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Weather, Leather, and the Obligation to Disclose: Kerr v. Danier Leather Inc.

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Abstract
Is an issuer legally obliged to update its prospectus if a material event occurs following the receipt for the prospectus but prior to the closing of the offering? This is the crucial issue that is addressed in Kerr v. Danier Leather Inc., a case that has been heard at the trial and appeal levels in Ontario and that will be heard in 2007 by the Supreme Court of Canada. In this commentary, we argue that the Court of Appeal decision in the case overlooked crucial aspects of contemporary securities law and policy in holding that there is no obligation to disclose intra-quarterly results that cast doubt on the achievement of an earnings forecast in a prospectus. Further, although the Court of Appeal took into account the business judgment rule, there is no precedent for applying it in the context of an obligation to fulfill statutory disclosure requirements. Ultimately, this is a case in which courts squarely confront the balance between legal obligations imposed on issuers and the expectations of investors in the context of forward-looking information. This issue was not a feature of the disclosure landscape when the Ontario statute was originally enacted and, until this case, had not been litigated in this country.

In Part II of this commentary, we explore the difference between material fact and material change and the meaning of section 57(1) of the Securities Act We also examine the policy rationales underpinning section 57(1) and section 130(1); we argue that if one reads these two sections together, changes in material facts as well as material changes must be disclosed if they arise following the issuance of a receipt for the prospectus but prior to the end of the distribution period. The notion of investor protection embedded in the Securities Act is severely undermined if investors are not provided -with information that they would consider to be material" regardless of whether the information is technically speaking a material "fact" or a material "change." In Part III, we turn to examine the business judgment rule: its history and development in Canada. We argue that the business judgment rule is inapplicable in a case such as Danier, which deals with the obligations under securities law to disclose material facts and material changes. We conclude the commentary in Part IV.

Keywords
Securities industry--Law and legislation; Business judgment rule; Canada; Ontario

Commentary

WEATHER, LEATHER, AND THE OBLIGATION TO DISCLOSE: *KERR V. DANIER LEATHER INC.*©

ANITA ANAND & MARY CONDON*

I. INTRODUCTION

Is an issuer legally obliged to update its prospectus if a material event occurs following the receipt for the prospectus but prior to the closing of the offering? This is the crucial issue that is addressed in *Kerr v. Danier Leather Inc.*,[1] a case that has been heard at the trial and appeal levels in Ontario and that will be heard in 2007 by the Supreme Court of Canada. In this commentary, we argue that the Court of Appeal decision in the case overlooked crucial aspects of contemporary securities law and policy in holding that there is no obligation to disclose intra-quarterly results that cast doubt on the achievement of an earnings forecast in a prospectus. Further, although the Court of Appeal took into account the business judgment rule, there is no precedent for applying it in the context of an obligation to fulfill statutory disclosure requirements. Ultimately, this is a case in which courts squarely confront the balance between legal obligations imposed on issuers and the expectations of investors in the context of forward-looking information. This issue was not a feature of the disclosure landscape when the Ontario statute was originally enacted and, until this case, had not been litigated in this country.

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[1] (2005), 77 O.R. (3d) 321 (C.A.) [*Danier*].

The case involves an alleged misrepresentation in a prospectus. Danier Leather Inc. was completing its initial public offering (IPO) in 1998. After three previous attempts at an IPO, the issuer finally went public with a final prospectus in May 1998. The prospectus contained a forecast of projected revenue and earnings for the last quarter of the company's fiscal year. Senior management prepared an internal analysis just before closing the distribution, which showed sales levels running below the anticipated forecast; the company did not release this information publicly. The IPO closed and shortly afterwards Danier issued a revised forecast. The share price dropped significantly. Ultimately, the company did achieve its original forecast.

The plaintiffs began a class action under section 130 of the *Securities Act*.[2] This section grants a statutory cause of action for misrepresentation in a prospectus. The plaintiffs alleged that the original forecast in the prospectus contained a misrepresentation which was evidenced by the internal analysis prepared before the IPO closed. The plaintiffs were successful at trial before Justice Lederman who found the chief executive officer (CEO), Jeffrey Wortsman, and the chief financial officer (CFO), Bryan Tatoff, liable for misrepresentation under section 130. In particular, the trial judge held that the result of the internal analysis was a material fact and that, because of the definition of misrepresentation in the legislation, section 130 required the company to update its prospectus. Justice Lederman also found that the prospectus contained an implied representation that the forecast was "objectively reasonable," but that on the basis of management's internal analysis, the forecast was not objectively reasonable at the time of closing. The trial judge declined to apply the business judgment rule, which the defendants relied on to show the reasonableness of their actions.

