

Securities and Mergers & Acquisitions Bulletin

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Danier Leather – The Supreme Court of Canada Weighs In

Introduction

With important ramifications for investors, public issuers and their management, the Supreme Court of Canada recently confirmed an earlier Ontario Court of Appeal decision that corporations or other entities issuing shares or other securities to the public pursuant to a prospectus are not obliged under the disclosure requirements found in Ontario's *Securities Act* to update the prospectus to reflect changes to material facts that occur after the final prospectus is filed but before the offering has closed. This confirms at the highest level that under the *Securities Act* a final prospectus is required to contain full, true and plain disclosure of all material facts as of the date of the final prospectus, but not afterwards (including the date of the closing of the offering). Once a final prospectus is filed and a receipt is obtained, only a "material change" in the business, operations or capital of the issuer during the period of distribution will require the issuer to prepare and file an amendment to the prospectus.

Although the Supreme Court upheld the Court of Appeal's decision, the Supreme Court took issue with a number of important aspects of the Court of Appeal's analysis. Perhaps most importantly, the Supreme Court clarified the role of the "Business Judgment Rule"

in disclosure matters. The Court of Appeal had stated that considerable deference should be given to the issuer's management in making determinations concerning what constitutes "material changes" and "material facts." The Supreme Court clarified that an issuer's disclosure obligations are a matter of law and issuers are therefore not entitled to deference based upon the Business Judgment Rule.

Background

On October 12, 2007, the Supreme Court of Canada released its decision¹ which affirmed a 2005 decision² of the Ontario Court of Appeal which had overturned a 2004 Ontario Superior Court of Justice decision³ which found that Danier Leather Inc. ("**Danier**") (TSX: DL) and its CEO and CFO were liable to investors for an amount totalling an estimated \$15 million in respect of a misrepresentation made in Danier's prospectus for its \$65 million initial public offering ("**IPO**"). The trial decision was the first judgment in Ontario where section 130 of Ontario's *Securities Act* was applied. Section 130 provides investors who purchase shares pursuant to a prospectus with the right to sue for damages if the prospectus contains a misrepresentation without the need for the investors to prove that they relied on the misrepresentation when making their investment decision.⁴

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The investor plaintiffs in *Kerr v. Danier Leather* purchased shares in Danier in 1998 under its IPO. Two weeks before the closing of the IPO, Danier filed a final prospectus that contained a financial forecast for the remainder of Danier's fiscal fourth quarter. Ten business days after the closing of the IPO, Danier issued a press release announcing that "unseasonably warm weather" had reduced the expected sales of its leather goods. Danier publicly revised its forecast for the fiscal fourth quarter and the market price of Danier's shares fell almost 30% in the next four days, leaving investors with millions of dollars in paper losses. However, by the end of the fourth quarter, the results in the original forecast contained in the final prospectus were in fact substantially achieved.

Investors in Danier's IPO sued for damages pursuant to section 130 of the *Securities Act* on the basis that the prospectus contained an untrue statement of a material fact and/or omitted a material fact at the time of closing of the IPO. The investors in the Danier IPO alleged that when the IPO closed, the original forecast no longer reflected management's best judgment of the most probable economic conditions and expected results. In fact, since information regarding sales performance was available to management of Danier on a daily basis, the plaintiff investors claimed in part that management knew at the time of the IPO closing that there had been a business downturn and that the forecast contained in the prospectus was not management's best estimate. The plaintiff investors argued that disclosure (by way of an amendment to the final prospectus prior to the closing of the IPO) was required to correct the false and misleading forecast and that the IPO price of the shares was artificially high due to the misrepresentation.

