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Prospectus Disclosure and the Business Judgment Rule: Lessons from *Danier*

In an important decision, the Ontario Court of Appeal has recently (a) clarified the scope of prospectus disclosure, (b) established that forecasts in prospectus need not necessarily be objectively reasonable, and (c) reinforced the legitimacy and application of the business judgment rule.

The Facts

In May 1998, Danier Leather Inc.'s ("Danier") founder decided to sell his shares by way of an initial public offering ("IPO") to the public. Danier, a manufacturer and retailer of leather goods, completed the IPO under a prospectus. The prospectus included actual revenues and earnings through the third quarter and a forecast of revenue and earnings for the company's fourth quarter of its fiscal year, which ended in June 1998.

After receiving a receipt for the prospectus but before the IPO closed, internal company analysis showed sales were lower than expected up to that point in the fourth quarter. The offering closed without any public disclosure of this shortfall because management still believed that the forecast would be achieved before year-end.

Danier held one of their two major sales of the quarter soon after the closing. The results were disappointing and management became concerned that the forecast would not be met. As a result, the company issued a press release two weeks after closing with a downward revision of the company's fourth quarter forecast. This caused a decline in the share price. In the end, however, business improved and Danier's fourth quarter results were substantially similar to the forecast in the prospectus.

The Trial

In *Kerr v. Danier Leather*, Danier's shareholders brought a class action against Danier, its CEO and CFO under section 130 of the Ontario *Securities Act*. This was the first prospectus class action case in Ontario to reach trial. The plaintiffs alleged that in light of the internal analysis done before closing, Danier should have amended its prospectus prior to closing; since it failed to do so, the original forecast constituted a misrepresentation at closing. At trial, Justice Sidney Lederman found Danier, the CEO and CFO liable to the shareholders. He held that no material change had occurred, but that Danier had failed to disclose material *facts* that arose after the date of its prospectus but before closing. Although he held that the CFO and CEO honestly believed the forecasts would be met despite lagging sales, the judge held that the undisclosed material facts made the earnings forecast contained in the prospectus objectively unreasonable as of the date of closing. The Court ordered Danier to compensate class members for their losses and legal costs.

The Appeal

This decision was appealed and on December 15, 2005, the Ontario Court of Appeal released its decision. The appeal was allowed, the original decision reversed and the action was dismissed. The Ontario Court of Appeal found that the trial judge made three errors.

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First, he erred in concluding that Danier had a continuing obligation to disclose material *facts* occurring between the date of its prospectus and the date of closing if such facts did not constitute a material *change*. Under the Ontario *Securities Act*, (a) a prospectus is only required to provide full, true and plain disclosure of all *material facts* as of the date of the prospectus and not the date of closing, and (b) issuers are required to amend a prospectus only when there is a *material change* to the issuer. The Ontario *Securities Act* defines "material changes" more narrowly than "material facts". Notwithstanding certain securities regulators' policy statements on continuous disclosure, there is no statutory requirement to amend a prospectus for material facts that arise after a receipt has been issued for a prospectus but before closing. The Court of Appeal made it clear that sections 56 and 57 of the Ontario *Securities Act* constitute a complete code of prospectus disclosure obligations. This is true both for the purpose of statutory compliance and for the purpose of statutory civil liability. That is, section 130 of the Ontario *Securities Act*, which is essentially a remedies section, does not impose an additional obligation to make continuous disclosure that is not expressly provided for in sections 56 and 57.

Second, the trial judge erred in concluding that Danier's prospectus contained an implied representation that the earnings forecast was objectively reasonable. The Court stated that in most cases a forecast in a prospectus can be taken to contain implied representations that the forecast represents management's best judgment, that the forecast was prepared using reasonable care and skill, and that management believes the forecast to be reasonable. Since this determination is a question of fact and there existed no evidence suggesting an additional implied representation that the forecast was "objectively reasonable", the trial judge erred in concluding that such an implied representation existed in this case.

Third, the trial judge erred in concluding that the forecast in the prospectus contained an implied representation that it was "objectively reasonable" because (a) he ignored the actual fourth quarter results that were substantially similar to the forecast, and (b) he failed to give any deference to the business judgment of Danier's senior management in determining the achievability of the earnings forecast. Danier's senior management was entitled to the benefit of the business judgment rule, which allows for decisions made by management within a range of reasonableness. As long as senior management selects one of several reasonable courses of action, deference should be accorded to their decision by the courts. That management was reasonable in its original forecast was re-enforced by the fact that Danier essentially met that forecast.

Published sources have stated that the plaintiffs will seek leave to appeal to the Supreme Court of Canada.

The Lessons

In sum, the *Danier* decision provides the following lessons to the Canadian business and legal communities:

1) The Ontario *Securities Act* requires full, true and plain disclosure of all *material facts* only as of the date of the prospectus, and not the date of closing of the offering of the securities.

2) When it includes an earnings forecast in its prospectus, an issuer is not making an implied representation that such forecast is "objectively reasonable" without additional evidence to this effect.

3) Courts should defer to the business judgment of an issuer's senior management in determining the reasonableness of business decisions.

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The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.

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