The defendants appealed successfully. The Court of Appeal held that section 130 does not require issuers to disclose material facts that arise after the receipt for a final prospectus and before the end of the distribution period. The Court of Appeal relied on the strict wording of section 57(1) of the *Securities Act*, which requires issuers to amend the prospectus if a material change occurs after the receipt for the prospectus is obtained, but before the completion of the distribution.

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[2] R.S.O. 1990, c. S. 5 [*Securities Act*].

Because both levels of court found that the information at issue (poor intra-quarterly results) constituted a material fact, as opposed to a material change, the issuer was not bound to amend the prospectus. Furthermore, the Court of Appeal found no basis on which Justice Lederman could have concluded that the forecast contained an implied representation of objective reasonableness. The Court of Appeal applied the business judgment rule in holding that senior management was required to make a reasonable, not a perfect, decision with respect to disclosing the earnings results. Though hindsight may suggest that it was not perfect, the decision to refrain from releasing the information was indeed reasonable.

In analyzing the Court of Appeal's reasoning, we argue that the internal earnings results constituted a material change, rather than a material fact, and were thus disclosable in accordance with section 57 of the *Securities Act.* We also suggest that section 57 should be given a broader reading than that adopted by the Court of Appeal, in order to accord with the underlying policy of the statute in the context of prospectus offerings. Furthermore, we object to the use of the business judgment rule in evaluating the duty to disclose information and argue that it has no place in fulfilling disclosure obligations under the *Securities Act.* We suggest that both continuity with appellate jurisprudence in the area of securities law and a proper understanding of the policy objectives underlying securities regulation provide persuasive arguments against the Court of Appeal's decision.

In Part II of this commentary, we explore the difference between material fact and material change and the meaning of section 57(1) of the *Securities Act.* We also examine the policy rationales underpinning section 57(1) and section 130(1); we argue that if one reads these two sections together, changes in material facts as well as material changes must be disclosed if they arise following the issuance of a receipt for the prospectus but prior to the end of the distribution period. The notion of investor protection embedded in the *Securities Act* is severely undermined if investors are not provided with information that they would consider to be material, regardless of whether the information is technically speaking a material "fact" or a material "change." In Part III, we turn to examine the business judgment rule: its history and development in Canada. We argue that the business judgment rule is inapplicable in a case such as *Danier,* which deals with the obligations under securities law to disclose material facts and material changes. We conclude the commentary in Part IV.

II. THE MATERIAL FACT/MATERIAL CHANGE CONUNDRUM

The Court of Appeal's central conclusion was that the poor intra-quarterly results discovered by the CEO and CFO just before the distribution closed did not have to be disclosed by Danier at that time. This result stemmed from an interpretation of section 57 that requires that only material changes, as opposed to material facts, must be disclosed during the period between obtaining a receipt for a prospectus from the regulators and the closing of the distribution.[3] This finding raises a number of issues that we examine in this part. First, did the trial court and the Court of Appeal come to the correct conclusion that the intra-quarterly results at issue in *Danier* are properly characterized as a material fact but not a material change? Second, was the Court of Appeal correct in its interpretation of the wording of section 57—that it imposes on issuers the requirement to disclose only material changes, but not material facts, once a receipt has been obtained but before closing the distribution? Third, assuming that the Court of Appeal's conclusions are correct, is it appropriate from a policy perspective that material facts that emerge post-receipt but pre-closing do not have to be disclosed?

A. *Were the intra-quarterly results a material change?*

Neither the trial judge nor the Court of Appeal spent much time explaining the conclusion that the poor intra-quarterly results could not be characterized as a "material change" because the agreed *cause* of the depressed results was unseasonably warm weather, which was an event external to the issuer. It is unclear why both levels of court focused on the "cause" of the results rather than the results themselves. The definitions of "material fact"[4] and "material change"[5] do not advert to

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[3] *Securities Act*, *ibid.* Section 57 requires an issuer to file an amendment to the prospectus where a material adverse change occurs after a receipt is obtained for a preliminary prospectus and before the receipt for the prospectus is obtained, or where a material change occurs after the receipt for the prospectus is obtained but prior to the completion of the distribution under such prospectus.