The Trial Decision

The trial judge accepted the plaintiffs' argument and held Danier and its CEO and CFO liable for the drop

in the price of Danier's shares caused by the alleged misrepresentation. The trial judge ruled that the *Securities Act's* definition of "misrepresentation" includes "additional disclosure obligations"⁵ in regard to an issuer's prospectus and that section 130 of the *Securities Act* also "contains separate and distinct [disclosure] obligations"⁶ and should be interpreted to include "a continuing obligation to disclose [all material facts] up to and including the termination of the period of distribution, which is typically the closing date."⁷ The trial judge ruled that investors who bought shares in the IPO and sold them in the immediate aftermath of Danier's profit warning were entitled to recoup their losses. Those who did not sell their stock were awarded \$2.35 per share in damages - an amount representing the fall in Danier's share price after the market had absorbed the effects of the revised forecast. Danier and its CEO and CFO appealed the trial court's judgment on five grounds, only three of which were addressed by the Court of Appeal.

The Court of Appeal Decision

The first ground of appeal was that the trial judge erred in concluding that, under section 130 of the *Securities Act*, Danier had a continuing obligation to disclose material facts occurring after the date of its final prospectus and until the date of the completion of the IPO. The Court of Appeal carefully examined the distinction between the definitions of "material change" and "material fact" found in the *Securities Act*. A "material change" means a change (or a decision to implement 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 issuer's securities.⁸ A "material fact" is broader than a "material change" in that a "material fact" means any fact that would reasonably be expected to have a significant effect on the market price or value of an issuer's securities.⁹ Many matters could therefore constitute material facts without necessarily

constituting material changes. The Court of Appeal accepted that a change to a company's forecasted financial results is likely a material *fact*, but it is not by itself a material *change*. The Court of Appeal found there was no obligation under section 130 of the *Securities Act* or elsewhere to disclose any new material fact that may arise after obtaining a receipt for the final prospectus and before the closing of an IPO unless the fact constitutes a material change.¹⁰ The Court of Appeal noted that the *Securities Act* has a "complete code of prospectus disclosure"¹¹ requiring: (i) full, true and plain disclosure of all material facts to be included in a prospectus on the date it is finalized¹²; and (ii) an amendment to a prospectus where a material change occurs after the receipt for the prospectus but prior to the completion of the distribution of the securities under the prospectus.¹³ In effect, the Court of Appeal found that the trial judge erred by reading the prospectus and related disclosure requirements in the *Securities Act* as though the prospectus were to be effectively signed on the date of the IPO closing instead of on the date of the filing of the final prospectus. The Court of Appeal also found that if the Ontario Legislature had intended to require issuers to disclose material facts occurring between the date of the final prospectus and the end of the distribution period, it would have expressly said so in the *Securities Act* as it does for material changes. Since prospectuses must be updated during the period of distribution only for material changes but not for material facts, purchasers of IPO shares are not entitled to assume that no new material facts have occurred that would reasonably be expected to have a significant impact on the market price or value of those shares after the date of the final prospectus and prior to the date on which they acquire the shares under the prospectus, unless such facts constitute a material change.¹⁴

The second ground of appeal was that the trial judge erred in concluding that Danier's prospectus contained an implied representation that its forecast

was objectively reasonable. The Court of Appeal found that "there was no basis upon which the trial judge could have properly concluded that the [f]orecast [in Danier's prospectus] contained an implied representation of objective reasonableness."¹⁵ The Court of Appeal found that the existence of such an implied representation was an issue of fact rather than an issue of law and that the trial judge could not have properly concluded that the forecast in Danier's prospectus contained such a representation.

The third ground of appeal was that the trial judge made a palpable and overriding error in assessing the objective reasonableness of the forecast without considering the business judgment of Danier's senior management and the fact that, in the end, Danier came close to actually achieving its forecasted financial results. The Court of Appeal decided that since the forecasted results represented "one of several reasonable alternatives" and was "within a range of reasonableness," the trial judge erred in law by failing "to give any deference to the business judgment of Danier's senior management" with regard to the materiality determinations and disclosure decisions.¹⁶

The Supreme Court of Canada Decision

In its decision, the Supreme Court of Canada upheld the outcome of the Court of Appeal's decision; however, in doing so, the Supreme Court refined the analysis and also differed in some respects with the Court of Appeal's reasoning.

