SGS "bill and hold" agreements became an issue. And (as appears from the evidence) it was only because of the unusual convergence of TRQ's rights offering, SGR's existential need to fund an upcoming loan payment, and PwC's insistence on a revenue restatement even though a year earlier it had approved the very financials in question, that SGR announced the November 8, 2013 restatement.

47 With this backdrop in mind, I can now turn to each of the individual defendants.

The two former CFOs

48 Mr. Krepiakevich, who resigned after a five-year stint in July 2011, was involved in just two of the reporting periods in issue, fiscal 2010 and 1Q2011. His uncontroverted evidence is that he oversaw the first application of the "bill and hold" criteria for revenue recognition in late 2010 and early 2011. He carefully analyzed the criteria against what was then just one "bill and hold" contract and concluded that all of the criteria had been met. His evidence was uncontroverted in cross-examination.

49 Mr. Krepiakevich also testified that in addition to his own judgment (it is widely recognized that Mr. Krepiakevich is an expert in IFRS) he relied upon the judgment of his colleagues in management, the expert opinion of the independent auditors, who at that time were PwC and Deloitte, and the review and approval of the audit committee and the board of directors.

50 Mr. O'Kane replaced Mr. Krepiakevich as CFO in July 2011. During the reporting periods that he was at SGR, he reviewed all of the "bill and hold" agreements (at one point there were five such agreements) and provided detailed and uncontroverted affidavit evidence that these revenues were properly reported under IFRS and IAS-18. Like his predecessor, Mr. O'Kane also relied on the

auditors and the reviews and approvals of the company's audit committee and board of directors. Mr. O'Kane left SGR on November 5, 2013.

51 Neither of the defendant CFOs was involved in the composition or release of the November 8 restatement. In any event, I am satisfied on the uncontroverted evidence before me that while they were CFOs, both Mr. Krepiakevich and Mr. O'Kane conducted or caused to be conducted a reasonable investigation of the relevant financial documents that were under their jurisdiction over the time periods in question.

52 The two former CFOs also clear the second branch of s. 138.4(6)(a)(ii). I find on the uncontroverted evidence before me that Messrs. Krepiakevich and O'Kane had no reasonable grounds to believe that the various financial disclosures that were released under their jurisdiction over the time periods in question contained any of the alleged misrepresentations about revenue recognition.

53 I come to this conclusion for the reasons just stated and because of the factors set out in s. 138.4(7). I place particular emphasis on the former CFOs' knowledge and experience (each have impressive accounting credentials and IFRS experience) and, as well, their reasonable reliance on Deloitte and PwC who reviewed and approved the revenue recognition decisions at the time. Recall again that in the second half of 2012 when the revenue recognition policy with respect to "bill and hold" was changed, PwC reviewed and approved the earlier financials and agreed with SGR that the earlier financials did not need to be restated.

54 In short, I have no difficulty concluding that the reasonable investigation defence has been made out and there is no reasonable possibility of proving otherwise at trial.

The three directors

55 The same can be said, in general, about the three defendant directors. There is however, one difference: Messrs. Deepwell, Lebel and Lancaster were still directors and on the board's audit committee when the November 8 revenue restatement and the November 14 "internal control" announcements were made.

56 I agree with Justice van Rensburg that an admission of a weakness in a company's internal financial controls is evidence that is "inconsistent" with the company having performed a "reasonable investigation" in connection with the subject of the alleged misrepresentations.[14] Here, however, the evidence, again uncontroverted on cross-examination, is that the November 14 reference to a weakness in internal controls was drafted by SGR management alone, and had not been put to the board. Thus, there is no linkage between the three defendant directors and the reference in the November 14 new release about a weakness in internal controls.

57 What remains then is whether, with regard to the November 8 restatement and the overall "bill and hold" narrative, Messrs. Deepwell, Lebel and Lancaster can foreclose the reasonable possibility

that their reasonable investigation defence will not prevail at trial. In my view, they can.