[4] A material fact, when used in relation to securities issued or proposed to be issued, means a fact that significantly affects or would reasonably be expected to have a significant effect on the market price or value of the securities: *ibid.*, s. 1(1).

the idea of the "cause" of the material fact or change, but to the existence of the fact or change itself. Extrapolating from the reasoning of both levels of court, had the "cause" of the poor results been instead a workers' strike that adversely affected sales, the results might have been disclosable. It is difficult to see how this distinction makes sense, despite the Court of Appeal's admission that "poor intra-quarterly results, could, under certain circumstances, in themselves amount to a material change."[6]

The fact that some intra-quarterly results are disclosable and some are not *on the basis of an interpretation of their root causes* builds unnecessary inconsistency and a lack of predictability into the obligations of issuers. Rather, in a modern securities marketplace, it is the results themselves that investors will consider material to their investment decisions, at least as much, if not more than, how they were caused. However, it is indeed possible that investors may weigh poor results caused by a one-time-only problem over which the issuer has no control differently from an ongoing deficit within the company's operations. If the logic underlying the *Securities Act*, particularly as expressed in sections 1(1) and 56(1), is to give investors relevant information to make good investment decisions, then significant results themselves matter more than their cause. In other words, if the intra-quarterly results themselves are good or bad enough to have a material impact on the price or value of the issuer's securities, then how they were caused is somewhat beside the point.

In their careful analysis of the Court of Appeal's decision, Fraiberg and Yalden analyze earnings results in the context of the language of the definition of a "material change."[7] This refers to a change in the "business, operations or capital" of the issuer that would have an impact on the price or value of the issuer's securities. They argue that earnings results cannot be slotted into any of these three categories of information about the issuer that are disclosable in

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[5] A material change means 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: *ibid.*, s. 1(1).

[6] *Supra* note 1 at 341.

[7] Jeremy D. Fraiberg & Robert Yalden, "*Kerr v. Danier Leather Inc.*: Disclosure, Deference and the Duty to Update Forward-Looking Information" (2006) 43 C.B.L.J. 106 at 116-17.

accordance with the definition. They conclude that the term in the definition that comes closest to covering intra-quarterly results is "operations." But, they argue for a distinction between "results of operations" and operations themselves, and assert that the definition of material change requires only disclosure of changes in the latter.

It is true that the precise meaning of the term "operations," for purposes of material change, has not been subjected to rigorous judicial analysis. However, we note that the Supreme Court of Canada has eschewed an overly technical approach to the endeavour of interpreting the elements of the definition of material change. In *Pezim v. British Columbia (Superintendent of Brokers)*,[8] the Court discussed the conclusion of the British Columbia Court of Appeal that "geological information of the nature obtained on a continuing basis as a result of a planned drilling program does not constitute a change in the business, the operations, the assets or the ownership of the issuer."[9] The British Columbia Court of Appeal continued, "Such information may constitute a basis for a perception that there has been a change in the value of an asset. But that is a far different thing than a change in an asset."[10] Justice Iacobucci forcefully responded:

> [T]he majority's view on this point is, in my opinion, clearly wrong and is inconsistent with the economic and regulatory realities the Act sets out to address... . Thus, from the point of view of investors, new information relating to a mining property (which is an asset) bears significantly on the question of that property's value. Accordingly, I agree with the approach taken by the Commission, namely that a change in assay and drilling results can amount to a material change depending on the circumstances.[11]

In reading the relevance of an inference about the "value" of an asset into the definition of material change in the British Columbia *Securities Act*, the Court in *Pezim* adopted an analysis driven by an assessment of the utility of information to investor decision making. Such an analysis accords both with the test for materiality embodied in

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[8] [1994] 2 S.C.R. 557 [*Pezim*].

[9] *Ibid* at 599. At the time, the British Columbia *Securities Act* defined a material change as "a change in the business, operations, assets or ownership of the issuer" that would have a market impact on the issuer's securities. See *Securities Act*, R.S.B.C. 1996, c. 418 [BCSA].

[10] *Pezim, ibid.*

[11] *Ibid.* at 600.

the definitions of both material fact and material change,[12] and with the broader investor protection objectives of securities regulation.