Material Facts vs. Material Changes

The Supreme Court upheld the Court of Appeal decision that issuers are not required to disclose in a prospectus (or amendment) any "material fact" occurring after the date the final prospectus is filed with the securities commission (provided that the material fact does not constitute a "material change").¹⁷ The Supreme Court confirmed that the

Securities Act is to be interpreted such that a prospectus is to contain full, true and plain disclosure of all material facts on the date it is finalized and that an amendment to a prospectus only needs to be filed where a material change occurs after the receipt for the prospectus but prior to the completion of the distribution of the securities under the prospectus.¹⁸ The Supreme Court found that the *Securities Act* does not oblige issuers to disclose any new material facts that may have occurred after the date of the final prospectus and prior to the closing date for the offering, even if it would reasonably be expected that the disclosure of such facts would have a significant impact on the market price or value of the shares being sold, unless the material fact constitutes a material change (i.e. a change, or a decision to implement a change, in the business, operations or capital of the issuer).

Business Judgment Rule

Although the Supreme Court agreed with the Court of Appeal with respect to the prospectus disclosure requirements, the Supreme Court rejected the idea that a court should give deference to the business judgment of the issuer's management when considering if an issuer has met its disclosure obligations. The Supreme Court's interpretation of the *Securities Act* allows for no such deference—the Business Judgment Rule has no application in determining whether an issuer has made the right decision about its disclosure obligations under the *Securities Act*. The Supreme Court remarked that “disclosure requirements under the [Securities] Act are not to be subordinated to the exercise of business judgment. ... It is for the legislature and the courts, not business management, to set the legal disclosure requirements.”¹⁹

Forecast was Objectively Reasonable

The Supreme Court also disagreed with the Court of Appeal's determination that no reasonable reader of Danier's prospectus would conclude that Danier's

management was implicitly representing that the forecast contained in the prospectus was objectively reasonable. The Supreme Court found instead that the specific wording in Danier's prospectus made it clear that the forecast was described as objectively reasonable as at the date of the prospectus.²⁰ However, this reversal of the Court of Appeal's decision regarding the characterization of the forecast in Danier's prospectus did not result in the appellants being successful since the Supreme Court noted that even the trial judge had found that the forecast was reasonable on the date of the filing of Danier's prospectus and, given the Supreme Court's interpretation of the *Securities Act*, the objective reasonableness of the forecast on any following date was irrelevant.²¹

Costs

The Supreme Court also upheld the Court of Appeal's decision to award costs against the losing party in this litigation, thereby reaffirming the “loser pay” principle in cost awards. As a result, the representative plaintiffs in this class action claim against Danier will have to pay costs of over \$1 million to Danier as a result of Danier ultimately prevailing in this nine-year saga.

Implications of the Supreme Court of Canada's Decision

For issuers and underwriters, the most significant implication of the Supreme Court's decision is that the exposure to potential statutory liability for a misrepresentation in a prospectus has conclusively been decided to be more limited than that found in the trial decision. Issuers and their advisors can focus on the date of the final prospectus when considering if their prospectus contains full, true and plain disclosure of all material facts. Although the practice may not be consistent with NP 51-201 or the TSX's disclosure requirements (both discussed below), the *Securities Act* does not require an issuer to disclose a new material fact arising after the date

of the final prospectus, unless such a *fact* also constitutes a material *change*.

For investors, the implication of the Supreme Court's decision in *Kerr v. Danier Leather* is that purchasers of securities pursuant to a prospectus cannot assume that a final prospectus contains full, true and plain disclosure of all material facts as at the day of the closing of their purchase. Assuming no material change has occurred and no amendment to the prospectus is filed, the date of the final prospectus is the relevant date for determining whether such disclosure has been made and, accordingly, whether investors may avail themselves of any recourse that section 130 of the *Securities Act* provides.