58 I find that the three defendant directors have presented detailed and credible affidavit evidence, unchallenged on cross-examination, that shows, in essence, that they did everything that could reasonably be expected of them as members of the SGR board and audit committee and further, that they had no reasonable grounds to believe that the various financial disclosures that were released under their jurisdiction over the time periods in question contained any misrepresentations about the "bill and hold" recognition of revenue.

59 Mr. Deepwell provided detailed and, again, uncontroverted evidence about his role as chair of the audit committee and member of the board of directors. As the chair of the audit committee, he engaged with the company's CFOs and independent auditors. He reviewed the audit reviews and opinions in advance of their presentation to the audit committee and presented the financial statements to the audit committee and to the board, along with the audit reviews and opinions of the independent auditors. In my view, his actions show an appropriate degree of attention to the reporting of revenue and, in particular, to the reporting of the "bill and hold" revenue over the time periods in question.

60 Mr. Lebel, the lead director, confirmed that the audit committee interacted with both management and the independent auditors in reaching their conclusions about the reporting of revenue for SGR, including the "bill and hold" revenue. He testified that neither the audit committee nor the board had at any time any reasonable grounds to believe that any of the "bill and hold" representations were untrue. Mr. Lebel was cross-examined. His evidence of corporate governance, the accounting procedures that were followed, the presence of internal controls and the fair presentation of the financial statements survived challenge on cross-examination.

61 Mr. Lancaster's evidence was that the revenue recognition decisions on the "bill and hold" agreements were made after careful review and the reasoned and unanimous approval by SGS and its independent auditor, PwC, and by SGR after the review and approval by its audit committee, its external auditors Deloitte and later PwC, its board of directors and its parent Ivanhoe/TQR. Like Messrs. Krepiakevich, Deepwell and Lebel, Mr. Lancaster was cross-examined but his evidence was not controverted.

62 The defendants' evidence taken as a whole shows that the individual defendants were fully alive to the "bill and hold" issues. There were visits to Mongolia by the CFO, the audit committee and board, and the external auditors. There was thoughtful preparation, review and approval of audit plans and draft financial statements and the correction and adjustment of these statements as and when needed. I am satisfied on the evidence before me that nothing more could have been done by the two CFOs or the three defendant directors to ensure the legitimacy and accuracy of the financial representations at issue.

63 In short, as with the two former CFOs, I have no difficulty concluding that the reasonable investigation defence has been made out by the three defendant directors and there is no reasonable

possibility of the plaintiff proving otherwise at trial.

The company itself

64 The same cannot be said about the company itself. The problem with the defendant SGR is that because of the actions of new management that assumed control in the fall of 2013 it cannot foreclose the reasonable possibility that its reasonable investigation defence will not prevail at trial.

65 The reason why there is a reasonable possibility that the company's reasonable investigation defence may not prevail at trial is three-fold:

(i) The fact that SGR conducted a restatement to correct material prior period errors is itself arguably inconsistent with a reasonable investigation. In IFRS, a prior period error is defined as arising "from a failure to use, or misuse of reliable information that was available when the financial statements for those periods were authorised for issue; and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements." That is, a failure to use or the misuse of reliable information that was (i) available at the time that the relevant financial statements were authorized for issue and (ii) could reasonably have been expected to be obtained and taken into account in the preparation of those financial statements is inconsistent with the concept of a reasonable investigation;

(ii) The fact that SGR management announced a material weakness in the company's internal financial reporting controls. As already noted, an admission of a weakness in a company's internal financial controls is evidence that is "inconsistent" with the company having performed a "reasonable investigation" in connection with the subject of the alleged misrepresentations;[15] and,

(iii) The absence of any evidence from any member of SGR management who was in place at the time of the restatement or the press release about the weakness in internal controls to explain why management said what it said. As I have already noted, this additional evidence, available following discoveries and related motions, may well assist the plaintiff in his claim against the defendant company.