We submit that the same results-oriented reasoning applied to *Danier* would require that disclosure of materially different "results of operations" should be read into the language of "operations." This would lead to a conclusion that the intra-quarterly results at issue should have been characterized as a material change and therefore disclosed by Danier in accordance with section 57.

B. *Is there a gap in the coverage of section 57 of the* Securities Act*?*

On the second issue enumerated in Part II, above, the Court of Appeal read sections 56 and 57 as imposing two discrete disclosure obligations on issuers. These were (i) to disclose material facts up to the time the prospectus is receipted; and (ii) to disclose material changes in the time period post-receipt and pre-closing. However, the Court of Appeal did not address in detail the range of possible relationships between material facts disclosed in a prospectus and changes in those material facts, which might not fit within the statutory definition of material change. In other words, a "change in material facts" may not necessarily mean the same thing as a "material change," given that the definitions of material fact and material change are differently placed on the external-internal continuum. The Court of Appeal concluded that the legislature intended to distinguish between the responsibilities to disclose material facts and material changes across different prospectus-related time periods.

This conclusion fails to address the possibility that there is a third relevant category, a "change in a disclosed material fact," as opposed to a new material fact or a material change, that the legislature may not have turned its mind to when crafting section 57. A requirement to update disclosed material facts that have changed would better capture the fluidity of information about an issuer that investors are interested in when deciding whether or not to purchase securities from it. This requirement would also better accord with the underlying investor protection policy objectives of the statute. It is difficult to imagine that the legislature intended that prospectuses could become misleading to investors before they purchase securities because the

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[12] That is, an impact on the price or value of the securities.

material facts contained therein become stale or inaccurate. Therefore, section 57 itself has to be read in the context of section 56, which requires issuers to provide "full, true and plain disclosure" of all material facts to prospective investors. As Underwood and Sorrell argue, a requirement to update material facts to reflect significant changes in those facts better accords with common law duties with respect to representations.[13] Thus, the common law definition of misrepresentation includes a representation that is no longer true as of the material date—that is, the date of reliance.

C. *Should prospectus amendment requirements be limited to material changes?*

Further policy arguments in favour of a broad interpretation of the scope of section 57 are also persuasive. First, there is undoubtedly some legitimacy to the argument of the Court of Appeal that a specific cut-off point, rather than an open-ended disclosure obligation, makes fulfilling prospectus-related statutory requirements more manageable for issuers, and moreover, may contribute to a vigorous rate of "going public" transactions. In this connection, we would point out that the broadening of short-form prospectus opportunities embodied in National Instrument 44-101[14] mean that the long-form prospectus requirements at issue in *Danier* will likely only apply in the future to issuers going public for the first time.

It is also true, as some commentators and, indeed, the Court of Appeal itself have noted, that section 62 contemplates that a prospectus distribution could extend over a one-year period. However, this is typically not the length of time a prospectus offering takes, and the period between the final receipt being obtained by the issuer and the closing of the distribution is more likely to be somewhere between ten and fourteen days. This raises the question of whether it is really all that onerous for investors to expect an update of material facts up to the end of closing. Reporting during this period would not be as burdensome, given that the threshold condition will always be the materiality of the

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[13] Harry Underwood & René Sorell, "*Danier Leather Inc.* and the Duty to Update a Prospectus" (2006) 43 C.B.L.J. 134.

[14] *Short Form Prospectus Distributions* (2005) 28 O.S.C. Bull. 10385.

information to the issuer, in the sense of its impact on the price or value of the securities being issued.[15]

On the other hand, investors, especially retail investors, will not typically think in terms of categories of "material fact" and "material change," or understand that one category may be disclosable while another is not, in the context of the same prospectus offering. There is a strong possibility of confusion in the investor community about why some significant pieces of information can be suppressed but not others. Indeed, this is likely why National Policy 51-201, promulgated by the Canadian Securities Administrators, has, as the Court of Appeal in *Danier* pointed out, "largely eliminated the distinction between material facts and material changes and has instead required the timely disclosure of all 'material information.'"[16]

A related point is that the statutory definition of insider trading in section 76 refers to the trading of issuer securities on the basis of undisclosed material facts *or* changes. The disconnect between the definition of insider trading, on the one hand, and the requirements of section 57, on the other, means that insiders of an issuer could be precluded from trading securities of that issuer in a situation where material facts in their possession post-receipt but pre-closing do not have to be disclosed to investors.