For issuers and their advisors, the Supreme Court's decision provides a helpful clarification regarding the terminology and disclosure responsibilities concerning "material facts" and "material changes." When a prospectus is accurate at the time of its filing, the *Securities Act* limits the obligation of post-filing disclosure to notice of a "material change,"²² which the *Securities Act* defines 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."²³ An issuer has no similar express obligation to amend a prospectus or to publicize and file a report regarding any new "material facts" that may arise after receiving a receipt for a prospectus (unless such fact constitutes a "material change"). As mentioned, a "material fact" is defined in the *Securities Act* more broadly than a "material change" and includes "a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the [issuer's] securities." A change in an issuer's intra-quarterly results is not itself a change in the issuer's *business*, *operations* or *capital* and, for that matter, does not necessarily signal that a material change has occurred. An issuer's sales often fluctuate (as occurred with *Danier*) in response

to factors that are external to the issuer. A change in an issuer's "results of operations" is not the same a change in an issuer's "operations" and a change, or expected change, in results does not in itself constitute a material change.²⁴

Although the Supreme Court's decision may make it easier for issuer's and their advisors to determine if a material *fact* is also a material *change*, in practice it will likely still remain challenging to make conclusive determinations regarding materiality. Determining the materiality of information is clearly an area which requires judgment. A fact or change is *material* if it is reasonably expected to have a significant effect on the market price or value of the issuer's securities. In making materiality judgments, it is inherently necessary to take into account a number of factors regarding the issuer's securities and such factors cannot be captured in a simple bright-line standard or test. These factors include the nature of the issuer, the volatility of the issuer's securities and prevailing market conditions. In addition, the materiality of a particular event or piece of information may vary from issuer to issuer, depending upon the issuer's size, the nature of its operations and many other factors including the key valuation metrics for the securities and the market's existing expectations. Therefore, although considerable judgment may be needed in making materiality determinations, in what is considered a victory for the Ontario Securities Commission²⁵ (who intervened in this case), the Supreme Court has made it clear that the Business Judgment Rule has no place in determining whether an issuer has satisfied its statutory disclosure obligations.

After the initial trial decision in *Kerr v. Danier Leather* was released, a change in practice by investment dealers emerged whereby it was considered prudent to conduct a pre-closing "bring-down" due diligence session with an issuer's management to ensure that no new material facts had arisen since the filing of the final prospectus. Although the plaintiff investors have now lost their

case at the Supreme Court of Canada, this bring-down due diligence practice by investment dealers should not be discontinued simply as a result of the Supreme Court's decision. The Supreme Court's decision should not stand for the idea that once an issuer has filed its final prospectus the underwriters need only conduct further "bring down" due diligence in regard to potential material changes in order to avoid liability. While the existence of any undisclosed material change is relevant in regard to potential statutory liability pursuant to section 130 of the *Securities Act*, investment dealers also have a regulatory obligation to "use due diligence to learn and remain informed of the essential facts relative to every customer and to every order or account accepted..., use due diligence to ensure that the acceptance of any order for any account is within the bounds of good business practice"²⁶ and "observe high standards of ... conduct in the transaction of their business ... [and] not engage in any business conduct or practice which is unbecoming or detrimental to the public interest."²⁷ Since the existence of an undisclosed material fact inherently means the existence of a fact that, once disclosed, would be expected to have a significant effect on the price or value of an issuer's securities, it may still be good practice for prudent investment dealers to conduct a bring-down due diligence session prior to the closing of an issuer's offering.

Both the Supreme Court of Canada and the Court of Appeal recognized that securities regulators and stock exchanges, such as the Toronto Stock Exchange ("TSX"), have adopted policies incorporating disclosure obligations going beyond those found in the Securities Act. One example is National Policy 51-201 - Disclosure Standards ("NP 51-201"), which deals with timely disclosure. Section 4.5 of NP 51-201 acknowledges that the TSX has a policy requiring listed companies to make timely disclosure of all "material information," which includes both "material facts" and "material changes" relating to the business and affairs of the

company.²⁸ NP 51-201 states that it expects listed companies to comply with the TSX's requirements. However, policy statements issued by securities regulators are not law. Policy statements may be relied on in proceedings before a securities regulator, but they cannot be used as the basis for an action for prospectus misrepresentation under section 130 of the *Securities Act*.²⁹ An issuer's obligation to comply with the TSX's requirements is based upon the listing agreement between the issuer and the exchange. Investors, who are not a party to this agreement, cannot use an allegation of breach of contract as a cause of action to sue an issuer for a disclosure violation based upon the listing agreement between the issuer and the exchange.