66 Thus, there is room for argument that the reasonable investigation defence on the part of SGR itself may not succeed at trial. That is, the reasonable possibility that the action against SGR will be resolved in the plaintiff's favour at trial has not been foreclosed.

Disposition

67 The motion for leave under s. 138.8 of the OSA is granted as against SGR but not as against the individual defendants Messrs. Krepiakevich, O'Kane, Deepwell, Lebel and Lancaster. Order to go accordingly.

68 I am inclined to find that success on this motion was evenly divided and thus no costs should be awarded.[16] If either side disagrees, it should forward a brief written submission within 14 days, copied to the other side for response within 14 days thereafter.

69 Counsel should also make arrangements to schedule the motion for certification which will most likely be limited to certification as against SGR only. It may also be worthwhile to schedule a case conference to discuss the remaining issues.

70 I thank counsel for their assistance.

E.P. BELOBABA J.

1 *Securities Act,* R.S.O. 1990, c. S.5.

2 *Class Proceedings Act,* 1992, S.O. 1992, c. 6.

3 Revenue can be recognized under the IFRS, and in particular IAS-18, if the following five criteria are met: (a) the entity has transferred to the buyer the significant risks and rewards of ownership of the goods; (b) the entity retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold; (c) the amount of revenue can be measured reliably; (d) it is probable that the economic benefits associated with the transaction will flow to the entity; and (e) the costs incurred or to be incurred in respect of the transaction can be measured reliably. The most important criteria in this case are sub-sections (a), (b) and (d); and the determinative indicia are transfer of title when the coal is delivered to the customer's stockpile in the bonded yard and likelihood of payment.

4 In its audit report for the first quarter of 2012, PwC agreed with SGR management that revenue recognition was "in compliance with IAS-18" and noted specifically that "The bonded yard is monitored by government officials and is not under the control of SouthGobi management ..." In his evidence Mr. O'Kane made the same point. It is also relevant to note that PwC Mongolia had regular access to the bonded yard during the 2010 to 2012 time period and that Deloitte visited the SGS site in both 2010 and 2011. There is no serious suggestion that when the customer coal yard was operational (i.e. until mid-2012) it was not a

bonded yard under governmental control.

5 As Farley J. noted in a similar case involving corporate governance issues, *Pente Investment Management Ltd. v. Schneider Corp.*, [1998] O.J. No. 6387, at para. 4: "This is not a technical area ... where a trier of fact would need assistance in understanding..."

6 OSA, *supra*, note 1, s. 138.8.

7 On appeal from *Green v. Canadian Imperial Bank of Commerce,* 2014 ONCA 90.

8 *Theratechnologies Inc. v. 121851 Canada Inc.,* 2015 SCC 18.

9 *Green*, *supra*, note 7, at para. 93 (affirming Strathy J.'s test in the court below). Also see the discussion in *Goldsmith v. National Bank of Canada,* 2015 ONSC 2746 at paras. 6-10; *Coffin v. Atlantic Power Corporation*, 2015 ONSC 3686 at paras. 16-21; and *Mask v. Silvercorp Metals Inc.,* 2015 ONSC 5348, at paras. 36-38.

10 *Theratechnologies, supra*, note 8, at para. 38.

11 *Green, supra,* note 7, at para. 94, agreeing with Strathy J. in the court below, who in turn had adopted Justice van Rensburg's language in *Silver v. Imax,* [2009] O.J. No. 5573 at para. 256.

12 *Silver v. Imax, supra,* note 11.

13 *Ibid.,* at para. 423.

14 *Ibid.,* at para. 392.

15 *Ibid.,* at para. 392.

16 The plaintiff would have obtained leave on the three misrepresentation claims (against the company and the five individual defendants) but for the reasonable investigation defence. The defendants prevailed on the reasonable investigation defence (but only as against the five individual defendants and not as against the company). In my view, success on the leave motion is almost evenly divided and no costs should be awarded.