

# Decision impacts investors and class actions

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The Supreme Court of Canada has clarified the statutory obligations concerning what public company directors and issuers are required to disclose when selling shares to the public through a prospectus.

In *Kerr v. Danier Leather Inc.*, the Supreme Court unanimously ruled that the leather clothing retailer had no legal obligation to update its prospectus, which included a positive fourth-quarter financial forecast, with news of lagging intra-quarterly sales results before closing its initial public offering in 1998.

The long-running case is the first trial of a class action concerning the civil liability of corporate issuers and their directors for misrepresentation in a prospectus governed by the Ontario Securities Act, and one of the first class actions ever to go to trial in Canada.

When a prospectus is accurate on the filing date, issuers do not have a legal obligation to amend the prospectus or to publicize "material facts" that come to light after the filing date but before an IPO closes unless the new information amounts to a "material change," the court said.

"Balancing the needs of the investor community against the burden imposed on issuers, the Ontario legislature adopted a policy governing the continuous disclosure requirements that drew the line at 'material change' in the 'business,

operations or capital of the issuer,'" wrote Justice Ian Binnie.

A material fact is defined more broadly in the act and includes "a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of . . . securities," said Binnie.

The decision means that issuers and directors must disclose any material facts known to them at the time of filing the prospectus, but have no continuous obligation to disclose material facts that arise during the distribution period, says George Glezos, a Lerner LLP lawyer who acted for the representative plaintiff Rick Durst.

"What is now very clear as a result of the Supreme Court of Canada decision is that an investor can only sue for prospectus misrepresentation contained in the prospectus itself," he says.

But if there is a material change, which arises after the filing of the prospectus, the issuer must disclose the material change and amend its prospectus, he adds.

During the week before its IPO closed, Danier's internal intra-quarterly results analysis determined that its fourth quarter revenue was 24 per cent behind projections, and that the company had a fourth quarter net loss of \$24,000, instead of projected net earnings of \$259,000.

Danier's then-chief executive officer, Jeffrey Wortsman, and its then-chief financial officer, Bryan Tatoff, concluded the company



**George Glezos says investors can only sue for prospectus misrepresentations found within prospectuses.**

could still meet the prospectus forecast, and chose not to disclose the new information.

But soon after closing, Wortsman discovered that sales were down significantly compared to the previous year, and identified the culprit as unseasonably warm weather that deterred customers from buying leather clothes.

Two weeks after closing, Wortsman issued a revised forecast, indicating Danier would fall short of the original forecast. The share price immediately fell by 22 per cent, and investors who then unloaded stock lost money, prompting the class action for prospectus misrepresentation.

However, the return of cooler weather and a 50-per-cent-off pro-

motion brought consumers back, and Danier substantially achieved its forecast.

Ontario Superior Court Justice Sidney Lederman concluded Danier had complied with its legal obligation under s. 57(1) of the act to provide "full, true and plain disclosure of all material facts" in the prospectus, and that the cause of the poor results, the weather, did not amount to a material change.

But Lederman still found Danier liable under s. 130(1) of the act, which he interpreted to impose a legal obligation to disclose a material fact during the period of distribution, and ordered Danier to pay investors \$11.5 million in damages plus interest. In December 2005, the Court of Appeal overturned this decision, and the Supreme Court agreed on Oct. 12.

The language in the act represents a "complete code" for management to follow and it's not up to courts to add language or to create a different scheme, which is what the trial judge did, says Alan Lenczner, a lawyer for Danier. "There's certainty for corporations that if they follow what the Securities Act [calls for], they can't be criticized," says Lenczner of Lenczner Slaght Royce Smith Griffin LLP in Toronto.

Lawyers for the representative plaintiff also lost a bid to reverse the Court of Appeal's decision finding their client liable for costs.

They relied on a section of the Class Proceedings Act to argue their client shouldn't have to pay

because Kerr was a novel case.

"We argued that the issues were important for the protection of the capital markets," says Glezos. But the Supreme Court rejected this argument.

Glezos says his client is "very disappointed" with the costs award, and admits investors might now "think twice" and "exercise caution when thinking about bringing an action." But he said another court in a different case could make a different decision on costs, depending on the circumstances.

And he says the court had some good news for investors which may cause management to err on the side of caution when making disclosure decisions.

The court concluded directors and officers aren't entitled to assert the business judgment rule when making disclosure decisions.

The rule holds that courts won't second-guess decisions made by a board of directors as long as their decisions fall within a reasonable range of decisions, explains Glezos. The ruling means, for instance, public companies cannot choose to omit material facts in their prospectus, and then assert the business judgment rule to shield themselves from liability, he says.

But Lenczner says the findings about the business judgment rule don't change much because the act already says management must make "full, true and plain disclosure of all material facts."

Management already didn't have a choice, he says. **LT**