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Securities Law Newsletter
November 2007
Westlaw eCarswell

THE SUPREME COURT OF CANADA WEIGHS IN ON *DANIER LEATHER*

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The Supreme Court of Canada's decision in the case of *Kerr v. Danier Leather Inc.*, 2007 SCC 44, has brought an end to the litigation in this closely-watched case, but not to the ongoing analysis and debate of the issues it has raised. To some, the result seems to be counterintuitive and fundamentally inconsistent with the principles of disclosure underlying securities legislation. To others, it is an important affirmation that participants in the capital markets are entitled to conduct their affairs in reliance on the legislation as it is written, without having to probe for hidden meanings or legislative intentions that are inconsistent with the plain words. It may be that both these propositions are valid, and that a problem lies with the legislation itself.

Background

In 1998, Danier Leather Inc. ("Danier") went public by way of a prospectus filed in Ontario and other Canadian jurisdictions. The final prospectus was dated May 6, 1998, and receipted on that date. The public offering closed on May 20, 1998. Danier's fiscal year ended on June 27, 1998, and the prospectus contained a forecast of projected revenue and earnings results for the fourth quarter and the 1998 fiscal year.

During the week before the closing of the offering, Danier conducted an internal analysis of its financial results for the first half of the fourth quarter. That analysis showed that the revenue and earnings for that period were lower than Danier had expected when the forecast in the prospectus was prepared. This new information became known to officers of Danier prior to the May 20 closing of the public offering, but no public disclosure about it was made at that time and the prospectus was not amended.

On June 4, 1998, Danier filed a material change report and issued a press release disclosing a revised forecast for the 1998 fiscal year. (National Policy 48 of the Canadian securities regulatory authorities provides that when a change occurs in the events or assumptions used to prepare a forecast that has a material effect on the forecast, the change must be reported in a manner identical to that followed when a "material change" occurs as defined in securities legislation.) In the release, Danier stated that it had revised its forecast downward due to the unseasonably warm weather in most of its markets. The announcement caused the company's stock price to drop substantially.

During the remainder of June, the weather cooled and Danier held a successful promotion. The company's financial performance recovered to the extent that the results forecasted in the May 6 prospectus were substantially achieved.

An action under section 130 of the *Securities Act* of Ontario (the "Act") for misrepresentation in the prospectus was launched against Danier and certain of its officers. The action was certified as a class action, with the plaintiff class being identified as those persons (with the exception of certain persons related to Danier) who purchased shares

under the prospectus and who continued to hold those shares on June 4, 1998, when the lowered forecast was published.

Court Decisions

Ontario Superior Court of Justice

The trial in the Ontario Superior Court of Justice concluded with a decision in favour of the plaintiffs ((2004), 46 B.L.R. (3d) 167). The trial judge determined that it was the "truthfulness" of the forecast as at May 20, 1998, when the securities were purchased under the public offering, that was relevant to establishing liability under section 130 of the Act. According to the judge, while a forecast is not a "fact" in the sense that actual results are facts, a forecast is an untrue statement of a material fact if any of the assertions implied in the forecast are untrue. One of the implied assertions is that the forecast is objectively reasonable, even if management subjectively believes in the validity of the forecast. Although the defendants took the position that, despite the financial results known to management on May 20, management still believed at that time that the numbers in the forecast would be met, the judge found that this belief was not objectively reasonable. Accordingly, the judge held that the prospectus should have been amended prior to closing and that the plaintiffs were entitled to damages from Danier and the individual defendants.

