

Update

Corporate Securities Law

October 17, 2007

The Final Chapter of the Danier Case

The release on Friday of the Supreme Court of Canada's decision in *Kerr v. Danier Leather Inc.* closed the book on the high profile securities case, much discussed and followed by investors, issuers and securities professionals across Canada. Though the litigation is done, the decision itself may well have enduring impact.

In particular:

- in upholding the Ontario Court of Appeal's determination that an issuer should not have civil liability for misrepresentation for not providing updates to a prospectus which are not required under applicable securities laws, the Supreme Court provided clarity and direction for the conduct of public offering processes, and related disclosure issues; and
- in requiring the (ultimately unsuccessful) class action plaintiff to bear the costs of the litigation, the Supreme Court decision may have a significant effect on the conduct of class action litigation, in which plaintiffs have often been insulated from cost awards.

The *Danier* decision also provides useful guidance as to the use of financial forecasts in prospectuses, and as to the application of the "business judgment" rule to the statutory obligations of issuers and their executives.

The Facts

To briefly recap the facts, the litigation related to the initial public offering completed by Danier in the spring of 1998. The final prospectus relating to the offering, filed on May 6, 1998 included a forecast of Danier's projected results through to its June 27 fiscal year end. On May 16, *after* the date of the prospectus but *before* the IPO

closed on May 20, an internal company analysis was prepared showing that Danier's intra-quarter results were lagging behind its internal store budget, though the company still expected that its forecast would be met, based in part on planned sales promotions over the balance of the fiscal year. Danier did not publicly disclose the intra-quarter results before closing.

After the offering closed, a planned sales promotion had disappointing results and Danier discovered that unseasonably hot weather was the cause. Danier then issued a revised (downward-adjusted) forecast, which was made based on a stated assumption that the unseasonably warm weather would continue, after which Danier's share price declined. Ultimately, the weather returned to normal, sales rebounded and the initial forecast was substantially achieved.

Duty to Update

Closings of public offerings do not occur on the date of the relevant final prospectus; rather, they take place a short time following the date of the final prospectus. Securities laws require that the prospectus be updated during this pre-closing period if a "material change" occurs (limited to changes in the "business, operations or capital of the issuer"), but do not require an update if a material fact occurs during that period.

The courts concluded that, while it may have been a material fact that Danier's intra-quarter *results of operations* were lagging behind its internal store budget, this was not itself a "material change" (in that the cause of the change in results was due to factors external to the company, specifically the effect of the weather on sales of leather). Consequently, the central question in the case was whether Danier could be liable for misrepresentation because it did not update its prospectus disclosure to include a material fact that occurred pre-closing.

The Supreme Court ruled that issuers do not have an obligation to update a prospectus to reflect material facts arising after filing and do not have civil liability for failing to do so. The court concluded that to

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impose civil liability where the issuer had complied fully with its statutory obligations would be contrary to the scheme of the securities legislative framework. In addition to clarifying the scope of potential liability, this conclusion will provide greater certainty in the conduct of public offerings, including on matters such as the terms of underwriting agreements and the conduct of due diligence exercises, which had been cast into question by the trial court's decision in *Danier*.

Costs

The portion of the *Danier* decision with potentially the greatest impact is the ruling on costs. In commercial litigation matters costs typically “follow the event,” in that the unsuccessful party pays all or a portion of the victor's costs. Notwithstanding that general approach, class action plaintiffs have often been insulated from cost awards, out of concern that the potential exposure to high cost awards may dissuade plaintiffs from proceeding and thereby effectively deny access to justice. In *Danier* the Supreme Court upheld the Court of Appeal's award of costs throughout against the class action plaintiff, concluding that, given the nature of the claims and the sophistication and resources of the class action plaintiff, there were no access to justice concerns and a costs order was justified.

The Business Judgment Rule and Disclosure Obligations

A final notable element of the decision is the court's discussion of the “business judgment rule,” which rule requires that deference be accorded by courts to executives' business decisions provided that the decisions are made on a reasonable basis. The Supreme Court stated clearly that while the rule applies in the context of business decisions – so that executives are free to take reasonable risks without having to worry that their decisions will be second-guessed by courts acting with the benefit of hindsight – the rule does *not* apply to limit statutory disclosure obligations if an obligation to make disclosure otherwise exists. This finding did not affect the outcome of the case – because the issuer was found not to have a duty to disclose in the circumstances. The decision provides useful guidance on certain limits of the business judgment rule.

Goodmans Role

Goodmans' litigators Ben Zarnett and Jessica Kimmel represented Danier's senior officers at the trial and on the appeals and led the successful defence arguments at both the Court of Appeal and Supreme Court.

If you have any questions with respect to the foregoing, please do not hesitate to contact:

Litigation

Jessica Kimmel jkimmel@goodmans.ca

Ben Zarnett bzarnett@goodmans.ca

Securities

Lawrence Chernin lchernin@goodmans.ca

John Connon jconnon@goodmans.ca

Jonathan Feldman jonfeldman@goodmans.ca

Sheldon Freeman sfreeman@goodmans.ca

Allan Goodman agoodman@goodmans.ca

William (Bill) Gorman wgorman@goodmans.ca

Avi Greenspoon agreenspoon@goodmans.ca

Francesca Guolo fguolo@goodmans.ca

Stephen Halperin shalperin@goodmans.ca

Tim Heeney theeney@goodmans.ca

Jonathan Lampe jlampe@goodmans.ca

Dale Lastman dlastman@goodmans.ca

Victor Liu vliu@goodmans.ca

Kari MacKay kmackay@goodmans.ca

David Matlow dmatlow@goodmans.ca

Neill May nmay@goodmans.ca

Grant McGlaughlin gmcgloughlin@goodmans.ca

Shevaun McGrath smgrath@goodmans.ca

Michael Partridge mpartridge@goodmans.ca

Stephen Pincus spincus@goodmans.ca

William Rosenfeld wrosenfeld@goodmans.ca

Meredith Roth meroth@goodmans.ca

Neil Sheehy nsheehy@goodmans.ca

Mark Spiro mspiro@goodmans.ca

Bob Vaux bvaux@goodmans.ca

Kenneth Wiener kwiener@goodmans.ca