

## Corporate Securities Law

December 21, 2005

### Forecasts and the Business Judgment Rule: Issuers, Directors and Officers Take Comfort in Court of Appeal's Decision in *Danier*

In an eagerly awaited decision released last week, the Ontario Court of Appeal reversed the May 2004 ruling of Justice Sidney Lederman in *Kerr v. Danier Leather Inc.*, which had held that Danier and certain of its senior officers were liable to investors for a prospectus misrepresentation relating to an earnings forecast included in a prospectus.

The Court of Appeal's decision in *Danier* is important for many reasons. The two most important are that the Court of Appeal:

1. Clarified that under the Ontario *Securities Act*, a prospectus is only required to provide full, true and plain disclosure of all material facts as of the date of the prospectus (*not* the date of closing) and issuers are required to amend for material changes, but *not* for material facts; and
2. Strongly endorsed what is referred to as the "business judgment rule."

#### Background

In May 1998, Danier (a manufacturer and seller of leather clothing and accessories) undertook an initial public offering of its shares. The prospectus contained a forecast that included Danier's projected revenue and earnings for the last quarter of its fiscal year.

An internal company analysis prepared a few days before the offering closed, but after the final prospectus had been filed, showed that Danier's fourth quarter revenue and earnings were lagging behind a front end loaded internal store budget. However, on the date of closing, Danier's senior management still believed that Danier could achieve the forecasted results, in part because of two planned sales promotions scheduled for the last six weeks of the fiscal year: Danier's annual Victoria Day Sale and a June promotion.

The Victoria Day Sale began the day after the offering closed. Unfortunately, the results of the sale were disappointing. Upon considering the results and investigating the matter further, Danier's CEO concluded that the unexpectedly low sales were due to unseasonably hot weather across Canada.

Danier's CEO told the underwriters that if the unseasonably hot weather continued, he could no longer be confident that Danier would meet the forecast. Danier's lawyer recommended that Danier assume the worst (that the hot weather would continue into June) and that the company prepare and file a revised forecast (under then National Policy 48) with the Ontario Securities Commission, which Danier did.

Danier's announcement of the revised forecast precipitated a significant temporary decline in its share price on small volumes. However, the weather later cooled and Danier's sales rebounded. By the end of the fiscal year, Danier had substantially achieved its original forecast.

Nonetheless, the plaintiffs began a class proceeding for prospectus misrepresentation under s. 130(1) of the *Securities Act*.

#### Recap of the Trial Decision

After a lengthy trial, Justice Lederman found Danier and certain of its senior officers liable for statutory misrepresentation regarding the forecast.

The trial judge's finding of liability was based primarily on the following conclusions:

- The poor fourth quarter revenue and earnings occurring after the prospectus was issued were material facts Danier was required by the *Securities Act* to disclose before closing (although they were not a material *change*);

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- The prospectus implied that the forecast was objectively reasonable both on the date of the prospectus *and* on the offering's closing date; and
- Because of Danier's failure to disclose the poor fourth quarter results, this implied representation, though true on the date of the prospectus, became false on the closing date.

Having found Danier and its senior officers liable, the trial judge awarded substantial damages, using the fall in Danier's share prices as the *prima facie* measure of that award.

## The Court of Appeal's Decision

In its decision released December 15, the Court of Appeal reversed Justice Lederman's finding of liability against Danier and its senior officers and dismissed the class action.

In particular, the Court of Appeal held that the trial judge 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 when no material change had occurred;
- Concluding that Danier's prospectus contained the implied representation that the forecast in question was objectively reasonable; and
- Failing to give any deference to the business judgment of Danier's senior management and to take into account that the forecast was substantially achieved.

## Disclosure Ruled Sufficient

The Court of Appeal held that Danier had complied with its disclosure obligations by filing a prospectus which was true on its date, and by not filing any amendment to the date of closing of the offering as no material change had occurred. The Court of Appeal rejected the trial judge's interpretation of the *Securities Act* that issuers have an obligation to update all material facts to the date of closing.

## Business Judgment Rule Strongly Endorsed

As mentioned above, the Court of Appeal held that the trial judge erred by failing to give any deference to the "business judgment" of Danier's senior management. On this point, the court emphasized that the "reasonableness" that is the centerpiece of the business judgment rule involves a "range of rea-

sonableness." The court went on to quote the following passage from a previous Court of Appeal decision (a passage also recently quoted by the Supreme Court of Canada in the *Peoples Department Stores* case):

The court looks to see that the directors made a *reasonable* decision *not a perfect decision*.

**Provided the decision taken is within a range of reasonableness**, the court ought not to substitute its opinion for that of the board even though subsequent events may have cast doubt on the board's determination. As long as the directors have **selected one of several reasonable alternatives**, deference is accorded to the board's decision. This formulation of deference to the decision of the Board is known as the "business judgment rule." [italics in original, bold added]

Adopting this approach, the Court of Appeal held that while the senior officers' view regarding the forecast might have been an optimistic one, it deserved deference because it represented "one of several reasonable alternatives" and was "within a range of reasonableness."

At a time when directors and officers of Canadian companies are becoming increasingly concerned about liability, this strong endorsement of the business judgment rule by the Court of Appeal should provide some level of comfort.

Benjamin Zarnett and Jessica Kimmel of Goodmans LLP represented Danier's senior officers in the action and the appeal.

If you wish to further discuss this decision, please contact any member of the Goodmans' securities team.

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