Ontario Court of Appeal

The Ontario Court of Appeal reversed the decision of the Superior Court of Justice on a number of grounds ((2005), 77 O.R. (3d) 321). The court noted that subsection 57(1) of the Act provides that if a material change occurs after a receipt for a prospectus is obtained but before the completion of the distribution under the prospectus, the prospectus must be amended. The Act defines a "material change", when used in relation to an issuer, as "a change in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer" (or, in certain circumstances, a decision to implement such a change). The trial judge had found that unseasonably warm weather was the cause of Danier's poor fourth quarter sales up to May 20, 1998, and that weather and its impact on financial results was not a material change. Since only a material change, as opposed to a material fact, triggers the amendment requirement under subsection 57(1), the Court of Appeal concluded that an amendment to the Danier prospectus prior to the May 20 closing was not mandated by the Act. According to the Court of Appeal, while the prospectus was required to provide "full, true and plain disclosure" as of May 6 when it was receipted, this requirement did not extend beyond May 6 to the closing date, in the absence of a "material change" during that period.

Section 130 of the Act, on which the action was based, does not refer to a material change, but the Court of the Appeal was of the view that the section did not constitute an additional source of an issuer's disclosure obligations. The section provides for liability for a misrepresentation in a prospectus, but the court's interpretation was that the misrepresentation must relate to the facts as they exist as of the date of the prospectus, and not to subsequent facts, in order to give rise to liability.

The Court of Appeal also disagreed with the trial judge's view that the forecast contained an implied representation that it was objectively reasonable. The Court of Appeal regarded this issue as a question of fact and concluded that the existence of such an implied representation in this case was not borne out by any evidence.

The Court of Appeal went on to decide that, even if there had been an implied representation that the forecast was objectionably reasonable on May 20, the trial judge committed a reviewable error in finding that this representation was false. Firstly, the court disagreed with the trial judge's finding that the fact that the forecast was substantially achieved was immaterial to the analysis of whether the forecast was reasonably achievable on May 20. Secondly, the court decided that the trial judge erred in his approach to determining the objective reasonableness of the forecast, especially by failing to give any deference to the judgment of Danier's senior management in accordance with recent Canadian jurisprudence that endorsed the "business judgment rule". In this connection, the court also objected to the trial judge's failure to take into account the expert testimony at trial that supported the reasonableness of the view taken by Danier management that the forecast continued to be valid on May 20.

Supreme Court of Canada

The Supreme Court of Canada dismissed the plaintiffs' appeal, but did not agree with the Court of Appeal on all the issues. On the question of whether the prospectus should have been amended prior to the May 20 closing of the offering in the absence of a "material change", the Supreme Court agreed with the Court of Appeal that there was no such requirement. However, the Supreme Court was of the view that the forecast did carry an implied representation of objective reasonableness, albeit only until May 6 when the prospectus was receipted and not on May 20. According to the court, a representation of objective reasonableness was implied from statements made in the prospectus by Danier in reference to the forecast and by Danier's auditors regarding the assumptions underlying the forecast.

In regard to the post-May 6 period, the court noted that the prospectus stated that the financial reports issued by Danier to its shareholders during the forecast period would contain either a statement that there were not significant changes to be made to the forecast or a revised forecast accompanied by explanations of significant changes. No financial reports were issued to the shareholders during the period of the distribution, and the prospectus did not promise that the forecast would be updated when conditions changed. According to the court, potential purchasers under the prospectus "should therefore have recognized that the forecast was just a snapshot of the company's prospects as of May 6," beyond which there was no requirement for objective reasonableness.

Despite the finding that, in the absence of a material change, there was no updating obligation after May 6, the Supreme Court, like the Court of Appeal, considered the question of whether the test of objective reasonableness was met on May 20. The Supreme Court disagreed with the trial judge, noting that the defendants' expert had testified that the forecast remained objectively reasonable as of May 20 and that the plaintiffs' expert witnesses did not testify to the contrary. Since "the trial judge did not provide any persuasive reasons to reject the unchallenged expert testimony on that point," the Supreme Court found his finding to be unreasonable or unsupported by the evidence.

The Supreme Court's discussion of the business judgment rule differed markedly from that of the Court of Appeal. The Supreme Court focused on clarifying that, "while forecasting is a matter of business judgment," the business judgment rule cannot override disclosure requirements under securities law. The court said it did not believe that the Court of Appeal intended to say that the disclosure requirements under the Act were subordinated to the exercise of management's business judgment, "although [the Court of Appeal's] treatment of the 'objective reasonableness' issue arguably had that effect in this case." According to

the Supreme Court, the business judgment rule applied to business decisions, not disclosure decisions, and therefore not to the *Danier* case.