This last point raises a broader issue about the context in which *Danier* was conducting its prospectus offering, which was raised by Justice Lederman at the trial level but not adverted to by the Court of Appeal. It is important that this transaction was to some degree a self-interested one on the part of the CEO of the issuer, as a significant portion of the proceeds of the offering was being channelled to the Wortsman family trust. This fact brings to the fore the asymmetry of information between corporate insiders and outside investors in both primary and secondary market transactions. We believe that there should be heightened expectations of disclosure placed on issuers where self-interested transactions with respect to the principals of the issuer are involved. We note that this was an element of the *Pezim* decision, where the Court endorsed the finding of the British Columbia Supreme Court that "the obligation to disclose 'as soon as practicable' includes a

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[15] Jeffrey MacIntosh, "Address" (University of Toronto Capital Markets Institute Roundtable on *Danier*, 9 November 2006) [unpublished].

[16] *Supra* note 1 at 344-45.

duty to inquire when an issuer is about to engage in a securities transaction."[17] As the Court explained:

> Although a duty to inquire is not expressly stated in s. 67 [of the BCSA], such an interpretation contextualizes the general obligation to disclose material changes and guarantees the fairness of the market, which is the underlying goal of the Act.[18]

If there is to be continuity with the sentiments about contextual analysis expressed in *Pezim*, the same Court in deciding the appeal in *Danier* must pay close attention to the consequences of information asymmetry between insiders and outsiders of the issuer. A perception that insiders have benefited unduly from the failure to update the positive forecast about earnings made in the prospectus may have deleterious effects on public confidence in securities markets. The Court of Appeal seemed to focus on the fact that those forecasts were ultimately substantially achieved as a result of a decision to engage in a sell-off of inventory later in the quarter. Yet, the investors who purchased Danier shares in the primary distribution may have paid more for those shares than they otherwise would have if the information about unusual intra-quarterly results had been disclosed at the appropriate time.

III. THE BUSINESS JUDGMENT RULE

The trial judge found that although Wortsman and Tatoff honestly believed that the forecast could be achieved, this belief was unreasonable. The Court of Appeal took issue with two aspects of the trial judge's analysis. First, the trial judge found the fact that the forecast was substantially achieved to be immaterial to the analysis of whether the forecast was reasonably achievable on 20 May 1998. Second, in determining the objective reasonableness of the forecast, the trial judge failed "to give any deference to the business judgment of Danier's senior management."[19] In this section, we focus on these two aspects of the Court of Appeal judgment, and, in particular, on the application of the business judgment rule to the statutory requirements in sections 56, 57, and 130 of the *Securities Act*.

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[17] *Supra* note 8 at 601.

[18] *Ibid.* at 603.

[19] *Supra* note 1 at 354.

It is useful at the outset to review briefly the history of the business judgment rule in order to evaluate its applicability in *Danier*. The business judgment rule has its origins in U.S. corporate law. The leading U.S. case is *Shlensky v. Wrigley*, in which the Appellate Court of Illinois stated:

> [W]e do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision. ... [W]e feel that unless the conduct of the defendants at least borders on one of the elements, the courts should not interfere.[20]

Thus, the rule creates a presumption in favour of directors. In the absence of evidence relating to fraud, illegality, and conflict of interest, the directors are presumed to have acted in good faith and on a reasonable basis.[21] The rule constitutes a standard of liability that guides courts in their review of a board's decisions.[22] The rule shifts the onus to the plaintiff—as opposed to the directors—to prove that the directors did not act in good faith and on a reasonable basis.

Courts are reticent to review and evaluate decisions of the board *ex post* for various policy reasons, one of which is that such scrutiny will lead to an inhospitable environment that undermines effective business decision making.[23] Furthermore, the board is seen to have expertise in operating the business that the courts admittedly do not (and logically could not) have. Finally, the security of the business judgment rule encourages risk taking at the board level which is necessary for businesses to grow and expand.

In the United States, takeover bid cases have provided fertile ground for elaboration of the business judgment rule. The premise is that in the takeover bid situation, the board may act in its own interests rather than the interests of the company it serves. As a result, in this context the onus of proof is on the directors themselves to show that

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[20] 95 Ill. App. 2d 173 (1968) at 181.