Lastly, the Supreme Court of Canada's decision may have implications for potential future securities class action lawsuits against issuers. The \$1 million or more of legal costs that were awarded to Danier may have a chilling effect on the plaintiff securities bar's willingness or enthusiasm to launch future lawsuits. In that regard, the Supreme Court observed that "protracted litigation has become the sport of kings in the sense that only kings or equivalent can afford it. Those who inflict it on others in the hope of significant personal gain and fail can generally expect adverse cost consequences."³⁰ Only time will tell if this result and these comments will result in any reduction in the number of class-action lawsuits against securities issuers.

For more information on the subject of this bulletin, please contact the authors or any member of Fasken Martineau's Securities and Mergers & Acquisitions Group or Securities Litigation Group.

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¹ *Kerr v. Danier Leather Inc.*, 2007 SCC 44 (Supreme Court of Canada); available online at:

<http://scc.lexum.umontreal.ca/en/2007/2007scc44/2007scc44.pdf>

² *Kerr v. Danier Leather Inc.* [2005] O.J. No. 5388 (Ontario Court of Appeal); available online at:

<http://www.ontariocourts.on.ca/decisions/2005/december/C41880.htm>

³ *Kerr v. Danier Leather Inc.* [2004] O.J. No. 1916 (Ontario Superior Court): available online at:

<http://www.canlii.org/en/on/onsc/doc/2004/2004canlii8186/2004canlii8186.html>

⁴ The common law legal test is that a plaintiff must prove (i) that a misrepresentation existed, and (ii) that the plaintiff *actually relied* on the misrepresentation when the plaintiff made its investment decision.

⁵ Para. 102, *Danier* (Trial), *supra* note 3.

⁶ Para 115, *Danier* (Trial), *supra* note 3.

⁷ Para. 129, *Danier* (Trial), *supra* note 3.

⁸ Section 1(1) of the *Securities Act*

⁹ Section 1(1) of the *Securities Act*

¹⁰ Para. 89 and para. 128, *Danier* (Ct. of Appeal), *supra* note 2.

¹¹ Para. 91, *Danier* (Ct. of Appeal), *supra* note 2.

¹² Section 56(1) of the *Securities Act*

¹³ Section 57(1) of the *Securities Act*

¹⁴ Para. 87 and para. 128, *Danier* (Ct. of Appeal), *supra* note 2.

¹⁵ Para. 142, *Danier* (Ct. of Appeal), *supra* note 2.

¹⁶ Para. 179 and para. 175, *Danier* (Ct. of Appeal), *supra* note 2.

¹⁷ Paras. 32 and 43, *Danier* (SCC), *supra* note 1.

¹⁸ Para. 37, *Danier* (SCC), *supra* note 1.

¹⁹ Para. 55, *Danier* (SCC), *supra* note 1.

²⁰ Para. 49, *Danier* (SCC), *supra* note 1.

²¹ Para. 51, *Danier* (SCC), *supra* note 1.

²² Section 57(1) of the *Securities Act*

²³ Section 1(1) of the *Securities Act*

²⁴ Para. 45, *Danier* (SCC), *supra* note 1.

²⁵ Jacquie McNish “Paragraph 55: ‘Good news ... for investors’” *The Globe & Mail* (October 17, 2007) at page B8

²⁶ IDA Regulation 1300.1

²⁷ IDA By-Law 29.1

²⁸ See section 408 of the TSX Company Manual

²⁹ Paras. 101 to 104, *Danier* (Ct. of Appeal), *supra* note 2.

³⁰ Para. 63, *Danier* (SCC), *supra* note 1.

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