Commentary

The Requirement to Amend a Prospectus

It is difficult to take issue with the determination by the appellate courts that the legal obligation to update a receipted prospectus is confined to circumstances where a material change, as defined in the Act, has occurred. A reference to any other kind of change in regard to a final prospectus is notably absent from subsection 57(1), which deals explicitly with the subject of prospectus amendments. Section 130 of the Act, the liability provision, did not refer to a post-receipt updating requirement, and arguably the wording of the section (as it read at the time of the events in *Danier*) did not provide absolute clarity on the issue of timing. Subsection 57(1), on the other hand, is quite clear.

Regardless of one's view as to whether the forecast was objectively reasonable on May 20, it may have come as a surprise to at least some observers of the *Danier* case that both the Court of Appeal and the Supreme Court of Canada appeared to be quite comfortable with the proposition that a prospectus can, in theory, be replete with materially outdated information at the time that investors buy securities under that prospectus, and that the possibility of this scenario has been blessed by the legislature. But was this really the legislature's intention when it introduced the definition of "material change" and subsection 57(1) of the Act?

Subsection 57(1) and the definition of "material change" came into force in 1979 when the entire *Securities Act* of Ontario was replaced with a new version. In the pre-1979 Act, there was no definition of "material change", and the predecessor to subsection 57(1) provided as follows:

> **Material change during distribution.** - Where a material change occurs during the period of distribution to the public of a security that makes untrue or misleading any statement of a material fact contained in a prospectus filed under this Part in respect of which a receipt has been issued by the Director, an amendment to the prospectus shall be filed with the Commission as soon as practicable, and in any event within ten days from the date the change occurs.

In the absence of a definition of "material change" that restricts its meaning, a plain reading of this section appears to indicate that a prospectus must be amended if, during the distribution period, something happens that, at the time it occurs, makes the prospectus materially misleading. Did the legislature intend to take this level of protection away from investors in 1979? The definition of "material change" was introduced as part of a new statutory timely disclosure regime that mandated press releases and material change reports. Can it be assumed that the legislature also fully considered the impact of the definition on prospectus distributions and enacted the definition partly to provide clarity to subsection 57(1)? If so, why does the Act not have a definition of "material adverse change", a term also used in subsection 57(1)?

Forecasts and the Business Judgment Rule

While not determinative of the outcome, the contrasting approaches the appellate courts took to the relevance of the business judgment rule to the case were of interest. The Court of Appeal cited the leading Canadian cases on the rule in support of its view that Danier's management should have been afforded the protection of the rule in the determination of whether the forecast was reasonably achievable on May 20. The Supreme Court did not think the rule applied to the case because the issue under consideration did not relate to a business decision, which is the traditional context in which the business judgment rule comes into play, but rather to a disclosure issue. What is unclear is whether there was any actual disagreement, in substance, between the two courts at all.

The Court of Appeal did not purport to take the position that a company's management can employ the business judgment rule to escape its disclosure obligations under securities law. (The Supreme Court did not believe that the Court of Appeal was taking this position, but felt the need to address the issue in any event.) The Court of Appeal did extend the application of the rule to new territory. It is arguable, however, that the same principles that apply to a court's review of management's business decisions, such as whether to make an acquisition, should also apply in the context of a court's review of a management forecast.

The logic of giving deference to management and its expertise in the case of a business decision would seem also to apply to a forecast. The business judgment rule does not provide a complete safe harbour for management. A business decision must be within a range of reasonableness in order for the rule to apply. A forecast that is challenged in court arguably should be subject to the same test. In fact, the Supreme Court stated in *Danier* that forecasting is a matter of business judgment. Accordingly, although the Court of Appeal engaged the "business judgment rule" terminology in a novel context which the Supreme Court did not endorse, there does not appear to be a fundamental difference in the positions of the appellate courts on the substantive issue.