[21] *Ibid.*

[22] See Stephen M. Bainbridge, "The Business Judgment Rule as Abstention Doctrine" (2004) 57 Vand. L. Rev. 83. Bainbridge goes on to characterize the rule as an abstention doctrine, though this formulation has not been accepted by the courts.

[23] A. Douglas Harris *et al.*, *Cases, Materials and Notes on Partnerships and Canadian Business Corporations*, 4th ed. (Toronto: Thomson Carswell, 2004) at 343.

"they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation."[24] This is a proportionality or "enhanced scrutiny" test, under which "the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance—that the responsive action taken is reasonable in relation to the threat posed."[25]

Canadian case law has developed a slightly different formulation of the business judgment rule. To begin with, in Canada the plaintiff bears the onus of proof in any case. Thus, the business judgment rule is not an onus shifting device. Apart from this basic proposition, however, Canadian law has been ambiguous on the precise meaning and application of the business judgment rule. The most recent discussion of the business judgment rule appeared in *Peoples v. Wise*, where the Court stated:

> It might be tempting for some to see unsuccessful business decisions as unreasonable or imprudent in light of information that becomes available *ex post facto*. Because of this risk of hindsight bias, Canadian courts have developed a rule of deference to business decisions called the 'business judgment rule', adopting the American name for the rule.[26]

The Court then cited a takeover bid case, *Maple Leaf Foods Inc. v. Schneider Corp.*,[27] which set forth the following formulation of the business judgment rule:

> 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 directors have selected one of several reasonable alternatives, deference is accorded to the board's decision.[28]

In Canada, therefore, it appears that the business judgment rule resembles, but certainly is not identical to, the U.S. rule. As noted above, there is no onus shifting in the Canadian context. However, like

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[24] *Unocal Corp. v. Mesa Petroleum Co.* 493 A.2d 946 (Del. Sup. Ct.) (1985) at 955 [*Unocal*].

[25] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. Sup. Ct.) (1986) citing *Unocal, ibid.*

[26] [2004] 3 S.C.R. 461 at 492 [*Peoples*].

[27] (1998), 42 O.R. (3d) 177 (C.A.) [*Schneider*].

[28] *Ibid.* at 192.

the U.S. rule, the Canadian version of the rule accords deference to the decisions of the board. This deference is paid by courts while reviewing decisions of the board. The idea that the decision must be "reasonable but not perfect" serves to guide the board's decision *ex ante*, as they know that this standard will be applied *ex post*.[29]

With this background, we can better assess the Court of Appeal's application of the business judgment rule in *Danier*. The discussion of the business judgment rule arose in the context of the Court of Appeal's observation that the trial judge failed to consider Wortsman and Tatoff's honest belief that the forecast was reasonably achievable. The Court of Appeal noted that the achievability of the forecast "was within a range of reasonable alternative opinions open to business people in their position, knowing what they knew and facing the circumstances they faced ... the trial judge failed to give any deference to the 'business judgment' of senior management... ."[30] In this instance, the Court of Appeal evaluated a decision of senior management concerning whether the information was material and must therefore be disclosed, and proceeded to employ the business judgment rule in its analysis. There is no precedent for application of the business judgment rule to an analysis of materiality (with regard to either material facts or changes). The business judgment rule is a presumption that relates to an assessment of the reasonableness of a board's decision. To date, it has not been applied to analyze and evaluate materiality in the securities law context.

We believe that the respondents' argument in the case is correct. This argument, as summarized by the Court of Appeal, revolved around "whether the prospectus did or did not contain a misrepresentation, and that once a misrepresentation has been established the court cannot defer to the issuer's business judgment not to disclose a material fact."[31] The Court of Appeal dismissed this argument without a thorough review of the business judgment rule and its application in Canada, as though this application was at once clear and accepted in this context. But, if we

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[29] It is not clear that Canadian courts have adopted the variation of the business judgment rule expressed in the U.S. takeover bid cases, although the *Producers Pipeline* decision suggests that some type of proportionality standard governs defensive tactics. See *347883 Alberta Ltd. v. Producers Pipelines Inc.* (1991), 3 B.L.R. (2d) 237 (Sask. C.A.) [*Producers Pipeline*].

[30] *Supra* note 1 at 356.

[31] *Ibid.* at 357.

stand back and examine the logic of the *Securities Act*, we note that it would not make sense to apply the business judgment rule to the statutory obligations contained therein. Section 130, which provides a statutory remedy to investors, requires proof of a misrepresentation. Once that misrepresentation is found to exist, the statute will deem reliance on that representation and allow due diligence to be asserted as a defence. Notably, in including omissions in the definition of misrepresentation as well as a deemed reliance provision, section 130 is broader than the common law and is clearly plaintiff-friendly. To apply the business judgment rule in this context seems to backtrack on this clear policy rationale.

The Court of Appeal decision reverses the logic of section 130 by bringing the business judgment rule into the very analysis of whether a misrepresentation has occurred in the first place. In our view, this is not contemplated by section 130. If the business judgment rule is applied to the analysis of the statutory requirement in section 130, it fuses the analysis of whether a misrepresentation existed with the analysis of whether the directors made a reasonable decision. Although the test for materiality is issuer-specific,[32] the *Securities Act* requires the materiality assessment to be based on an objective analysis of whether, if the information were disclosed, it would be reasonably likely to have an impact on the market price or value of the securities. This test does not accord well with the idea of the business judgment rule, which implies that a range of decisions could be adopted, as long as the decisions were reasonable.

In short, the business judgment rule should not be a factor in the analysis regarding the disclosure obligations of issuers. From a policy perspective, it would undermine investor protection concerns if the disclosure that investors are entitled to rely on (and have come to rely on) can be withheld if directors and senior managers, on the basis of their reasonable judgment as opposed to the test for materiality in the *Securities Act*, believe that the information is not material. We admit that an analysis of materiality necessarily involves judgment calls that are specific to the issuer and its business. However, these judgments relate to a decision about materiality as defined by the *Securities Act*.

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[32] Some things that will be material for some issuers will not be for others, based on size, complexity, and so on.

The protection meant to be afforded to decision makers of the issuer by the business judgment rule is not part of this definition.

It comes as no surprise that there is no precedent for application of the business judgment rule in analyzing materiality. Previous Canadian case law dealing with the business judgment rule that was cited by the Court of Appeal is inapplicable here. Specifically, *Peoples* dealt with creditors' claims that they were owed a duty of care by a company that was almost insolvent. *Schneider* was a takeover bid case, in which the directors of the target entered into a lock-up agreement with a white knight bidder in place of an unwanted hostile bid; the controlling shareholder approved of the lock-up but did not approve of the hostile bid. *Brant Investments Ltd. v. KeepRite Inc.*,[33] another case in which the business judgment rule has been applied, dealt with a parent company's decision to merge one of its subsidiaries, Keeprite, with two of its other subsidiaries. Two of these cases, *Schneider* and *Brant*, deal with acquisition transactions, while one of them, *Peoples*, deals with creditors' rights. There appears to be no legal basis on which to import the business judgment rule to decisions regarding materiality in the securities regulatory context. Thus, the ambiguity in *Danier* should not be interpreted as being whether the business judgment rule applies—it does not—but whether the information was material within the meaning of materiality in the act and therefore needed to be disclosed.[34]

IV. CONCLUSION

The significance of the Court's impending decision on the issues discussed above cannot be underestimated. In terms of substantive law, the decision will provide a definitive interpretation of the scope of the section 130 remedy as well as the disclosure obligation in section 57. The decision may provide guidance on the treatment of forward-looking information, both in terms of whether such information constitutes a material fact or material change and the basis on which misrepresentations with respect to such information are actionable. The

[33] (1991), 3 O.R. (3d) 289 (C.A.) [*Brant*].

[34] We examined this latter issue in Part II, above.

decision will reveal whether the business judgment rule can apply in the context of a board's analyses regarding materiality.

From a practical standpoint, the facts at issue in *Danier* may well have caused "disclosure chill" as issuers reject the risk of providing forward-looking financial information that may leave them open to private rights of action in the context of primary offerings. But by the same token, investors are left wondering whether they will be entitled to receive updated information following the receipt of the prospectus but prior to closing, regardless of whether such information is classified as a "material fact" or a "material change." Following *Pezim*, investor protection concerns would seem to dictate that an expansive approach should be taken to the interpretation of the statutory wording in order to ensure a continued flow of capital into Canadian securities markets.